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WHAT DETERMINES THE FINANCIAL PERFORMANCE OF ISLAMIC BANKS IN INDONESIA?

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ABSTRACT - This study aims to determine the effect of the Capital Adequacy Ratio (CAR), Non-Performing Financing (NPF), and Operational Efficiency Ratio (OER) at Islamic Commercial Banks in Indonesia for the 2010-2019 period. The test was carried out using panel data regression with the Random Effect Model (REM) model, tested using the t-test and f test with a significance of 5%. Based on the results of the t-test, partially, OER has a negative and significant effect on Return on Assets (ROA), whilst NPF and CAR do not significantly affect ROA. Moreover, the results of the F-test show that CAR, NPF, and OER simultaneously affect ROA. The results of this study indicate that to maximize the financial performance of Islamic banking in Indonesia, the Islamic banks must pay attention to the OER variable.
Keywords: Financial Performance, Islamic Bank, ROA, CAR, NPF, OER

ABSTRAK – Determinan Apa yang Mempengaruhi Kinerja Keuangan Bank Syariah di Indonesia? *Penelitian ini bertujuan untuk menganalisis pengaruh Capital Adequacy Ratio (CAR), Non-Performing Financing (NPF), dan Beban Operasional terhadap Pendapatan Operasional (BOPO) pada Bank Umum Syariah di Indonesia periode 2010-2019. Pengujian dilakukan menggunakan regresi data panel dengan model Random Effect Model (REM) yang pengujiannya menggunakan uji t dan uji f dengan signifikansi yaitu 5%. Berdasarkan hasil uji t, secara parsial BOPO berpengaruh negatif dan signifikan terhadap Return on Asset (ROA), sedangkan variabel NPF dan CAR tidak memiliki pengaruh yang signifikan terhadap ROA. Selanjutnya, hasil uji F menunjukkan bahwa CAR, NPF, dan BOPO secara simultan berpengaruh terhadap ROA. Hasil penelitian ini memberikan rekomendasi kepada Bank Syariah di Indonesia agar memberikan perhatian yang lebih serius terhadap variabel BOPO jika ingin memaksimalkan kinerja keuangannya.*
Kata Kunci: *Kinerja Keuangan, Bank Umum Syariah, ROA, CAR, NPF, BOPO*

INTRODUCTION

The growth and development of Islamic banking in Indonesia are increasing as evidenced by the establishment of Islamic-based businesses, where Islamic Banking consists of Islamic Commercial Banks *(Bank Umum Syariah - BUS)*, Islamic Business Units *(Unit Usaha Syariah - UUS)*, and Islamic Rural Bank *(Bank Pembiayaan Rakyat Syariah - BPRS)*. The BUS is a group of full-fledged Islamic banks operated independently as a single sharia entity. The UUS is a sharia unit of a conventional bank, while the BPRS is a group of relatively small Islamic banks operated independently in a relatively small scope (Yusuf & Ichsan, 2021; Aulia, Ibrahim, & Tarigan, 2020).

The tight competition with the conventional banks requires the Islamic banking industry to continually improve its performance to compete in the national banking market (Nadia, Ibrahim, & Jalilah, 2019). In the service industries, including the banking industry, performance is an essential aspect of maintaining. It plays a vital role in setting the trusted image in its customers' minds. The more positive image grows, the more trusted the banks are. Financial performance is an assessment analysis of the extent to which banks carry out activities by financial implementation rules (Fahmi, 2013: 2). It affects the increasing number of third-party funds *(Dana Pihak Ketiga – DPK)*. Banks distributed the DPK in the financing scheme and subsequently increased their profitability (Dimitha, Ibrahim, & Ahmadsyah, 2021). Profitability can be regarded as one of the most appropriate indicators to measure a company's performance because the company's ability to generate profits can be a benchmark of the company's performance. The higher the profitability, the better the company's financial performance (Mailinda, Ibrahim, & Zainul, 2018; Kusumastuti, 2019). Profitability is often proxied by the bank's ability to maximize its assets through variable Return on Assets (ROA).

One indicator in measuring the overall performance of banking activities is the ability to maintain its capital adequacy. Capital is one of the crucial factors for a bank to develop its business and accommodate the risk of loss. A bank's capital must principally be sufficient to cover the entire business risks that it faces. A bank's capital is represented by the Capital Adequacy Ratio (CAR), which is used as an indicator of the ability of the bank's assets to cover the potential risks financed by its capital. CAR is generally utilized to measure a bank's financial performance.

Like its conventional counterparts, Islamic banking is also facing risks in its operations, including financing/credit risk proxied by Non-Performing Financing (NPF). It is an indicator for assessing the performance of a bank's functionality as an intermediary institution that arises because banks cannot get back loans that have been given or invested (Nisak & Ibrahim, 2014). NPF is a financial ratio related to the amount of financing risk experienced by a bank. The higher the NPF of a bank, it means that the bank has a financing risk that the bank bears. So that the greater the NPF of a bank, the lower the profitability of the bank.

Another indicator in measuring financial performance is efficiency. Each bank must be efficient in its activities to reduce costs to increase profitability. It is usually measured through the Operational Efficiency Ratio (OER). According to the financial dictionary, OER is a ratio group that measures companies' operational efficiency and effectiveness by comparing lines one against the other. Various numbers income and expenditure from the reported profit and loss to numbers on the balance sheet. The OER provides a comparison between operating expenses and operating income (Elkamiliati & Ibrahim, 2014). With a bigger OER, the bank's ROA gets smaller because the profit earned by the bank also gets smaller.

Several studies on the financial performance of Islamic banks have been conducted recently. Setyawati, Suroso, Suryanto, and Nurjannah (2017), for instance, studied the internal and external factors affecting the performance of Islamic banking in Indonesia for the period of 2004-2012. Similarly, Istan and Fahlevi (2020) studied the effect of external and internal factors on the financial performance of Islamic banking in Indonesia. The assessed variables included GDP, inflation, interest rates, FDR, OER, and ROA. Furthermore, Mukhibad and Khafid (2018) examined financial performance determinants of Islamic banking in Indonesia, particularly the impact of GCG, number of SSB, FDR, PLS, PSR, and temporary *syirkah* fund ratio on the performance of NPF and ROA. They found relatively similar results.

However, the above studies differ from this study. The studies did not examine bank profitability to differentiate between big and small banks. The differences between the studies and the current study lay in the investigated variables, which comprise almost all financial factors. In addition, as the present study includes most Islamic banks as the object, the previous studies limited only to

one or two Islamic banks. Therefore, it is important to re-examine the said variables in a larger entity and more relevant variables.

This study aims to determine the influence of Islamic banking performance. In specific, it examines the impact of the Capital Adequacy Ratio (CAR), Non-Performing Financing (NPF), and Operating Costs of Operating Income (OER) on Return on Assets (ROA) of five Islamic commercial banks operating in Indonesia during the period 2010-2019. The findings of this study are expected to enlighten customers about the financial performance of Islamic Commercial Banks in Indonesia so that they can obtain maximum investment returns.

LITERATURE REVIEW

Generally, the high burden of bank operating costs will be borne by the income earned. Operational Expenses to Operating Income (OER) compares operating costs and operating income in measuring the level of efficiency and the ability of a bank to carry out its operations. The bank carries out operational efficiency to determine whether the bank in its functions related to the bank's primary business is carried out correctly and is used to show whether the bank has used all its production factors appropriately and effectively. The lower the OER means, the more efficient the bank controls its operational costs. With the efficiency of operating expenses, the benefits obtained will be maximum.

The increased ratio reflects the inability of banks to reduce operating costs and increase income which can cause losses because banks are less efficient in managing their business (Mawardi, 2015). ROA is used to measure management's ability to earn an overall profit (Dendawijaya, 2003). The greater a bank's ROA, the larger the profit it will make and the better its position regarding the use of assets (Dendawijaya, 2003). A high ROA indicates the excellent performance of an organization to generate high income. A high ROA in an Islamic bank shows the ability of the bank to optimize its financing in gaining profits (Rifqi, 2020). The following parts discuss previous related studies that led the researchers to draw the hypotheses.

Effect CAR on Islamic Banks' Performance (ROA)

As previously mentioned, CAR is used as the performance indicator in measuring the ability of a financial institution to handle the depreciation of its assets (Dendawijaya, 2003). Conventional wisdom suggests that the riskiness of a bank is determined by its ability to absorb unforeseen losses. Past studies

show the significance of CAR in influencing the banks' performance. Given that capital is viewed as a buffer against losses, a high capital asset ratio (CAR) tends to be associated with lower profitability (Nyoka, 2019; Sofiati and Limakrisna, 2017). Meanwhile, Wibowo and Syaichu (2013) found that the CAR variable positively affects profitability (ROA). Based on the facts, the first hypothesis can be drawn as follows:

H1: Capital adequacy ratio positively affects Islamic banks' performance (ROA)

Effect NPF on Islamic Banks' Performance (ROA)

Previous studies showed that NPF has a negative effect on the profitability of Islamic commercial banks (Rivai, 2010), especially on its ROA component. The financing risk occurs if the process of giving finance is not accompanied by the prudential principle (Chabachib et al., 2013). The financing/credit risk, measured by the non-performing financing/loan (NPF/L) or variable, will reduce the bank's profit. The research results by Abdillah et al. (2016) and Abduh and Alias (2014) show that NPL has a significant negative effect on bank performance. Meanwhile, the findings of Milhem and Istaiteyeh (2015) and Mahmud et al. (2016) show an insignificant effect. Non-performing financing has a significant and negative impact on asset returns and total asset growth (Setyawati, I. 2016). The larger the ratio of non-performing financing, the more bank is exposed to the associated risk. The higher the risk, the more possibility the bank can decrease its profit-sharing from the channeled funding. Earlier researches showed that NPF negatively affected profit (Bilal, Saeed, Gull, & Akram 2013; Mawardi, 2014; Mokni & Rachdi, 2014; Petria, Capraru, & Ihnatov, 2015; Putranto, Herwany & Sumirat, 2012). Thus, the aforementioned studies drive to the second hypothesis:

H2: Non-performing financing negatively affects Islamic banks' performance (ROA)

Effect of OER on Islamic Banks' Performance (ROA)

Return On Assets (ROA) as a proxy for measuring the performance of Islamic banks has identified several influencing factors, both internally and externally, that affect performance. It showed that liquidity risk, operating costs, and inflation have a significant negative impact on the performance of Indonesian Islamic banks (Muflih, 2019). Operating expenses to the total asset ratio have

a significant negative effect on asset returns and total asset growth (Setyawati, I. 2016). Operational Cost to Operating Income (OER) is a financial ratio used to measure efficiency and effectiveness in carrying out its operational activities. A high OER means an organization's operating costs are greater than its income. The findings of past studies show an opposite relationship between OER and the level of profitability (ROA) in the banking industry (Zulifiah & Susilowibowo, 2014). Based on the information, the third hypothesis is concluded:

H3: Operating Costs to Operating Income (OER) affects Islamic banks' performance (ROA)

RESEARCH METHOD

The population in this study were all Islamic commercial banks operating in Indonesia. The samples were Bank Rakyat Indonesia Syariah, Bank Negara Indonesia Syariah, Bank Syariah Mandiri, Bank Muamalat Indonesia, and Bank Mega Syariah. The sample was selected using purposive sampling, with the following criteria: 1) categorized as big ten Islamic banks; 2) listed on the Indonesia Financial Service Authority (OJK); and 3) have published the financial statements when this study is conducted. The data was collected from the report for the 2010-2019 period, resulting in 200 observations.

The financial performance is proxied by Return on Assets (ROA). The Generalized Least Square analysis panel was adopted and estimated using the E-Views statistical software. The data regression panel analysis was adopted because the data used in this study is a combination of time series data for ten years (2010-2019) and a cross-section of 5 Islamic commercial banks. Before data estimation, the classical assumption tests—normality, multicollinearity, autocorrelation, and heteroscedasticity—were performed. Following the steps, hypothesis testing was carried out through this equation:

$$ROAit = a + b_1CAR_{1it} + b_2NPF_{2it} + b_3OER_{it} + \mu_{it}$$

Where: the ROA is a proxy for financial performance; CAR is the capital adequacy ratio; NPF is a ratio that shows the efficiency of the comparison between operating costs and operating income; b_1 is an estimated variable, a constant term; and μit is an error term.

Two common models are often used to estimate panel regression: the fixed effect model and the random effect model (Ajija et al., 2011). The Hausman test will be employed to determine which of the two models is more appropriate to use in the study. This test follows the statistical distribution of Chi-square, with the degree of freedom is equal to the number of independent variables. If the Hausman statistic value is greater than the critical value of Chi-square statistics, it indicates that the fixed effect model is more appropriate to adopt. On the other hand, if the Hausman statistic value is smaller than the critical value of Chi-square statistics, then the random effect model is a more appropriate model to be used. The fixed-effect model uses dummy variables to capture intercept differences as the following equation:

$$ROA_{it} = a + b_1CAR_{1it} + b_2NPF_{2it} + b_3OER_{it} + \mu_{it}$$

Meanwhile, the random effect model assumes that the intercept coefficient differs between individuals and time (random effect). The random effect model is estimated as the following equation:

$$ROA_{it} = a + b_1CAR_{1it} + b_2NPF_{2it} + b_3OER_{it} + e_{it} + \mu_{it}$$

The normality test was conducted by referring to the asymptotic probability. If its probability value is greater than 0.5, the data is normally distributed. A multicollinearity test uses the Variance Inflation Factor (VIF). The data is free from multicollinearity problems if the VIF value is below 10. Durbin Watson's (DW) value was employed for the autocorrelation test. Data is free from the autocorrelation problem if the DW statistical value is around 2. Finally, the heteroscedasticity test is performed by referring to the Bruesch-Pagan (BP) test. If the value of the BP Chi-square is greater than its p-value, the data is concluded to be free from the heteroscedastic problem.

RESULT AND DISCUSSION

Result

Table 1 illustrates the descriptive statistics of investigated variables. The descriptive statistics describe trends of the variables, covering their minimum, maximum, and mean values and the dispersion of variables (standard deviations).

Table 1. Descriptive Statistics of the Variables

Variable	Minimum	Maximum	Mean	Standard Deviation
ROA	-12.020	92.450	1.553	6.690
CAR	10.120	30.070	16.303	4.524
NPF	1.350	7.230	3.757	1.320
OER	67.980	304.600	91.461	21.746

The table display that the minimum value is -12% recorded by Bank Negara Indonesia Syariah in 2010, while the maximum value was 92.4% recorded by Bank Muamalat Indonesia in 2011. The average ROA of Islamic Commercial Banks in the said period was 1.5%, above the minimum requirement of 1.26%. It indicates that the average ROA of Islamic commercial banks in Indonesia is on track.

Further, the minimum CAR value of 10% was recorded by Bank Muamalat Indonesia in 2010. While the maximum CAR value was recorded by Bank Rakyat Indonesia Syariah in 2018, and the average CAR of Islamic Commercial Banks in Indonesia for the 2010-2019 period was 16%, above the provisions of Bank Indonesia, which is 8%. It indicates that Islamic Commercial Banks in Indonesia are in good condition with capital above the standards set by Bank Indonesia.

Moreover, the minimum NPF value was 1.3% which Bank Muamalat Indonesia recorded in 2013, while Bank Muamalat Indonesia recorded the maximum NPF in 2016. The average NPF of Islamic Commercial Banks in Indonesia for the 2010-2019 period was 3.7 %, below the provisions of Bank Indonesia, which is 5%. It indicates that Islamic Commercial Banks in Indonesia are in good condition regarding financing problems from the standards set by Bank Indonesia.

In addition, the minimum OER value for Islamic commercial banks was 68% recorded by Bank Negara Indonesia Syariah in 2011, while the maximum OER was recorded by Bank Negara Indonesia Syariah in 2010. The average OER of Islamic Commercial Banks for the 2010-2019 period was 91%. This value is above Bank Indonesia provisions, 85% at maximum. Thus, the Islamic Commercial Banks are not operating efficiently.

Discussion

Based on the Hausman test, this study found that the random effect model is the most appropriate Generalized Least Square model compared to the fixed effect model to estimate the effect of CAR, NPF, and OER's effect on the

performance of Islamic banking in Indonesia in the period of 2010-2019. This information is illustrated in Table 2, where the p-*value* of the Hausman test is above the probability value of 0.05. Table 2 also provides an estimate of the regression coefficient based on the Generalized Least Square Panel analysis.

Table 2. Regression Coefficient based on GLS Panel

Variable	**Coefficient**	**t-Statistics**
Constants	7.574	2.829
CAR	0.134	0.327
NPF	-0.024	-0.193
OER	-0.067	-2.816
Hausman Test (p-value) = 0.517, F-statistic (p-value) = 0.002, Adj R2 = 0.029, KS-test (p-value) = 0.790 VIF= 1,371 DW= 2.094 and BP (p-value)= 0.463		

Note: *shows significance at the 1% level, the Hausman test is performed to select a proper model between fixed and random effect models, Adj. R2 is the Adjusted R-squared, KS is the Kolmogorov-Smirnov test for normality, VIF is the variance inflation factor criteria for multicollinearity, DW is the Durbin-Watson test for autocorrelation, and BP is the Bruesch-Pagan test for heteroscedasticity.

The estimates of the General Least Square model also meet the requirements of the classical assumptions. As shown above, Kolmogorov-Smirnov (KS) was found to be insignificant with a *p-value* of 0.792, indicating the normality of the variable, Variance Inflation Factor (VIF) with a value of less than 10 (VIF = 1.371), indicating an independent variable independent of the multicollinearity problem. The Durbin-Watson (DW) autocorrelation test is a 2.094, suggesting no autocorrelation problem. Meanwhile, the Bruesch-Pagan (BP) test for heteroscedasticity results in a 0.463 value, which indicates that the variable is homoscedastic. This finding further confirms that our forecast model is quite suitable to measure the effect of CAR, NPF, OER, and ROA on Islamic Commercial Banks in Indonesia during the period 2011-2019.

Table 2 reported that of the three variables studied, only OER significantly affects financial performance as proxied by ROA. In contrast, CAR and NPF have no significant impact on financial performance. In particular, this study finds that an increase in OER of 1% will reduce financial performance by 0.6%. Thus, to improve the financial performance of Islamic commercial banks, they must ensure that their operational activities are carried out efficiently, which is reflected in the low OER value. The lower the OER ratio, the better the operational activities of Islamic commercial banks. This empirical evidence is supported by research by Susilowibowo (2013) and Amalina (2015), which show that OER negatively affects the ROA of Islamic commercial banks.

On the other hand, CAR and NPF were found to have no significant effect on Islamic financial performance. This conclusion is made with an insignificant probability value of the estimated independent variables. Thus, the results of this study find that CAR and NPF do not have a significant role in determining the financial performance of Islamic commercial banks. However, to maintain the company's existence, the company needs to preserve the minimum CAR and NPF allowed by the Financial Services Authority. The insignificant effect of NPF and CAR on the performance of Islamic commercial banks is in line with empirical evidence from Milhem and Istaiteyeh (2015) and Mahmud et al. (2016). However, this finding contradicts the research results by Abdillah et al. (2016), and Abduh and Alias (2014) showed a significant negative effect of NPL on bank performance.

The results also found a negative and significant effect of OER on financial performance, as shown by the significance of probability value. This finding suggests that Islamic banking needs to improve company efficiency to increase its profits. This output shows an opposite relationship between OER and profitability (ROA) in the Islamic banking industry in Indonesia, which is supported by the research of Zulfiah & Susilowibowo (2013). The findings show that reporting the company's operational activities in each period in financial statements is very important for stakeholders, especially for investors or customers of the bank. Most importantly, if the public also owns the shares of the banks. The financial performance report can be used as a reference for the current and inbound investors to become part of the Islamic commercial bank or vice versa.

The findings have implications for various parties. For the banking institution, it can be used for decision-making concerning the elements that should be focused on in increasing efficiency and, thus, profitability. For customers, it is a reference for investing in specific products. As for the regulator, the findings provide an insight into a better understanding of Islamic banking so that regulations can be created accordingly (Ibrahim, 2020).

In relation to the current digital era, this study suggests that Islamic banking institutions should maximize the use of information technology in reducing operational costs. The opening of physical branches/offices should be reduced and replaced digital offices. Many researchers have predicted that future banking is more focused on digital matters (Abbasov, Mamedov, & Aliev,

2019; Deorukhkar & Xia, 2015; Mamadiyarov, 2020; Ya, 2020). Thus, the use of technology should be the topmost concern for Islamic banking management.

CONCLUSION

This study examines CAR, NPF, and OER and their impact on Islamic banking performance in Indonesia. The findings conclude that operating efficiency (OER) significantly influences financial performance (ROA). Other variables, CAR and NPF, show insignificant effects in boosting the performance of Islamic banking. In specific, the CAR variable shows a positive impact on performance but is insignificant. Meanwhile, the NPF demonstrates a negative but insignificant effect on the performance variable. This finding suggests that Islamic banking needs to improve company efficiency to increase its profits.

This study has provided empirical evidence on the impact of CAR, NPF, and OER variables on the financial performance of Islamic banking in Indonesia as proxied by the ROA variable. It also supports several previous studies, and at the same time, contradicts some others. As this study only focused on Islamic Commercial Banks, the subsequent studies are encouraged to extend to all components of the Islamic banking sector in Indonesia, including the Islamic Business Units (IBU) and the Islamic Rural Banks (IRB).

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