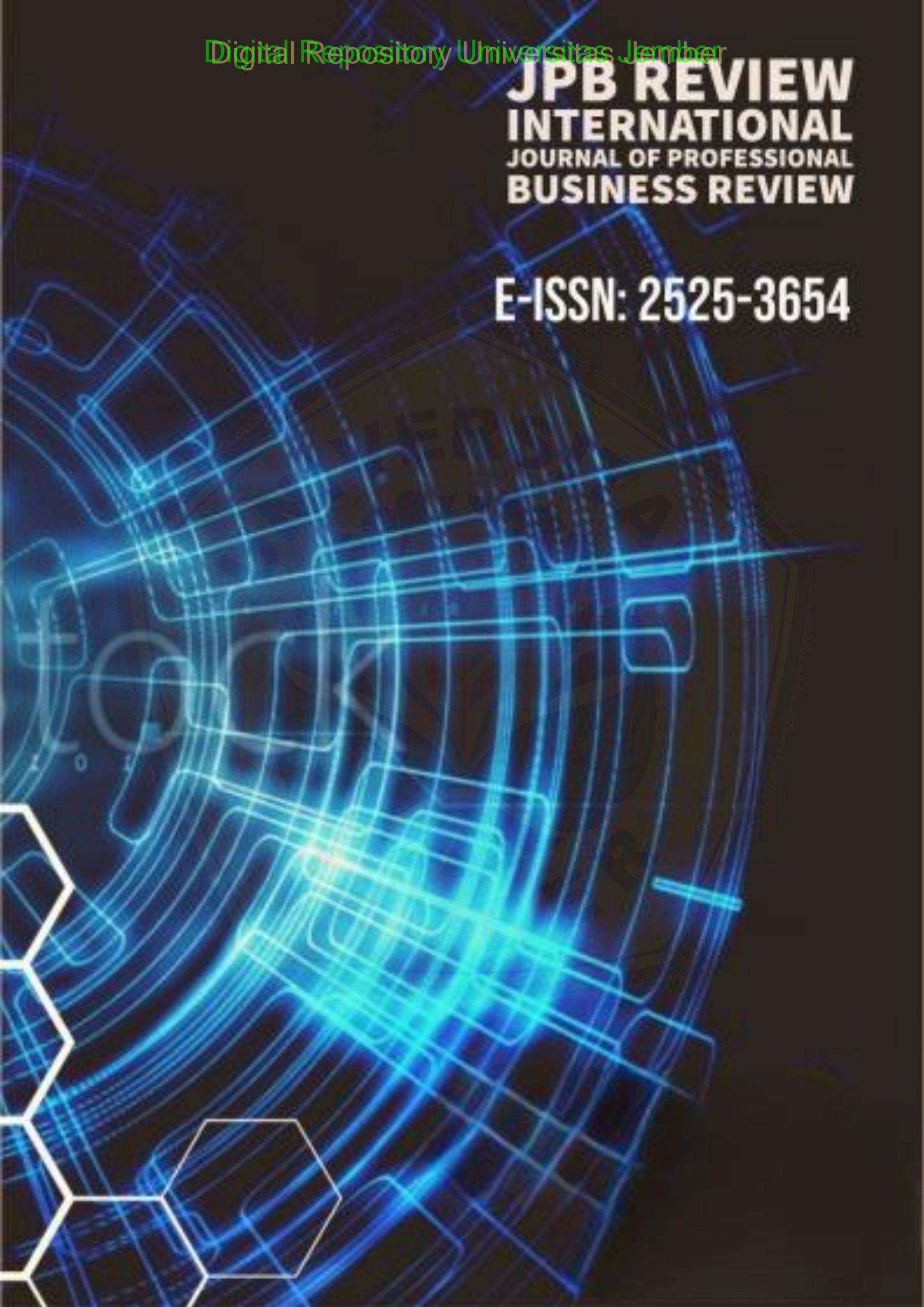


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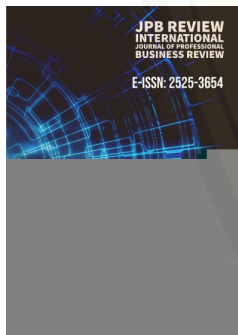
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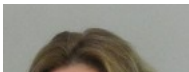


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**EFFECTS OF INTERNAL FINANCE, ISLAMIC GOVERNANCE AND ISLAMIC CORPORATE RESPONSIBILITY ON PROFITABILITY: EVIDENCE OF ISLAMIC BANKING IN INDONESIA**

**Novi Puspitasari<sup>A</sup>, Sela Jururi<sup>B</sup>, Sutan Emir Hidayat<sup>C</sup>**



ARTICLE INFO	ABSTRACT
<p><b>Article history:</b></p> <p><b>Received</b> 20 February 2023</p> <p><b>Accepted</b> 08 May 2023</p>	<p><b>Purpose:</b> The objective of this study was analyze the interrelationships of internal financial factors, which include financing risk and capital adequacy, ICG and ICSR as determinants of ROA in Islamic banking in Indonesia.</p> <p><b>Theoretical framework:</b> Previous studies have provided mixed results regarding the application of ICG to profitability. Therefore, it is necessary to re-examine the implementation of ICG on the profitability of Islamic banks.</p> <p><b>Design/methodology/approach:</b> The research sample consist of 14 sharia commercial banks in Indonesia in the study period 2012 to 2021 with a total of 130 observations. This study used multiple regression analysis.</p> <p><b>Findings:</b> The results showed a negative effect of NPF on ROA financial performance. Furthermore, there was a positive effect of CAR and ICG disclosure on ROA financial performance. Meanwhile, disclosure of ICSR had no significant effect on ROA financial performance. Age control variables and Islamic bank size were found to have no effect on ROA.</p> <p><b>Research, Practical &amp; Social implications:</b> The government can make a regulation requiring Islamic banks in Indonesia to carry out ICSR because it is more suitable with business forms that use Islamic concepts.</p> <p><b>Originality/value:</b> This study offers an examination of the factors affecting financial performance of financial and non-financial factors. Financial factors are seen in terms of financing risk and capital adequacy while non-financial factors are represented by sharia governance and sharia social responsibility in sharia commercial banks in Indonesia.</p> <p>Doi: <a href="https://doi.org/10.26668/businessreview/2023.v8i5.2102">https://doi.org/10.26668/businessreview/2023.v8i5.2102</a></p>
<p><b>Keywords:</b></p> <p>Financial Performance; Bank Risk; Islamic Governance; Islamic Social Responsibility.</p> <div data-bbox="172 1003 475 1249" style="text-align: center;"> </div>	

**EFEITOS DAS FINANÇAS INTERNAS, GOVERNANÇA ISLÂMICA E RESPONSABILIDADE CORPORATIVA ISLÂMICA NA RENTABILIDADE: EVIDÊNCIAS DE BANCOS ISLÂMICOS NA INDONÉSIA**

**RESUMO**

**Objetivo:** Este artigo tem como objetivo avaliar os efeitos do risco de financiamento, adequação de capital, governança corporativa islâmica e responsabilidade social corporativa islâmica no desempenho financeiro de bancos islâmicos na Indonésia.

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**Referencial teórico:** Estudos anteriores forneceram resultados mistos em relação à aplicação da ICG à rentabilidade. Portanto, é necessário reexaminar a implementação da ICG sobre a lucratividade dos bancos islâmicos.

**Desenho/metodologia/abordagem:** A amostra da pesquisa consiste em 14 bancos comerciais sharia na Indonésia no período de estudo de 2012 a 2021 com um total de 130 observações. Este estudo utilizou análise de regressão múltipla.

**Resultados:** Os resultados mostraram um efeito negativo do NPF no desempenho financeiro do ROA. Além disso, houve um efeito positivo da divulgação do CAR e do ICG no desempenho financeiro do ROA. Enquanto isso, a divulgação do ICSR não teve efeito significativo no desempenho financeiro do ROA. Variáveis de controle de idade e tamanho do banco islâmico não tiveram efeito sobre o ROA.

**Pesquisa, implicações práticas e sociais:** O governo pode fazer uma regulamentação exigindo que os bancos islâmicos na Indonésia realizem o ICSR porque é mais adequado com formas de negócios que utilizam conceitos islâmicos.

**Originalidade/valor:** Este estudo oferece uma análise dos fatores que afetam o desempenho financeiro de fatores financeiros e não financeiros. Os fatores financeiros são vistos em termos de risco de financiamento e adequação de capital, enquanto os fatores não financeiros são representados pela governança da sharia e pela responsabilidade social da sharia nos bancos comerciais da sharia na Indonésia.

**Palavras-chave:** Desempenho Financeiro, Risco Bancário, Governança Islâmica, Responsabilidade Social Islâmica.

## EFECTOS DE LAS FINANZAS INTERNAS, LA GOBERNANZA ISLÁMICA Y LA RESPONSABILIDAD CORPORATIVA ISLÁMICA SOBRE LA RENTABILIDAD: EVIDENCIA DE BANCOS ISLÁMICOS EN INDONESIA

### RESUMEN

**Propósito:** Este artículo tiene como objetivo evaluar los efectos del riesgo de financiamiento, la adecuación del capital, el gobierno corporativo islámico y la responsabilidad social corporativa islámica en el desempeño financiero de los bancos islámicos en Indonesia.

**Marco teórico:** Estudios previos han arrojado resultados mixtos con respecto a la aplicación de ICG a la rentabilidad. Por lo tanto, es necesario volver a examinar la implementación del ICG sobre la rentabilidad de los bancos islámicos.

**Diseño/metodología/enfoque:** La muestra de la encuesta consta de 14 bancos comerciales de la sharia en Indonesia desde el período de estudio de 2012 a 2021 con un total de 130 observaciones. Este estudio utilizó análisis de regresión múltiple.

**Resultados:** Los resultados mostraron un efecto negativo de la NPF en el desempeño financiero del ROA. Además, hubo un efecto positivo de la divulgación de CAR e ICG en el desempeño financiero de ROA. Mientras tanto, la divulgación de ICSR no tuvo un efecto significativo en el desempeño financiero de ROA. Las variables de control de edad y tamaño del banco islámico no tuvieron efecto sobre el ROA.

**Implicaciones de investigación, prácticas y sociales:** el gobierno puede hacer una regulación que requiera que los bancos islámicos en Indonesia lleven a cabo ICSR porque es más adecuado con formas de negocios que usan conceptos islámicos.

**Originalidad/Valor:** Este estudio proporciona un análisis de los factores que afectan el desempeño financiero de los factores financieros y no financieros. Los factores financieros se consideran en términos de riesgo de financiación y suficiencia de capital, mientras que los factores no financieros están representados por la gobernabilidad de la sharia y la responsabilidad social de la sharia en los bancos comerciales de la sharia en Indonesia.

**Palabras clave:** Desempeño Financiero, Riesgo Bancario, Governanza Islámica, Responsabilidad Social Islámica.

### INTRODUCTION

Sharia banking in Indonesia has been running for 30 years and the market share of Islamic banking to national banks has only reached 7.03% as of August 2022 (Financial Services Authority, 2022). This shows that, despite its ability to survive and have good

development, Islamic banking has not been able to optimally encourage an increase in Islamic banking market share because it is still below 10%. Intense competition between Sharia and conventional banking means that Sharia banking must have substantial product advantages compared to conventional banking products and continue to show good financial performance improvement to meet the public's needs for a broader range of Sharia financial products. This is in line with the concept of Resource Based Theory stated by (Masakure et al. (2005) and Burvill (2018) that companies must have competitive resources to support company performance.

Syamni et al. (2018) argue that ROA is preferred to measure bank financial performance because an increase in ROA indicates an increase in bank profitability. Many factors, both financial and non-financial factors, determine profitability. Some reserachers used ROA to measure bank profitability. They are Salim et al. (2011), who identify determinants of profitability of Islamic banking institutions registered in Malaysia; Saif-alyousfi (2021), who examined the influence of bank-specific factors, financial structure, and macroeconomics on risk-taking behavior, stability, and profitability of banks in the Gulf Cooperative Council (GCC) economy during 1998–2017. Meanwhile, El-charani and Abraham (2022) examined and explained the profitability (ROA and ROE) of the Islamic and conventional banking sector in GCC countries before and during Covid-19. Also, Bansal et.al. (2023) investigated the impact of corporate governance and ROA on the banking Industry of Bahrain for the period of 2012–2020.

The growth of Sharia banking assets was superior to conventional banks throughout 2020 when the Covid-19 pandemic hit the world (Financial Services Authority, 2022). In addition, the growth of Islamic banking in TPF (Third Party Funds) is higher than that of conventional banks (11.98% vs 10.93%) and the growth of Islamic bank financing. However, slowing, is relatively higher than conventional banks (8.08% vs -4.20%). Pricewaterhousecoopers (2017) states that credit risk or financing risk is considered to be one of the top risks for the Indonesian banking industry. Non-performing financing activities will trigger an increase in financing risk. Increased financing problems experienced by banks will influence productive assets, affecting Islamic banks' profitability (Bachri et al., 2013). Thus, it can be interpreted as the influence of risk financing on profitability. In addition, another financial variable that affects profitability is capital adequacy of Islamic bank capital as stated by Tashkandi (2022).

The Islamic Finance Development Indicator (IFDI) measures five financial aspects including quantitative development, knowledge, governance, awareness, and Corporate Social Responsibility (CSR) (Nurrahman, 2019). Thus, the Islamic finance industry began to improve its performance in non-quantitative or financial sectors, including the Islamic banking sector. Sharia banks carry out operations based on Islamic rules so that the implementation of corporate governance and responsibility should align with sharia rules. The stakeholder theory is in accordance with the implementation mechanism of Islamic Corporate Governance which emphasizes the importance of all stakeholders and does not focus only on the interests of shareholders.

Previous studies have provided inconsistent results regarding the application of ICG to profitability. Research by Ajili and Bouri (2015) states that implementing ICG has no effect on financial performance. On the other hand, studies by Hisamuddin and Tirta (2015), Prasojo (2015), Norman (2017), Yadiat et al. (2017), and Khan and Zahid (2020) concluded that ICG has a positive effect on financial performance. Meanwhile, Norman and Haron (2019) and Ben Abdallah and Bahloul (2021) found ICG hurt the financial performance of Islamic banks. Therefore, it is necessary to re-examine the implementation of ICG on the profitability of Islamic banks.

In addition, the competitiveness and health of the banking industry have an important role in creating social benefits (Gangi et al., 2019). Companies that are active by implementing social responsibility programs have been empirically proven capable of improving financial performance (Syamni et al., 2018). This aligns with the Good Management Theory statement that CSR is related to the company's financial performance (Budi, 2021). (Riyadh, Al-Shmam, and Firdaus 2022) and (Hermawan et al. 2023) state that CSR has a significant effect on financial performance in Indonesian companies. The discussion of corporate social responsibility in the Islamic context has received special attention by researchers. Previous studies have shown that implementing Islamic corporate social responsibility (ICSR) is related to financial performance (Yaparto et al., 2013).

Based on the description of the phenomenon, theory, and previous studies, this study aims to analyze the interrelationships of internal financial factors, which include financing risk and capital adequacy, ICG and ICSR on ROA in Islamic banking in Indonesia. This research has implications for the practice of ICSR in Islamic banks that should be implemented or can become an obligation. The government can regulate Islamic banks in Indonesia to carry out ICSR because it is more suitable with business forms that use Islamic concepts. Furthermore,

Islamic banks are required to publish ICSR reports on the website of each bank so that the public can find out information, which hopefully can increase public trust. The increasing in trust can be predicted to increase the market share of Islamic banking in general and the profitability of Islamic banks in particular. Meanwhile, the theoretical contribution is to support the development of literature on the discussion of risk, capital adequacy, ICG and ICSR on profitability in the Islamic banking sector. public knows and creates trust in Islamic banks.

## LITERATURE REVIEW

Resources Based Theory (RBT) comes from Porter's model, which suggests two central strategic issues to achieve high profitability: choosing an attractive industry and achieving a relatively strong competitive position in an industry as a cost leader, differentiator, or focused company. This theory leads to the natural source of company success as a specific organization or exceptional resource (Conner, 1991; Olavarrieta & Ellinger, 1997). Empirical studies show that firm-specific factors are more important than environmental characteristics or industry structure in explaining superior-performing firms, which have given further credence to early conceptual work on RBT (Hansen, 1989; Rumelt, 1950).

Stakeholder theory argues that companies are related to not only owners and managers and essential parties from the company but also other external parties involved, including suppliers, customers and competitors (Al-Nasser Mohammed & Muhammed, 2017). Stakeholder theory emphasizes that organizations meeting the demands and needs of stakeholders will accelerate their financial performance (Berrone, 2007; Donaldson & Preston, 1995). Stakeholder theory in an Islamic perspective provides a comprehensive description of responsibilities that are guided by Islamic rules. These guidelines are recognized in the Islamic principles of property rights and contracts as stated by Chapra (2004). Stakeholder theory as the foundation of governance and performance relationships in the perspective of Islamic Banking must refer to the existence of the Sharia Supervisory Board (SSB) because it relates to accountability and supervision in accordance with Islamic law (Al-Nasser Mohammed & Muhammed, 2017).

Good Management Theory is an extension of the stakeholder theory developed by Waddock and Grave in 1997 (Donaldson & Preston, 1995). The company should be able to satisfy all interested parties without reducing its financial performance to have a good image and reputation (Budi, 2021). Basically, this theory encourages companies to continue to look for better ways to increase the company's competitive advantage, which in turn can improve



the company's financial performance (Asutay, 1975). Social and environmental activities are an alternative way to satisfy stakeholders and can be an advantage that increases competitiveness as written (Miles et al., 2002). Good management practices have good relationships with stakeholders which, in turn, will improve the company's financial performance and competitive advantage (Donaldson & Preston, 1995; Edwards, 2004; Waddock & Graves, 2016).

### **Effect of Financing Risk on Financial Performance**

Financing that is too high creates the risk of sharia banking facing the problem of congestion over financing that has been channeled by Syamni et al. (2018). A high NPF indicates a high level of problem financing (Hasibuan et al., 2020). Pramono and Widiarto (2019) state that problems in the Islamic bank financing process will reduce the bank's financial performance, in this case, the reduced value of the company's ROA ratio. The increasing financing problems can cause a delay in the velocity of money which has an impact on reducing company profits (Rini Malinda Sari et al., 2021). A large NPF value will create difficulties in managing financing, which can lead to bankruptcy. The movement of ups and downs of NPF affects the financial performance of Islamic banks. Financing risk measured using NPF is in line with research conducted by Rohansyah et al. (2021), Welly and Hari (2018) and Pramono and Widiarto (2019) which shows that NPF has a significant negative effect on the financial performance of Islamic banks. Thus, the research hypothesis can be formed as follows:

H<sub>1</sub>: Financing Risk has a negative effect on the Financial Performance of Islamic Commercial Banks

### **Effect of Capital Adequacy (CAR) on Financial Performance**

CAR is a guideline for a bank to expand in financing. ROA will increase if the CAR value is high (Yusuf, 2017). This ability shows that banks can provide smooth distribution of financing and other services (Welly & Hari, 2018). The greater the CAR, the greater the profit the bank gains, so the smaller the risk accepted by the bank. Additional capital can encourage increased confidence to increase financing activities thereby triggering an increase in operating income (Parisi, 2017). The minimum CAR ratio protects investors and strengthens sustainable finance by increasing the trust of regulators and depositors (Aspal & Dhawan, 2016). Reyad et al. (2020) argue that CAR growth in Islamic banks is necessary to maintain the risk level of capital adequacy so that it is sustainable in a competitive financial market. Capital adequacy as

measured by CAR is in line with research conducted by Yusuf (2017), Parisi (2017) and Hamdani et al. (2018) which show that CAR has a positive effect on the financial performance of Islamic banks. Thus, the research hypothesis can be formed as follows:

H<sub>2</sub>: Capital Adequacy has a positive effect on the Financial Performance of Islamic Commercial Banks

### **Effect of Islamic Corporate Governance on Financial Performance**

Grassa (2018) states that Islamic banks have several special characteristics that make them different from conventional banks so that the development of detailed corporate governance for Islamic financial institutions and institutions offering Islamic financial products seems to be decisive for the development of the Islamic financial industry in the Middle East and North Africa Region (MENA). Safieddine (2009) states that the implementation of ICG will create more efficient banking activities and is able to increase corporate profits. Effective ICG implementation will increase the efficiency of bank operations, reduce risk, increase market growth, and investor confidence (Marcinkowska, 2012). Yadiat et al. (2017) stated that good disclosure by Islamic banks is expected to be able to answer the expectations of society, especially depositors regarding fund management in accordance with sharia principles and prudential principles. ICGDI is in line with research conducted by Hisamuddin and Tirta (2015), Prasojo (2015), and Yadiat et al. (2017) which shows that ICG has a positive effect on the financial performance of Islamic banks. Hence, the research hypothesis can be formed as follows:

H<sub>3</sub>: Islamic Corporate Governance has a positive effect on the Financial Performance of Islamic Commercial Banks

### **Effect of Islamic Corporate Social Responsibility (ICSR) on Financial Performance**

Implementation of ICSR is very important because it aims to build a company's image or reputation in the public eye (Refe, 2018). Reyad et al. (2020) state that Islamic banks in Oman are growing financially and enhancing their reputation regionally and internationally by conducting sustainable business with sharia principles. Islamic banking has the capacity to encourage the implementation of sustainable finance based on principles that prioritize human development, natural preservation, prosperity, peace and partnership (5P) during the Covid-19 pandemic (Gunardi, 2021). This is because the implementation of ICSR is not only intended as a fulfillment of legal and moral obligations but as a form of corporate strategy to survive in the

long term (Syukron, 2015). ICSR in banking and financial institutions can be carried out through financing and investment policies provided so that they can meet company standards that care or are sensitive to the environment (Bidari & Djajadikerta, 2020). One of ICSR goals is to increase public trust in companies so that they can improve the financial performance of Islamic banks (Magdalena et al., 2017). Public trust can grow when the company's image has been well built by the company through disclosure of ICSR. A good corporate image can attract investors to invest their capital so that it can provide an increase in the company's financial performance (Yaparto et al., 2013). Thus, the research hypothesis can be formed as follows:

H4: Islamic Corporate Social Responsibility has a positive effect on the Financial Performance of Islamic Commercial Banks

## RESEARCH METHODOLOGY

This study involved 14 Islamic commercial banks in Indonesia from 2012 to 2021. Total data were 130 observations. Data were collected from annual reports on the official websites of each bank. This research used multiple regression analysis. Table 1 contains details of the data distribution for the year of observation in this study.

Table 1. Data Distribution of Observation Years

No	Bank Name	Year of Establishment	Annual Reports	Year of Observation
1	Bank Central Asia Syariah	2010	2012-2021	10
2	Bank Pembangunan NTB Syariah	1964	2012-2021	10
3	Bank Mandiri Syariah	2000	2012-2020	9
4	Bank Nasional Indonesia Syariah	2010	2012-2020	9
5	Bank Bukopin Syariah	2008	2012-2021	10
6	Bank Panin Syariah	2009	2012-2021	10
7	Bank Rakyat Indonesia Syariah	2008	2012-2020	9
8	Bank Mega Syariah	2004	2012-2021	10
9	Bank Muamalat	1992	2012-2021	10
10	Bank Tabungan Pensiunan Nasional Syariah	2014	2014-2021	8
11	Bank Victoria Syariah	2010	2012-2021	10
12	Bank Net Indonesia Syariah	2010	2015-2021	7
13	Bank Pembangunan Jawa Barat dan Banten Syariah	2010	2014-2021	8
14	Bank Pembangunan Daerah Aceh Syariah	2004	2012-2021	10
	Total			130

Source: Financial Services Authority (ojk.co.id)

## Research Variables

Dependent Variable: ROA

Measurement of bank's financial performance used ROA which is calculated by the ratio of net income to total assets.

**Independent Variables: NPF, CAR, Disclosure of ICG and ICSR of Islamic banks.**

NPF is calculated by the non-performing financing ratio of all bank financing, and CAR is calculated by the bank's capital to risk-weighted asset value. Hidayat and Abdulrahman (2014), Syamni et al. (2018), and Abdallah and Bahloul (2021) agree on using the disclosure index as a way to meet AAOIFI and IFSB compliance standards. The assessment of each item is coded as (1) if disclosed, (0) if not disclosed. Disclosure compliance index is calculated as the number of disclosures disclosed by the bank with the total number of disclosures that apply. Syamni et al. (2018) developed the ICG index based on IFSB guidelines and several developments in subsequent studies conducted by Darmadi (2013) and Grassa and Matoussi (2014). The ICG Disclosure Index consists of Shariah Governance and General Governance sub-sections with a total of 57 disclosures. Meanwhile, the ICSR disclosure index in this study adopted the Islamic Social Reporting (ISR) model developed by Haniffa (2002) and Othman and Thani (2010), based on AAOIFI standard guidelines. The ICSR Disclosure Index consists of sub-sections including Finance & Investment, Products, Employees, Society and the Environment with a total of 38 disclosures.

**Control Variables: Size and Age**

This study considers the control variables, namely the size and age of the bank. Bank size is calculated using the natural logarithm of the total assets of Islamic banks (Grassa, 2018). Meanwhile, bank age is measured by the number of years of the company's bank establishment (Grassa, 2018).

The research variables are summarized in Table 2

Table 2. Variables Identification

Variable Type	Variable Name	Symbol	Definition
Dependent Variable	Return On Assets	ROA	Net profit to total assets
Independent Variable	Non Performing Financing	NPF	Non-performing financing of all bank-distributed financing
	Capital Adequacy Ratio	CAR	Bank capital to total Risk Weighted Asset
Control Variables	Islamic Corporate Governance	ICG	ICG Disclosure of all disclosures
	Islamic Corporate Social Responsibility	ICSR	Disclosure of ICSR for all disclosures
	Bank Size	SIZE	Natural Logarithm of Total Assets
	Bank Age	AGE	Number of Years

## Empirical Models

The regression equation formed below:

$$ROA_{it} = \beta_0 + \beta_1 NPF_{it} + \beta_2 CAR_{it} + \beta_3 ICG_{it} + \beta_4 ICSR_{it} + \beta_5 SIZE_{it} + \beta_6 AGE_{it} + \varepsilon_{it}$$

Notes:

ROA<sub>it</sub> = Financial Performance (Independent Variable)

NPF<sub>it</sub> = Financing Risk (Independent Variable)

CAR<sub>it</sub> = Capital Adequacy (Independent Variable)

ICG<sub>it</sub> = Islamic Governance of Islamic Banks (Independent Variable)

ICSR<sub>it</sub> = Islamic Social Responsibility of Islamic Banks (Independent Variable)

SIZE<sub>it</sub> = Bank Size (Control Variable)

AGE<sub>it</sub> = Bank Age (Control Variable)

## RESULTS AND DISCUSSION

### Description of Statistics

Table 3 reports descriptive statistics for a research sample of 14 Islamic commercial banks in Indonesia from 2012 to 2021 with a total of 130 research data. The average value of ROA shows 1.13. The maximum and minimum ROA values are 13.58 and -20.13. This shows that the ROA value data range is quite large, which means that the value is far from the average value. The average values of the variables NPF, CAR, ICG and ICSR respectively show 3.93, 30.50, 69.53 and 62.85, respectively. The maximum values of NPF, CAR, ICG and ICSR are 43.99, 390.5, 80.7 and 78.95, respectively. Furthermore, the minimum values of NPF, CAR, ICG and ICSR are 0, 11.1, 59.65 and 36.84, respectively. Meanwhile, the control variables Size and Age have an average value of 9.24 and 13.26, respectively. The maximum values of Size and Age are, respectively, 11.75 and 57 while the minimum values of Size and Age are, respectively, 6.5 and 0. This indicates that there was an Islamic bank established in 2012.

Table 3. Statistical Description

	N	Minimum	Maximum	Means	std. Dev
ROA	130	-20.13	13.58	1.13	3.98
NPF	130	0	43.99	3.93	5.47
CAR	130	11.1	390.5	30.50	48.4
ICG	130	59.65	80.7	69.53	5.33
ICSR	130	36.84	78.95	62.85	10.73
SIZE	130	6.5	11.75	9.24	1.21
AGE	130	0	57	13.26	12.79
Valid N (listwise)	130				

Source: Secondary data processed by the author

### Classical Assumption Test Results

Data analysis of this study is through the classical assumption test. Based on the classic assumption test results which include normality tests, multicollinearity, heteroscedasticity, and

autocorrelation, the data have been released and meets the best linear unbiased estimation (BLUE). The data are normal because they have a value of  $\alpha = 0.054$  and do not have multicollinearity because the VIF value is below 10. The data are also free from heteroscedasticity because the  $\alpha$  of each variable is above 0.05, and the data are not autocorrelated because they have a value of 2.353 which is in the range 1.6508 and 1.7774

### Correlation Analysis

This study uses partial correlation analysis because it has a more complex research design involving control variables. Solís (2017) states that the control variable must be controlled so as not to confuse the effect of the independent variable on the dependent variable. Table 4 shows that, by controlling for bank size and age, a significant correlation was found between financing risk, capital adequacy and ICG on financial performance or  $\rho > 0.05$ . Meanwhile, there is no significant correlation between ICSR and financial performance or  $\rho < 0.05$ .

Table 4. Partial Correlation Test

Control Variables		Financial Performance	Financing Risk	Capital	ICG	CSR	
LNSIZE & LNAGE	Financial performance	Correlation	1000	-0.347	0.320	0.293	-0.021
		Sig.		0	0	0.001	0.81
		Df	0	126	126	126	126
	Risk Financing	Correlation	-0.347	1000	-0.213	-0.257	-0.078
		Sig.	0		0.016	0.003	0.381
		Df	126	0	126	126	126
	Capital	Correlation	0.320	-0.213	1000	0.33	0.168
		Sig.	0	0.016		0	0.058
		Df	126	126	0	126	126
ICG	Correlation	0.293	-0.257	0.33	1000	0.268	
	Sig.	0.001	0.003	0		0.002	
	Df	126	126	126	0	126	
ICSR	Correlation	-0.021	-0.078	0.168	0.268	1000	
	Sig.	0.81	0.381	0.058	0.002		
	Df	126	126	126	126	0	

Source: Secondary data processed by the author

### Regression Analysis

Table 5 contains the results of running multiple linear regression test data. Based on this, the regression equation of this study is as follows:

$$ROA_{it} = 14.262 - 0.356NPF_{it} + 0.613CAR_{it} + 3.805ICG_{it} - 1.440ICSR_{it} + 1.322SIZE_{it} - 0.220AGE_{it} + \varepsilon_{it}$$

Table 5. Hypothesis Testing

Variable	B	Q	Sig.
(Constant)	14.262	-2.090	0.039
NPF	-0.356	-3.136	0.002
CAR	0.613	2.625	0.010
ICG	3.805	2.111	0.037
ICSR	-1.440	-1.561	0.121
SIZE	1.322	.825	0.380
AGE	-0.220	-1.244	0.216

Source: Secondary data processed by the author

It shows that the variables NPF, CAR, ICG have  $t_{count} > t_{table}$  (1.97838) or  $pvalue < (0.05)$ , which means it has a significant effect on financial performance (LNROA). Meanwhile, the ICSR variable  $t_{count} < t_{table}$  (1.97838) or  $pvalue > (0.05)$ , which means it has no effect on financial performance (ZROA). Furthermore, the control variables, SIZE and AGE, have a  $pvalue > 0.05$ , which shows that the control variable does not affect financial performance.

### Effect of Financing Risk on Financial Performance

The results of the statistical test shows that the first hypothesis is accepted, which means that financing risk has a significant negative effect on profitability. This result is in line with Reyad et al. (2020), stating that financing risk (NPF) will cause costs to become a burden, causing losses to Islamic banks. Siddique et al. (2022) confirm that an increase in financing problems will reduce the ROA value of Islamic Commercial Banks. In addition, non-performing financing will block operating income, reduce opening up for investment and develop a liquidity crisis which results in bankruptcy problems and a weak economic system (Khan et al., 2020). An increase in the NPF value at Islamic Commercial Banks will disrupt bank operations because banks must reserve a large portion of funds in the form of Allowance for Productive Assets Losses (PPAP) in order to mitigate the impact of the emergence of problem financing. This is stated in the resources-based theory that the company must be a specific organization with special resources. Resource-based theory also suggests that companies must have competitive resources in order to support company performance (Burvill, 2018; Masakure et al., 2005). Low NPF ownership for Islamic Banks is a resource that can improve financial performance, especially ROA. Therefore, Islamic banks must strive to create a minimum NPF since this is a parameter in creating maximum profitability.

### **Effect of Capital Adequacy on Financial Performance**

Based on the results of statistical tests, capital adequacy has a significant positive effect on ROA and supports the second hypothesis of this research. The results of this study are in line with the argument which states that Islamic banks are responsible for ensuring adequate capital so that they can support bank operations and business development (Indonesian Bankers Association, 2016). Besides that, increasing capital in Islamic commercial banks will support banking operational activities and business development activities through improving products and services so as to optimize the profits generated by banks (Siddique et al., 2022). According to Sukmana (2015), the CAR ratio is useful in managing the risk of loss of productive assets, especially those originating from financing risks. Provision of sufficient capital will increase the reserves of Islamic banks so as to guarantee the continuity of the banking business from potential risks. In addition, capital adequacy will encourage increased public trust because higher capital signals higher guarantees for public funds at banks (Aspal & Dhawan, 2016). Referring to the statement of Resources Based Theory that companies must have competitive resources to support company performance, in this case financial performance is proxied by ROA. Capital adequacy for Islamic banking is very important and this is one of the resources that must be fulfilled by Islamic banks to achieve the best financial performance, especially in creating profitability.

### **The Influence of Islamic Corporate Governance on Financial Performance**

Multiple regression tests resulted in a significant positive effect on the ICG variable on profitability, which supports the third hypothesis. The results of this study support the stakeholder theory which states that, if the company's goals are in accordance with the interests of the stakeholders, then management will have better capability to create better company performance (Freeman & McVea, 1984). The implementation of sharia management governance will create smooth banking operations that can protect the interests of stakeholders and provide benefits for the company. Yadiat et al. (2017) state that good Islamic bank management governance will have an impact on effective and efficient banking activities so as to encourage the creation of smooth financial conditions and improve financial performance. Stakeholder theory seems to be implemented in this research. The implementation of ICG provides satisfaction for the stakeholders of Islamic banks. Islamic banks with all rules based on Islam are a separate guarantee for stakeholders that their operations reflect Islamic rules. This is supported by the existence of a sharia supervisory board which is the major determinant



in providing advice, reprimands, and reports related to the implementation of sharia rules in Islamic banks. In addition, information disclosure regarding sharia compliance in the governance process can provide value expectations to customers and investors who have a focus on sharia compliance and can become a separate business strategy in banking competition (Alam et al., 2022). Therefore, these conditions can encourage increased investor and customer confidence in Islamic banks, thus encouraging an increase in the number of DPK and also investment by investors, which can provide profits for banks.

### **Effect of Islamic Corporate Social Responsibility on Financial Performance**

The statistical test shows that ICSR has no significant effect on profitability, which means rejecting the fourth hypothesis of this research. The research results do not support the good management theory which states that the implementation of CSR will positively impact financial performance. The results of this study are also in conflict with previous research which supports good management theory, i.e. Yaparto et al. (2013), Magdalena et al. (2017), and Reyad et al. (2020). These studies have had a significant positive effect of implementing ICSR on financial performance.

ICSR findings have no effect on financial performance indicating that Islamic banks have not communicated corporate responsibility properly so that the benefits of CSR cannot be received properly and have not optimally touched the interests of society and interested parties. Yoon and Chung (2018) argue that this is possible because implementing ICSR social performance is expected to provide material returns in the long term so it takes time to achieve financial benefits from investments in customers, communities and activities related to the environment. In addition, ICSR programs are often not performed consistently, and implementation is only limited to fulfilling obligations under regulations to avoid administrative sanctions (Chapagain, 2021). In fact, Asim et al. (2020) stated that disclosure of ICSR is not an obligation for companies and CSR activities are voluntary activities according to the will of the company.

### **Control Variables**

The size and age of Islamic banks are the control variables in this research model which apparently have no effect on ROA. This means that the size of Islamic banks in Indonesia is not a determinant of profitability as has been the case in another research. This shows that the existence of Islamic banking in Indonesia which has been in practice for almost 30 years is not

a guarantee in determining the level of profitability. This condition can be reflected in the market share of Islamic banking, which only touched 7.03% in August 2022, as stated in the OJK report on the Islamic Finance Market Update for the period August 2022 (OJK, 2022). The age variable has a negative relationship with profitability, which means that the longer Islamic banks operate, the lower the profitability, because it is often found that companies that have a high age actually have a lower level of efficiency. This is in line with Ajili and Bouri (2018), Albarrak and El-halaby (2019), and Elgattani (2020) who show no significant effect between bank age and ROA. Meanwhile, the size of Islamic banks in Indonesia as seen from total assets has almost the same value as seen from the low standard deviation value. This indicates that Islamic banking in Indonesia has relatively the same size so that it is less able to show variations in the level of profitability. The results of this study are in line with the findings of Adusei (2011), Elgattani (2020), and Tsapa (2022) that there is no significant effect between bank size and ROA.

## CONCLUSION

This study aims to examine the effect of financing risk, capital adequacy, sharia governance (ICG) and sharia social responsibility (ICSR) on the financial performance of sharia commercial banks in Indonesia. The result showed that financing risk has a significant negative effect on financial performance, but capital adequacy has a significant positive effect on financial performance. Meanwhile, ICG has a significant positive effect on financial performance. In contrast, implementing ICSR has no significant effect on financial performance. This study involved the size and age of the bank as control variables that they did not have a significant effect on financial performance.

The limitation of this study is that variables control, size and age, showed no effect on ROA which is different from previous research. This is likely due to the use of multiple linear regression to analyze this research model, so it is unsuitable for testing as a control variable. For further research, testing the control variable can use path analysis sebagaimana yang dilakukan oleh Altameemi dan Al Slehat (2022). It will give the analysis results are more appropriate in placing the function of size and age of the company as controllers for the determinant variables in ROA.

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# EFFECTS OF INTERNAL FINANCE, ISLAMIC GOVERNANCE AND ISLAMIC CORPORATE RESPONSIBILITY ON PROFITABILITY: EVIDENCE OF ISLAMIC BANKING IN INDONESIA

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ARTICLE INFO	ABSTRACT
<p><b>Article history:</b></p> <p><b>Received</b> 20 February 2023</p> <p><b>Accepted</b> 08 May 2023</p>	<p><b>Purpose:</b> The objective of this study was analyze the interrelationships of internal financial factors, which include financing risk and capital adequacy, ICG and ICSR as determinants of ROA in Islamic banking in Indonesia.</p> <p><b>Theoretical framework:</b> Previous studies have provided mixed results regarding the application of ICG to profitability. Therefore, it is necessary to re-examine the implementation of ICG on the profitability of Islamic banks.</p> <p><b>Design/methodology/approach:</b> The research sample consist of 14 sharia commercial banks in Indonesia in the study period 2012 to 2021 with a total of 130 observations. This study used multiple regression analysis.</p> <p><b>Findings:</b> The results showed a negative effect of NPF on ROA financial performance. Furthermore, there was a positive effect of CAR and ICG disclosure on ROA financial performance. Meanwhile, disclosure of ICSR had no significant effect on ROA financial performance. Age control variables and Islamic bank size were found to have no effect on ROA.</p> <p><b>Research, Practical &amp; Social implications:</b> The government can make a regulation requiring Islamic banks in Indonesia to carry out ICSR because it is more suitable with business forms that use Islamic concepts.</p> <p><b>Originality/value:</b> This study offers an examination of the factors affecting financial performance of financial and non-financial factors. Financial factors are seen in terms of financing risk and capital adequacy while non-financial factors are represented by sharia governance and sharia social responsibility in sharia commercial banks in Indonesia.</p> <p>Doi: <a href="https://doi.org/10.26668/businessreview/2023.v8i5.2102">https://doi.org/10.26668/businessreview/2023.v8i5.2102</a></p>
<p><b>Keywords:</b></p> <p>Financial Performance; Bank Risk; Islamic Governance; Islamic Social Responsibility.</p> <div data-bbox="235 892 479 1092"> </div>	

**EFEITOS DAS FINANÇAS INTERNAS, GOVERNANÇA ISLÂMICA E RESPONSABILIDADE CORPORATIVA ISLÂMICA NA RENTABILIDADE: EVIDÊNCIAS DE BANCOS ISLÂMICOS NA INDONÉSIA**

**RESUMO**

**Objetivo:** Este artigo tem como objetivo avaliar os efeitos do risco de financiamento, adequação de capital, governança corporativa islâmica e responsabilidade social corporativa islâmica no desempenho financeiro de bancos islâmicos na Indonésia.

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**Referencial teórico:** Estudos anteriores forneceram resultados mistos em relação à aplicação da ICG à rentabilidade. Portanto, é necessário reexaminar a implementação da ICG sobre a lucratividade dos bancos islâmicos.

**Desenho/metodologia/abordagem:** A amostra da pesquisa consiste em 14 bancos comerciais sharia na Indonésia no período de estudo de 2012 a 2021 com um total de 130 observações. Este estudo utilizou análise de regressão múltipla.

**Resultados:** Os resultados mostraram um efeito negativo do NPF no desempenho financeiro do ROA. Além disso, houve um efeito positivo da divulgação do CAR e do ICG no desempenho financeiro do ROA. Enquanto isso, a divulgação do ICSR não teve efeito significativo no desempenho financeiro do ROA. Variáveis de controle de idade e tamanho do banco islâmico não tiveram efeito sobre o ROA.

**Pesquisa, implicações práticas e sociais:** O governo pode fazer uma regulamentação exigindo que os bancos islâmicos na Indonésia realizem o ICSR porque é mais adequado com formas de negócios que utilizam conceitos islâmicos.

**Originalidade/valor:** Este estudo oferece uma análise dos fatores que afetam o desempenho financeiro de fatores financeiros e não financeiros. Os fatores financeiros são vistos em termos de risco de financiamento e adequação de capital, enquanto os fatores não financeiros são representados pela governança da sharia e pela responsabilidade social da sharia nos bancos comerciais da sharia na Indonésia.

**Palavras-chave:** Desempenho Financeiro, Risco Bancário, Governança Islâmica, Responsabilidade Social Islâmica.

## EFFECTOS DE LAS FINANZAS INTERNAS, LA GOBERNANZA ISLÁMICA Y LA RESPONSABILIDAD CORPORATIVA ISLÁMICA SOBRE LA RENTABILIDAD: EVIDENCIA DE BANCOS ISLÁMICOS EN INDONESIA

### RESUMEN

**Propósito:** Este artículo tiene como objetivo evaluar los efectos del riesgo de financiamiento, la adecuación del capital, el gobierno corporativo islámico y la responsabilidad social corporativa islámica en el desempeño financiero de los bancos islámicos en Indonesia.

**Marco teórico:** Estudios previos han arrojado resultados mixtos con respecto a la aplicación de ICG a la rentabilidad. Por lo tanto, es necesario volver a examinar la implementación del ICG sobre la rentabilidad de los bancos islámicos.

**Diseño/metodología/enfoque:** La muestra de la encuesta consta de 14 bancos comerciales de la sharia en Indonesia desde el período de estudio de 2012 a 2021 con un total de 130 observaciones. Este estudio utilizó análisis de regresión múltiple.

**Resultados:** Los resultados mostraron un efecto negativo de la NPF en el desempeño financiero del ROA. Además, hubo un efecto positivo de la divulgación de CAR e ICG en el desempeño financiero de ROA. Mientras tanto, la divulgación de ICSR no tuvo un efecto significativo en el desempeño financiero de ROA. Las variables de control de edad y tamaño del banco islámico no tuvieron efecto sobre el ROA.

**Implicaciones de investigación, prácticas y sociales:** el gobierno puede hacer una regulación que requiera que los bancos islámicos en Indonesia lleven a cabo ICSR porque es más adecuado con formas de negocios que usan conceptos islámicos.

**Originalidad/Valor:** Este estudio proporciona un análisis de los factores que afectan el desempeño financiero de los factores financieros y no financieros. Los factores financieros se consideran en términos de riesgo de financiación y suficiencia de capital, mientras que los factores no financieros están representados por la gobernabilidad de la sharia y la responsabilidad social de la sharia en los bancos comerciales de la sharia en Indonesia.

**Palabras clave:** Desempeño Financiero, Riesgo Bancario, Gobernanza Islámica, Responsabilidad Social Islámica.

### INTRODUCTION

Sharia banking in Indonesia has been running for 30 years and the market share of Islamic banking to national banks has only reached 7.03% as of August 2022 (Financial Services Authority, 2022). This shows that, despite its ability to survive and have good

development, Islamic banking has not been able to optimally encourage an increase in Islamic banking market share because it is still below 10%. Intense competition between Sharia and conventional banking means that Sharia banking must have substantial product advantages compared to conventional banking products and continue to show good financial performance improvement to meet the public's needs for a broader range of Sharia financial products. This is in line with the concept of Resource Based Theory stated by (Masakure et al. (2005) and Burvill (2018) that companies must have competitive resources to support company performance.

Syamni et al. (2018) argue that ROA is preferred to measure bank financial performance because an increase in ROA indicates an increase in bank profitability. Many factors, both financial and non-financial factors, determine profitability. Some reserachers used ROA to measure bank profitability. They are Salim et al. (2011), who identify determinants of profitability of Islamic banking institutions registered in Malaysia; Saif-alyousfi (2021), who examined the influence of bank-specific factors, financial structure, and macroeconomics on risk-taking behavior, stability, and profitability of banks in the Gulf Cooperative Council (GCC) economy during 1998–2017. Meanwhile, El-chaarani and Abraham (2022) examined and explained the profitability (ROA and ROE) of the Islamic and conventional banking sector in GCC countries before and during Covid-19. Also, Bansal et.al. (2023) investigated the impact of corporate governance and ROA on the banking Industry of Bahrain for the period of 2012–2020.

The growth of Sharia banking assets was superior to conventional banks throughout 2020 when the Covid-19 pandemic hit the world (Financial Services Authority, 2022). In addition, the growth of Islamic banking in TPF (Third Party Funds) is higher than that of conventional banks (11.98% vs 10.93%) and the growth of Islamic bank financing. However, slowing, is relatively higher than conventional banks (8.08% vs -4.20%). Pricewaterhousecoopers (2017) states that credit risk or financing risk is considered to be one of the top risks for the Indonesian banking industry. Non-performing financing activities will trigger an increase in financing risk. Increased financing problems experienced by banks will influence productive assets, affecting Islamic banks' profitability (Bachri et al., 2013). Thus, it can be interpreted as the influence of risk financing on profitability. In addition, another financial variable that affects profitability is capital adequacy of Islamic bank capital as stated by Tashkandi (2022).

The Islamic Finance Development Indicator (IFDI) measures five financial aspects including quantitative development, knowledge, governance, awareness, and Corporate Social Responsibility (CSR) (Nurrahman, 2019). Thus, the Islamic finance industry began to improve its performance in non-quantitative or financial sectors, including the Islamic banking sector. Sharia banks carry out operations based on Islamic rules so that the implementation of corporate governance and responsibility should align with sharia rules. The stakeholder theory is in accordance with the implementation mechanism of Islamic Corporate Governance which emphasizes the importance of all stakeholders and does not focus only on the interests of shareholders.

Previous studies have provided inconsistent results regarding the application of ICG to profitability. Research by Ajili and Bouri (2015) states that implementing ICG has no effect on financial performance. On the other hand, studies by Hisamuddin and Tirta (2015), Prasojoo (2015), Norman (2017), Yadiat et al. (2017), and Khan and Zahid (2020) concluded that ICG has a positive effect on financial performance. Meanwhile, Norman and Haron (2019) and Ben Abdallah and Bahloul (2021) found ICG hurt the financial performance of Islamic banks. Therefore, it is necessary to re-examine the implementation of ICG on the profitability of Islamic banks.

In addition, the competitiveness and health of the banking industry have an important role in creating social benefits (Gangi et al., 2019). Companies that are active by implementing social responsibility programs have been empirically proven capable of improving financial performance (Syamni et al., 2018). This aligns with the Good Management Theory statement that CSR is related to the company's financial performance (Budi, 2021). (Riyadh, Al-Shmam, and Firdaus 2022) and (Hermawan et al. 2023) state that CSR has a significant effect on financial performance in Indonesian companies. The discussion of corporate social responsibility in the Islamic context has received special attention by researchers. Previous studies have shown that implementing Islamic corporate social responsibility (ICSR) is related to financial performance (Yaparto et al., 2013).

Based on the description of the phenomenon, theory, and previous studies, this study aims to analyze the interrelationships of internal financial factors, which include financing risk and capital adequacy, ICG and ICSR on ROA in Islamic banking in Indonesia. This research has implications for the practice of ICSR in Islamic banks that should be implemented or can become an obligation. The government can regulate Islamic banks in Indonesia to carry out ICSR because it is more suitable with business forms that use Islamic concepts. Furthermore,

Islamic banks are required to publish ICSR reports on the website of each bank so that the public can find out information, which hopefully can increase public trust. The increasing in trust can be predicted to increase the market share of Islamic banking in general and the profitability of Islamic banks in particular. Meanwhile, the theoretical contribution is to support the development of literature on the discussion of risk, capital adequacy, ICG and ICSR on profitability in the Islamic banking sector. public knows and creates trust in Islamic banks.

## LITERATURE REVIEW

Resources Based Theory (RBT) comes from Porter's model, which suggests two central strategic issues to achieve high profitability: choosing an attractive industry and achieving a relatively strong competitive position in an industry as a cost leader, differentiator, or focused company. This theory leads to the natural source of company success as a specific organization or exceptional resource (Conner, 1991; Olavarrieta & Ellinger, 1997). Empirical studies show that firm-specific factors are more important than environmental characteristics or industry structure in explaining superior-performing firms, which have given further credence to early conceptual work on RBT (Hansen, 1989; Rumelt, 1950).

Stakeholder theory argues that companies are related to not only owners and managers and essential parties from the company but also other external parties involved, including suppliers, customers and competitors (Al-Nasser Mohammed & Muhammed, 2017). Stakeholder theory emphasizes that organizations meeting the demands and needs of stakeholders will accelerate their financial performance (Berrone, 2007; Donaldson & Preston, 1995). Stakeholder theory in an Islamic perspective provides a comprehensive description of responsibilities that are guided by Islamic rules. These guidelines are recognized in the Islamic principles of property rights and contracts as stated by Chapra (2004). Stakeholder theory as the foundation of governance and performance relationships in the perspective of Islamic Banking must refer to the existence of the Sharia Supervisory Board (SSB) because it relates to accountability and supervision in accordance with Islamic law (Al-Nasser Mohammed & Muhammed, 2017).

Good Management Theory is an extension of the stakeholder theory developed by Waddock and Grave in 1997 (Donaldson & Preston, 1995). The company should be able to satisfy all interested parties without reducing its financial performance to have a good image and reputation (Budi, 2021). Basically, this theory encourages companies to continue to look for better ways to increase the company's competitive advantage, which in turn can improve

the company's financial performance (Asutay, 1975). Social and environmental activities are an alternative way to satisfy stakeholders and can be an advantage that increases competitiveness as written (Miles et al., 2002). Good management practices have good relationships with stakeholders which, in turn, will improve the company's financial performance and competitive advantage (Donaldson & Preston, 1995; Edwards, 2004; Waddock & Graves, 2016).

### Effect of Financing Risk on Financial Performance

Financing that is too high creates the risk of sharia banking facing the problem of congestion over financing that has been channeled by Syamni et al. (2018). A high NPF indicates a high level of problem financing (Hasibuan et al., 2020). Pramono and Widiarto (2019) state that problems in the Islamic bank financing process will reduce the bank's financial performance, in this case, the reduced value of the company's ROA ratio. The increasing financing problems can cause a delay in the velocity of money which has an impact on reducing company profits (Rini Malinda Sari et al., 2021). A large NPF value will create difficulties in managing financing, which can lead to bankruptcy. The movement of ups and downs of NPF affects the financial performance of Islamic banks. Financing risk measured using NPF is in line with research conducted by Rohansyah et al. (2021), Welly and Hari (2018) and Pramono and Widiarto (2019) which shows that NPF has a significant negative effect on the financial performance of Islamic banks. Thus, the research hypothesis can be formed as follows:

H<sub>1</sub>: Financing Risk has a negative effect on the Financial Performance of Islamic Commercial Banks

### Effect of Capital Adequacy (CAR) on Financial Performance

CAR is a guideline for a bank to expand in financing. ROA will increase if the CAR value is high (Yusuf, 2017). This ability shows that banks can provide smooth distribution of financing and other services (Welly & Hari, 2018). The greater the CAR, the greater the profit the bank gains, so the smaller the risk accepted by the bank. Additional capital can encourage increased confidence to increase financing activities thereby triggering an increase in operating income (Parisi, 2017). The minimum CAR ratio protects investors and strengthens sustainable finance by increasing the trust of regulators and depositors (Aspal & Dhawan, 2016). Reyad et al. (2020) argue that CAR growth in Islamic banks is necessary to maintain the risk level of capital adequacy so that it is sustainable in a competitive financial market. Capital adequacy as

measured by CAR is in line with research conducted by Yusuf (2017), Parisi (2017) and Hamdani et al. (2018) which show that CAR has a positive effect on the financial performance of Islamic banks. Thus, the research hypothesis can be formed as follows:

H<sub>2</sub>: Capital Adequacy has a positive effect on the Financial Performance of Islamic Commercial Banks

### **Effect of Islamic Corporate Governance on Financial Performance**

Grassa (2018) states that Islamic banks have several special characteristics that make them different from conventional banks so that the development of detailed corporate governance for Islamic financial institutions and institutions offering Islamic financial products seems to be decisive for the development of the Islamic financial industry in the Middle East and North Africa Region (MENA). Safieddine (2009) states that the implementation of ICG will create more efficient banking activities and is able to increase corporate profits. Effective ICG implementation will increase the efficiency of bank operations, reduce risk, increase market growth, and investor confidence (Marcinkowska, 2012). Yadiat et al. (2017) stated that good disclosure by Islamic banks is expected to be able to answer the expectations of society, especially depositors regarding fund management in accordance with sharia principles and prudential principles. ICGDI is in line with research conducted by Hisamuddin and Tirta (2015), Prasojo (2015), and Yadiat et al. (2017) which shows that ICG has a positive effect on the financial performance of Islamic banks. Hence, the research hypothesis can be formed as follows:

H<sub>3</sub>: Islamic Corporate Governance has a positive effect on the Financial Performance of Islamic Commercial Banks

### **Effect of Islamic Corporate Social Responsibility (ICSR) on Financial Performance**

Implementation of ICSR is very important because it aims to build a company's image or reputation in the public eye (Refe, 2018). Reyad et al. (2020) state that Islamic banks in Oman are growing financially and enhancing their reputation regionally and internationally by conducting sustainable business with sharia principles. Islamic banking has the capacity to encourage the implementation of sustainable finance based on principles that prioritize human development, natural preservation, prosperity, peace and partnership (5P) during the Covid-19 pandemic (Gunardi, 2021). This is because the implementation of ICSR is not only intended as a fulfillment of legal and moral obligations but as a form of corporate strategy to survive in the



long term (Syukron, 2015). ICSR in banking and financial institutions can be carried out through financing and investment policies provided so that they can meet company standards that care or are sensitive to the environment (Bidari & Djajadikerta, 2020). One of ICSR goals is to increase public trust in companies so that they can improve the financial performance of Islamic banks (Magdalena et al., 2017). Public trust can grow when the company's image has been well built by the company through disclosure of ICSR. A good corporate image can attract investors to invest their capital so that it can provide an increase in the company's financial performance (Yaparto et al., 2013). Thus, the research hypothesis can be formed as follows:

H<sub>4</sub>: Islamic Corporate Social Responsibility has a positive effect on the Financial Performance of Islamic Commercial Banks

## RESEARCH METHODOLOGY

This study involved 14 Islamic commercial banks in Indonesia from 2012 to 2021. Total data were 130 observations. Data were collected from annual reports on the official websites of each bank. This research used multiple regression analysis. Table 1 contains details of the data distribution for the year of observation in this study.

Table 1. Data Distribution of Observation Years

No	Bank Name	Year of Establishment	Annual Reports	Year of Observation
1	Bank Central Asia Syariah	2010	2012-2021	10
2	Bank Pembangunan NTB Syariah	1964	2012-2021	10
3	Bank Mandiri Syariah	2000	2012-2020	9
4	Bank Nasional Indonesia Syariah	2010	2012-2020	9
5	Bank Bukopin Syariah	2008	2012-2021	10
6	Bank Panin Syariah	2009	2012-2021	10
7	Bank Rakyat Indonesia Syariah	2008	2012-2020	9
8	Bank Mega Syariah	2004	2012-2021	10
9	Bank Muamalat	1992	2012-2021	10
10	Bank Tabungan Pensiunan Nasional Syariah	2014	2014-2021	8
11	Bank Victoria Syariah	2010	2012-2021	10
12	Bank Net Indonesia Syariah	2010	2015-2021	7
13	Bank Pembangunan Jawa Barat dan Banten Syariah	2010	2014-2021	8
14	Bank Pembangunan Daerah Aceh Syariah	2004	2012-2021	10
	Total			130

Source: Financial Services Authority (ojk.co.id)

## Research Variables

Dependent Variable: ROA

Measurement of bank's financial performance used ROA which is calculated by the ratio of net income to total assets.

**Independent Variables: NPF, CAR, Disclosure of ICG and ICSR of Islamic banks.**

NPF is calculated by the non-performing financing ratio of all bank financing, and CAR is calculated by the bank's capital to risk-weighted asset value. Hidayat and Abdulrahman (2014), Syamni et al. (2018), and Abdallah and Bahloul (2021) agree on using the disclosure index as a way to meet AAOIFI and IFSB compliance standards. The assessment of each item is coded as (1) if disclosed, (0) if not disclosed. Disclosure compliance index is calculated as the number of disclosures disclosed by the bank with the total number of disclosures that apply. Syamni et al. (2018) developed the ICG index based on IFSB guidelines and several developments in subsequent studies conducted by Darmadi (2013) and Grassa and Matoussi (2014). The ICG Disclosure Index consists of Shariah Governance and General Governance sub-sections with a total of 57 disclosures. Meanwhile, the ICSR disclosure index in this study adopted the Islamic Social Reporting (ISR) model developed by Haniffa (2002) and Othman and Thani (2010), based on AAOIFI standard guidelines. The ICSR Disclosure Index consists of sub-sections including Finance & Investment, Products, Employees, Society and the Environment with a total of 38 disclosures.

**Control Variables: Size and Age**

This study considers the control variables, namely the size and age of the bank. Bank size is calculated using the natural logarithm of the total assets of Islamic banks (Grassa, 2018). Meanwhile, bank age is measured by the number of years of the company's bank establishment (Grassa, 2018).

The research variables are summarized in Table 2

Table 2. Variables Identification

Variable Type	Variable Name	Symbol	Definition
Dependent Variable	Return On Assets	ROA	Net profit to total assets
Independent Variable	Non Performing Financing	NPF	Non-performing financing of all bank-distributed financing
	Capital Adequacy Ratio	CAR	Bank capital to total Risk Weighted Asset
	Islamic Corporate Governance	ICG	ICG Disclosure of all disclosures
	Islamic Corporate Social Responsibility	ICSR	Disclosure of ICSR for all disclosures
Control Variables	Bank Size	SIZE	Natural Logarithm of Total Assets
	Bank Age	AGE	Number of Years

### Empirical Models

The regression equation formed below:

$$ROA_{it} = \beta_0 + \beta_1 NPF_{it} + \beta_2 CAR_{it} + \beta_3 ICG_{it} + \beta_4 ICSR_{it} + \beta_5 SIZE_{it} + \beta_6 AGE_{it} + \varepsilon_{it}$$

Notes:

ROA<sub>it</sub> = Financial Performance (Independent Variable)

NPF<sub>it</sub> = Financing Risk (Independent Variable)

CAR<sub>it</sub> = Capital Adequacy (Independent Variable)

ICG<sub>it</sub> = Islamic Governance of Islamic Banks (Independent Variable)

ICSR<sub>it</sub> = Islamic Social Responsibility of Islamic Banks (Independent Variable)

SIZE<sub>it</sub> = Bank Size (Control Variable)

AGE<sub>it</sub> = Bank Age (Control Variable)

## RESULTS AND DISCUSSION

### Description of Statistics

Table 3 reports descriptive statistics for a research sample of 14 Islamic commercial banks in Indonesia from 2012 to 2021 with a total of 130 research data. The average value of ROA shows 1.13. The maximum and minimum ROA values are 13.58 and -20.13. This shows that the ROA value data range is quite large, which means that the value is far from the average value. The average values of the variables NPF, CAR, ICG and ICSR respectively show 3.93, 30.50, 69.53 and 62.85, respectively. The maximum values of NPF, CAR, ICG and ICSR are 43.99, 390.5, 80.7 and 78.95, respectively. Furthermore, the minimum values of NPF, CAR, ICG and ICSR are 0, 11.1, 59.65 and 36.84, respectively. Meanwhile, the control variables Size and Age have an average value of 9.24 and 13.26, respectively. The maximum values of Size and Age are, respectively, 11.75 and 57 while the minimum values of Size and Age are, respectively, 6.5 and 0. This indicates that there was an Islamic bank established in 2012.

Table 3. Statistical Description

	N	Minimum	Maximum	Means	std. Dev
ROA	130	-20.13	13.58	1.13	3.98
NPF	130	0	43.99	3.93	5.47
CAR	130	11.1	390.5	30.50	48.4
ICG	130	59.65	80.7	69.53	5.33
ICSR	130	36.84	78.95	62.85	10.73
SIZE	130	6.5	11.75	9.24	1.21
AGE	130	0	57	13.26	12.79
Valid N (listwise)	130				

Source: Secondary data processed by the author

### Classical Assumption Test Results

Data analysis of this study is through the classical assumption test. Based on the classic assumption test results which include normality tests, multicollinearity, heteroscedasticity, and

autocorrelation, the data have been released and meets the best linear unbiased estimation (BLUE). The data are normal because they have a value of  $\alpha = 0.054$  and do not have multicollinearity because the VIF value is below 10. The data are also free from heteroscedasticity because the  $\alpha$  of each variable is above 0.05, and the data are not autocorrelated because they have a value of 2.353 which is in the range 1.6508 and 1.7774

### Correlation Analysis

This study uses partial correlation analysis because it has a more complex research design involving control variables. Solís (2017) states that the control variable must be controlled so as not to confuse the effect of the independent variable on the dependent variable. Table 4 shows that, by controlling for bank size and age, a significant correlation was found between financing risk, capital adequacy and ICG on financial performance or  $\rho > 0.05$ . Meanwhile, there is no significant correlation between ICSR and financial performance or  $\rho < 0.05$ .

Table 4. Partial Correlation Test

Control Variables			Financial Performance	Financing Risk	Capital	ICG	CSR
LNSIZE & LNAGE	Financial performance	Correlation	1000	-0.347	0.320	0.293	-0.021
		Sig.		0	0	0.001	0.81
		Df	0	126	126	126	126
Risk Financing	Risk Financing	Correlation	-0.347	1000	-0.213	-0.257	-0.078
		Sig.	0		0.016	0.003	0.381
		Df	126	0	126	126	126
Capital	Capital	Correlation	0.320	-0.213	1000	0.33	0.168
		Sig.	0	0.016		0	0.058
		Df	126	126	0	126	126
ICG	ICG	Correlation	0.293	-0.257	0.33	1000	0.268
		Sig.	0.001	0.003	0		0.002
		Df	126	126	126	0	126
ICSR	ICSR	Correlation	-0.021	-0.078	0.168	0.268	1000
		Sig.	0.81	0.381	0.058	0.002	
		Df	126	126	126	126	0

Source: Secondary data processed by the author

### Regression Analysis

Table 5 contains the results of running multiple linear regression test data. Based on this, the regression equation of this study is as follows:

$$ROA_{it} = 14.262 - 0.356NPF_{it} + 0.613CAR_{it} + 3.805ICG_{it} - 1.440ICSR_{it} + 1.322SIZE_{it} - 0.220AGE_{it} + \varepsilon_{it}$$

Table 5. Hypothesis Testing

Variable	B	Q	Sig.
(Constant)	14.262	-2.090	0.039
NPF	-0.356	-3.136	0.002
CAR	0.613	2.625	0.010
ICG	3.805	2.111	0.037
ICSR	-1.440	-1.561	0.121
SIZE	1.322	.825	0.380
AGE	-0.220	-1.244	0.216

Source: Secondary data processed by the author

It shows that the variables NPF, CAR, ICG have  $t_{count} > t_{table}$  (1.97838) or  $pvalue < (0.05)$ , which means it has a significant effect on financial performance (LNROA). Meanwhile, the ICSR variable  $t_{count} < t_{table}$  (1.97838) or  $pvalue > (0.05)$ , which means it has no effect on financial performance (ZROA). Furthermore, the control variables, SIZE and AGE, have a  $pvalue > 0.05$ , which shows that the control variable does not affect financial performance.

#### Effect of Financing Risk on Financial Performance

The results of the statistical test shows that the first hypothesis is accepted, which means that financing risk has a significant negative effect on profitability. This result is in line with Reyad et al. (2020), stating that financing risk (NPF) will cause costs to become a burden, causing losses to Islamic banks. Siddique et al. (2022) confirm that an increase in financing problems will reduce the ROA value of Islamic Commercial Banks. In addition, non-performing financing will block operating income, reduce opening up for investment and develop a liquidity crisis which results in bankruptcy problems and a weak economic system (Khan et al., 2020). An increase in the NPF value at Islamic Commercial Banks will disrupt bank operations because banks must reserve a large portion of funds in the form of Allowance for Productive Assets Losses (PPAP) in order to mitigate the impact of the emergence of problem financing. This is stated in the resources-based theory that the company must be a specific organization with special resources. Resource-based theory also suggests that companies must have competitive resources in order to support company performance (Burvill, 2018; Masakure et al., 2005). Low NPF ownership for Islamic Banks is a resource that can improve financial performance, especially ROA. Therefore, Islamic banks must strive to create a minimum NPF since this is a parameter in creating maximum profitability.

### Effect of Capital Adequacy on Financial Performance

Based on the results of statistical tests, capital adequacy has a significant positive effect on ROA and supports the second hypothesis of this research. The results of this study are in line with the argument which states that Islamic banks are responsible for ensuring adequate capital so that they can support bank operations and business development (Indonesian Bankers Association, 2016). Besides that, increasing capital in Islamic commercial banks will support banking operational activities and business development activities through improving products and services so as to optimize the profits generated by banks (Siddique et al., 2022). According to Sukmana (2015), the CAR ratio is useful in managing the risk of loss of productive assets, especially those originating from financing risks. Provision of sufficient capital will increase the reserves of Islamic banks so as to guarantee the continuity of the banking business from potential risks. In addition, capital adequacy will encourage increased public trust because higher capital signals higher guarantees for public funds at banks (Aspal & Dhawan, 2016). Referring to the statement of Resources Based Theory that companies must have competitive resources to support company performance, in this case financial performance is proxied by ROA. Capital adequacy for Islamic banking is very important and this is one of the resources that must be fulfilled by Islamic banks to achieve the best financial performance, especially in creating profitability.

### The Influence of Islamic Corporate Governance on Financial Performance

Multiple regression tests resulted in a significant positive effect on the ICG variable on profitability, which supports the third hypothesis. The results of this study support the stakeholder theory which states that, if the company's goals are in accordance with the interests of the stakeholders, then management will have better capability to create better company performance (Freeman & McVea, 1984). The implementation of sharia management governance will create smooth banking operations that can protect the interests of stakeholders and provide benefits for the company. Yadiat et al. (2017) state that good Islamic bank management governance will have an impact on effective and efficient banking activities so as to encourage the creation of smooth financial conditions and improve financial performance. Stakeholder theory seems to be implemented in this research. The implementation of ICG provides satisfaction for the stakeholders of Islamic banks. Islamic banks with all rules based on Islam are a separate guarantee for stakeholders that their operations reflect Islamic rules. This is supported by the existence of a sharia supervisory board which is the major determinant

in providing advice, reprimands, and reports related to the implementation of sharia rules in Islamic banks. In addition, information disclosure regarding sharia compliance in the governance process can provide value expectations to customers and investors who have a focus on sharia compliance and can become a separate business strategy in banking competition (Alam et al., 2022). Therefore, these conditions can encourage increased investor and customer confidence in Islamic banks, thus encouraging an increase in the number of DPK and also investment by investors, which can provide profits for banks.

### **Effect of Islamic Corporate Social Responsibility on Financial Performance**

The statistical test shows that ICSR has no significant effect on profitability, which means rejecting the fourth hypothesis of this research. The research results do not support the good management theory which states that the implementation of CSR will positively impact financial performance. The results of this study are also in conflict with previous research which supports good management theory, i.e. Yaparto et al. (2013), Magdalena et al. (2017), and Reyad et al. (2020). These studies have had a significant positive effect of implementing ICSR on financial performance.

ICSR findings have no effect on financial performance indicating that Islamic banks have not communicated corporate responsibility properly so that the benefits of CSR cannot be received properly and have not optimally touched the interests of society and interested parties. Yoon and Chung (2018) argue that this is possible because implementing ICSR social performance is expected to provide material returns in the long term so it takes time to achieve financial benefits from investments in customers, communities and activities related to the environment. In addition, ICSR programs are often not performed consistently, and implementation is only limited to fulfilling obligations under regulations to avoid administrative sanctions (Chapagain, 2021). In fact, Asim et al. (2020) stated that disclosure of ICSR is not an obligation for companies and CSR activities are voluntary activities according to the will of the company.

### **Control Variables**

The size and age of Islamic banks are the control variables in this research model which apparently have no effect on ROA. This means that the size of Islamic banks in Indonesia is not a determinant of profitability as has been the case in another research. This shows that the existence of Islamic banking in Indonesia which has been in practice for almost 30 years is not

a guarantee in determining the level of profitability. This condition can be reflected in the market share of Islamic banking, which only touched 7.03% in August 2022, as stated in the OJK report on the Islamic Finance Market Update for the period August 2022 (OJK, 2022). The age variable has a negative relationship with profitability, which means that the longer Islamic banks operate, the lower the profitability, because it is often found that companies that have a high age actually have a lower level of efficiency. This is in line with Ajili and Bouri (2018), Albarrak and El-halaby (2019), and Elgattani (2020) who show no significant effect between bank age and ROA. Meanwhile, the size of Islamic banks in Indonesia as seen from total assets has almost the same value as seen from the low standard deviation value. This indicates that Islamic banking in Indonesia has relatively the same size so that it is less able to show variations in the level of profitability. The results of this study are in line with the findings of Adusei (2011), Elgattani (2020), and Tsapa (2022) that there is no significant effect between bank size and ROA.

## CONCLUSION

This study aims to examine the effect of financing risk, capital adequacy, sharia governance (ICG) and sharia social responsibility (ICSR) on the financial performance of sharia commercial banks in Indonesia. The result showed that financing risk has a significant negative effect on financial performance, but capital adequacy has a significant positive effect on financial performance. Meanwhile, ICG has a significant positive effect on financial performance. In contrast, implementing ICSR has no significant effect on financial performance. This study involved the size and age of the bank as control variables that they did not have a significant effect on financial performance.

The limitation of this study is that variables control, size and age, showed no effect on ROA which is different from previous research. This is likely due to the use of multiple linear regression to analyze this research model, so it is unsuitable for testing as a control variable. For further research, testing the control variable can use path analysis sebagaimana yang dilakukan oleh Altameemi dan Al Slehat (2022). It will give the analysis results are more appropriate in placing the function of size and age of the company as controllers for the determinant variables in ROA.



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