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DETERMINANTS OF ISLAMIC BANK PERFORMANCE IN INDONESIA

FAZA YASYFA

Submitted in Fulfilment of the Requirements for the Degree of
Bachelor in Finance

MANAGEMENT AND SCIENCE UNIVERSITY

2023

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candidate for the degree of

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DECLARATION

I, Faza Yasyfa, hereby declare that the final year project is based on my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at MSU or other institution.

Faza Yasyfa

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ABSTRACT

Islamic banking industry in Indonesia still has limited market share, around 6.52% of the total market share of the banking industry, while the conventional bank is 93.48% at the end of 2021. This study aims to determine the factors that influence Islamic Bank Performance in Indonesia. This study adopts quantitative methods where secondary data was collected from the annual Islamic Banking financial statements for the period 2017 to 2021 obtained directly from the official website of each bank and Indonesia Financial Services Authority. The data collected was analyze using SPSS. The results of regression analysis indicate that asset quality and liquidity significantly leads to the negative Islamic bank's performance of ROA, whereas capital adequacy positively contributes to the Islamic bank's performance of ROA. Unfortunately, the findings reveal that gross domestic product and inflation have no association with Islamic bank's performance. This research also includes a discussion, limitations, recommendations and conclusion.

Keywords: *Islamic bank, bank performance, profitability, return on asset, indonesia*

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Chapter 1

INTRODUCTION

1.1 Background of study

A bank defined as a financial institution whose activities of its business is to collect funds from the community and returns them back to the community, in addition to providing other financial services. The role of a financial intermediary, which refers to an institution that links and bridges money providers and clients, is fulfilled by the banking system, which is one of the financial systems. The banking industry plays a critical role in the development of the national economy. Bad performance in banking industry can have a negative impact on the economy as a whole.

As a result, bank operations must be efficient on both a macroeconomic and microeconomic scale. Community mobility funds are rapidly and properly given to diverse economic sectors and all places in need. Islamic banks were first presented to the general public in an official capacity in the year 1992. This was done with the objectives of enhancing the mobilization of public funds that the traditional banking sector had not handled and meeting the need for financial services that correspond to the norms of Sharia law.

Conventional banks and Islamic banks are two distinct categories of financial institutions that can be differentiated by the nature of their business activities. A conventional bank is one that conducts its business activities conventionally, an Islamic bank, on the other hand, is one that performs its banking activities in accordance with the principles of Islamic law. The maximization of earnings, the reduction of potential losses, and the maintenance of adequate liquidity are the primary responsibilities of sharia banks. Both types of banks are examples of financial institutions. The restriction on interest rates is the primary distinction between Islamic and regular banks. Furthermore, no gharar or speculative aspects may be present in any transaction. Real assets must be used to back up all financial transactions. Investments in enterprises that engage in activities banned by the Quran, such as pork and alcohol, are not permitted by Islamic banks. Second, Islamic

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banking has unique solvency requirements. Third, Islamic banks have fewer experiences than conventional banks.

The Islamic financial industry is becoming more visible and established as time passes and the financial sector advances. Today, Islamic finance has become a major player in global finance. The size of the number of financial institutions, the amount of their assets, and the size of the client base on the kind of financing demonstrate the ongoing expansion of Islamic finance. Due to an intense competition that exists between conventional banks and Islamic banks in Indonesia, Islamic banks are expected to have strong performance in order for them to be able to compete for the national banking market. One of the performance assessments that can be carried out is to assess financial performance, because financial performance provides the quality of a bank through the calculation of its financial ratios. The financial performance of Islamic banking is a description of an Islamic banking's financial condition that is analyzed with financial analysis tools so that the pros and cons of an Islamic banking's financial condition that reflects work performance in a specific period can be known.

The assessment of financial performance is one method that management may use to accomplish its commitments to stakeholders while simultaneously achieving the aims outlined by Islamic banking. In order for a single bank to be able to carry out all of its operations in an appropriate manner, the following steps need to be carried out: planning, operating, controlling, and supervising. Continuously process financial flows and record the outcomes of such processing in financial reports such as balance sheets and profit and loss computations. In the beginning, a bank's financial reports served merely as a testing tool for the work of the bookkeeping department. However, as time went on, financial reports not only served as a testing tool but also served as a foundation for evaluating or analysing the financial situation or condition of the bank. Where the results of financial analysis may provide anything of value and are employed as a material of consideration in management policy-making of all parts of the banking business. The information presented in the financial performance can be used by related parties, both investors, creditors, and banking external parties to predict the actual financial performance at any period

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There are various financial performance indicators that essentially indicate the bank's performance in carrying out its activities. In these indicators, various financial ratios are presented that measure the bank's ability to manage its finances. Financial indicators that commonly used to measure the performance of Islamic banks such as capital adequacy ratio, non performing financing, and finance to deposit ratio. While profitability indicators can usually be measured by indicators of return on assets, return on equity, and the total assets. Besides that, Islamic bank performance is also can be affected by external factors. External factors related to macroeconomic conditions in the business activities of Islamic banks include the development of economic growth rates and inflation rates. In addition, macroeconomic conditions that can have an influence on bank profitability is the inflation rate.

1.2 Problem Statement

Indonesia is likewise experiencing fast expansion in the number of Islamic banks. The Development of Islamic banking in Indonesia is quite rapid as it can see based on the Sharia Financial National Committee (KNKS) at the end of 2022 there have been 13 operating sharia commercial banks, 22 Islamic business units, and about 1500 different rural banks located in Indonesia.

However, data published by the Islamic Financial Service Board/IFSB (2022) states that the average growth trend for Islamic banks globally shows a fluctuating decline from 2017 to 2021 in terms of assets, financing and deposits. This was also supported by Indonesia Financial Services Authority publications on financial ratios as measured by ROA and NOM, the financial performance of Islamic banking still fluctuating from 2017-2021.

And while having been in operation for the past three decades, this quick development has not yet been successful in reaching the market share target. According to the data obtained from official website of Indonesia financial services authority, Islamic banking industry in Indonesia still has a limited market share, around 6.52% of the total market share of the banking industry, while the conventional bank is 93.48% at the end of 2021. Although Islamic banking industry exhibits relatively significant growth for the last two decades, the market share of this industry never reaches the expected target of 20%,

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whereas the conventional banking industry, at the same time, also enjoys considerable growth. Considering that the importance of the function and role of Islamic banks in Indonesia, banks need to improve their performance.

1.3 Research objective

The research objective of this study is as follow:

1. To examine the influence of asset quality on Islamic bank performance
2. To examine the influence of capital adequacy on Islamic bank performance
3. To examine the influence of liquidity on Islamic bank performance
4. To examine the influence of gross domestic product on Islamic bank performance
5. To examine the influence of inflation on Islamic bank performance

1.4 Research question

The research questions that are going to use in the study is as follow:

1. Does asset quality influence Islamic bank performance?
2. Does capital adequacy influence Islamic bank performance?
3. Does liquidity influence Islamic bank performance?
4. Does gross domestic product influence Islamic bank performance?
5. Does Inflation influence Islamic bank performance?

1.5 Scope

The goal of this study is to identify the factors that can be a determinant of Islamic bank’s performance. The information will be taken from the database produced by Indonesia’s financial services authority and annual financial report from official website of each bank. The information provided the data of Islamic banking statistic in Indonesia and financial ratio of Islamic banks in Indonesia.

1.6 Significance of study

The findings of this research will be beneficial in bringing to the attention of managers working in Islamic banks in Indonesia the importance of recognizing these factors, which may either directly or indirectly affect the performance of banks. Additionally, to enhance the economic competitiveness of Islamic banks in Indonesia. The information that was gathered as a result of this study may also be utilized by investors so that they can base their investment choice on the financial performance of Islamic banks.

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1.7 Organisation of study

The research is organized into five chapters. The first chapter of the study covers the general introduction, which includes the study's background, problem statement of the study, purpose of study, research questions, objective of the study, scope of the study, and organization of the study. The second chapter is the literature review, in which the works of other researchers on the topic, their methods, relevant theory, and the formulation of hypotheses are analyzed and evaluated. Chapter three is the research methodology which contains research design, population and sample, research methodology, and chapter summary. Chapter four is the results and data analysis which provides the result of data analysis of the study. And the last one is chapter five consist of discussion, contribution, conclusion, limitation, and recommendation.

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Chapter 5

CONCLUSIONS AND RECOMMENDATIONS

5.1 Overview of study

This study aims to determine the internal and external factors affecting Islamic bank's financial performance (ROA). This chapter presents the summary of the findings, conclusions and recommendations for further study based on the results of the analysis described in the previous chapter regarding the determinant of Islamic bank's performance in Indonesia.

5.2 Discussion

5.2.1 Asset quality

According to the findings of this research, the asset quality of an Islamic bank's has a considerable and negative impact on the bank's performance / return on assets (ROA). This study is consistent with previous studies conducted by (Stephen Kingu et al., 2018) and (Harjanti, 2021) which asserted that asset quality has a significant negative effect on bank's profitability (ROA). (Usman & Lestari, 2019) pointed out that asset quality had a significant negative impact on bank performance / return on asset. This means that bank-owned assets cannot absorb losses from both excessive lending, rising costs, the cost of productive asset reserves, and other income-generating expenses. It leads to a decrease in bank income. A decline in bank earnings can affect a bank's performance and can indicate poor asset quality due to banks' reluctance to lend.

5.2.2 Capital Adequacy

According to the findings of this research, it indicates that capital adequacy has a positive significant effect on Islamic bank's performance (ROA). This finding is consistent with previous studies conducted by (Haidary & Abbey, 2018) who discovered that capital adequacy had a favorable and substantial influence on return on asset. (Stephen Kingu et al., 2018) found that capital adequacy has been demonstrated to have a favorable influence on bank profitability, allowing banks to utilize their own cash to support asset expansion and improve earnings.

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5.2.3 Liquidity

This study discovered that liquidity has a considerable negative impact on Islamic bank performance (ROA). The results are in line with research conducted by (Harjanti, 2021) and (Sitompul & Nasution, 2019) that demonstrates that liquidity has a considerable negative impact on return on asset. Due to their poor yield in comparison to other assets, liquid assets impose an opportunity cost on the bank.

5.2.4 Gross Domestic Product

According to the findings of this study, gross domestic product has no positive significant influence on Islamic bank performance (ROA). The result is consistent with previous studies (Stephen Kingu et al., 2018) who found that gross domestic product are not correlated with bank performance / return on asset. Another study conducted by (Usman & Lestari, 2019) found similar results that the GDP growth rate does not influence the bank profitability / return on asset. Because the level of gross domestic product growth rate is an external factor, it does not greatly influence the profitability of banks. This is due to the fact that the gross domestic product growth rate is the level of state income that does not considerably affect the profitability of banks. However, if a bank has a good internal financial infrastructure, the bank will be unaffected by the gross domestic product growth rate.

5.2.5 Inflation

This study found that inflation has no positive significant effect on Islamic bank's performance (ROA). The result is similar to the study conducted by (Fuadi et al., 2022) who found that inflation had a low or insignificant effect on the return on asset, the result shows that although inflation has increased, the profit earned by Islamic banks does not experience a significant decline and vice versa if inflation decreases profits obtained by Islamic bank did not increase significantly.

5.3 Contribution of the study

The findings of this study assist to bring to the notice of managers working in Islamic banks in Indonesia the significance of knowing these characteristics, which might either directly or indirectly influence the performance of banks. And to improve the financial

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performance of Islamic banks in Indonesia. The data produced from this study also can be used for the investors to make an investment decision based on Islamic bank's performance.

5.4 Conclusion

A better performance is based on bank profitability. It is the profitability factor, in addition to social and environmental factors, that guarantees the bank is sustainable in order for it to be able to function over the long term in order to serve the general public, shareholders, the government, and the economy of the nation in general, as well as other stakeholders in general. This study provides empirical evidence on the factors that can be a determinant of Islamic bank's performance in Indonesia. This study is done by using bank specific determinants such as asset quality, capital adequacy, and liquidity and the macroeconomic determinants such as gross domestic product and inflation. Using a sample of 10 Islamic banks in Indonesia from 2017 to 2021, it is found that asset quality and liquidity is associated with the decline in return on asset, while capital adequacy is associated with an increase in return on asset bank. Therefore, the implication of this finding is the presence of a rate of inflation and gross domestic product has unfavorable impact on the return on asset.

5.5 Recommendation

It is important to admit that this study does have certain limitations, and it is equally important to offer some suggestions for future research. First, this study is only focused on Islamic banks in Indonesia and does not examine the conventional banks so that the results do not represent the whole bank industry in Indonesia. Hence, to get a better picture for future studies, it can include conventional banks in the research. Besides, it was limited to the number of Islamic banks that meet the criteria used in the study and the financial data of the Islamic banks is 5 years only from 2017 to 2021. It is suggested for the future studies can add more banks and also extend the analyses time to cover a longer period. This will provide a thorough insight of factors that can be a determinant of Islamic bank's financial performance. Despite the fact that this study focuses on factors that have been regularly employed by previous studies to predict bank performance, this analysis discovered that these variables have limited explanatory power. As a result, it is suggested that future studies look for additional specialized bank performance indicators, such as operation efficiency and macroeconomic indicator such as interest rate that may give a better explanation of bank performance.

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APPENDICES

No	Islamic banks in Indonesia
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2	PT BANK ALADIN SYARIAH Tbk
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12	PT BANK SYARIAH INDONESIA Tbk
13	PT BANK SYARIAH INDONESIA Tbk

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