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## Financial Performance Determinant of Islamic Banking in Indonesia

### Abstract

The rapid growth of Islamic banks also occurred in Indonesia. The high growth of Islamic banks' assets gave opportunities to increase bad debt (non-performing financing). We examined the impact of good corporate governance (GCG), number of sharia supervisory board (SSB), financing to deposit ratio (FDR), profit and loss sharing (PLS) financing ratio, profit sharing rate of financing, and temporary *syirkah* fund ratio on the performance of non-performance financing (NPF) and return on assets (ROA). This research also tested the influence of NPF on ROA. The population of this research was Islamic commercial banks in Indonesia with the observation ranged from 2009-2016. The samples were determined by using a purposive sampling method. Data analysis used a structural equation model with WarpPLS. We proved that empirically GCG disclosure did not affect NPF. NPF bank was influenced by PLS financing and temporary *syirkah* fund ratio. PLS financing income and FDR financing did not affect the NPF. Moreover, GCG, SSB, temporary *syirkah* fund, and NPF disclosures influenced profitability

**Keywords:** Corporate Governance; Non-Performing Financing; Profit and Loss Sharing Financing; Risk Financing; Sharia Supervisory Board

**JEL Classification:** G31, G32, G34

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### Abstrak

Pesatnya pertumbuhan bank syariah juga terjadi di Indonesia. Pertumbuhan aset bank syariah yang tinggi memberikan peluang terjadinya peningkatan kredit macet (non-performing financing). Kami menguji pengaruh Good Corporate Governance (GCG), jumlah dewan pengawas syariah (DPS), Financing to Deposit Ratio (FDR), rasio pembiayaan Profit and Loss Sharing (PLS), tingkat pendapatan bagi hasil pembiayaan, dan rasio dana syirkah temporer terhadap kinerja Non Performance Financing (NPF) dan Return On Assets (ROA). Selain itu, penelitian ini juga menguji pengaruh NPF terhadap ROA. Populasi penelitian adalah bank umum syariah di Indonesia dengan tingkat pengamatan dari tahun 2009-2016. Sampel ditentukan dengan metode purposive sampling. Analisis data yang digunakan adalah structural equation model dengan WarpPLS. Kami membuktikan secara empiris bahwa pengungkapan GCG tidak memengaruhi NPF. NPF bank dipengaruhi oleh PLS financing dan syirkah dana temporer ratio. Pendapatan dari pembiayaan PLS dan FDR tidak memengaruhi NPF. Pengungkapan GCG, SSB, dana syirkah temporer dan NPF memengaruhi profitabilitas.

**Kata Kunci:** Tata Kelola Perusahaan; Non-Performing Financing; Pembiayaan Profit and Loss Sharing; Risiko Pembiayaan; Dewan Pengawas Syariah

## Financial Performance Determinant of Islamic Banking in Indonesia

Hasan Mukhibad & Muhammad Khafid

The first Islamic bank was Mit Ghamr Local Savings Bank that was established by Ahmad Al-Najjarin 1963 in *Egypt* (Adib & Khalid, 2010). After that, in the 1970s, Islamic banking industry grew massively in line with oil booming in the Middle East (Adib & Khalid, 2010). Data also show that the global amount of sharia financial institutions' assets was US\$ 80 billion in 2000 and increased to US\$ 1.1 trillion at the end of 2011. The average growth rate during 2000–2007 was 30 percent (Syafii, Sanrego, & Taufiq, 2012). Moreover, based on the data of the International Monetary Fund (October 2009), the gulf countries had developed their Islamic banks' assets as many as 44 percent annually (Matoussi & Grassa, 2012). With this achievement, Islamic banks in the world developed very highly more than conventional banks (Aström, 2012).

The rapid growth of Islamic banks also occurs in Indonesia. The data of Indonesian banks from 2012–2017 show that Islamic banks in Indonesia have assets development as many as 28.42 percents annually, while conventional banks have assets development as many as 11.91 percent. This means that the achieved growth of Islamic banks was higher than the growth of conventional banks.

The high growth of Islamic banks' assets gives opportunities to increase bad debt. Mustafidah & Mukhibad (2018) has shown that in 2012–2017, Islamic banks in Indonesia has continually increased non-performing financing (NPF) ratio. Furthermore, Islamic bank NPF is higher than conventional banks Mustafidah & Mukhibad (2018). Damanhur et al.

(2018) said that the increase of assets of Islamic banks had an impact on increasing loans and subsequently it tends to increase NPF. Credit is the main assets for banks, thus the enhancement of NPF will also have the impact on reduction of the bank revenue (Anggraeni, 2016; Buchory, 2017; Husni & Rahim, 2017; Kusmayadi, Badruzaman, & Firmansyah, 2017). The decrease of bank income could give effect to the bank assets reduction through both decreased capital and fund that the Islamic banks may collect (third party funds). Said & Ali (2016) found that loan to deposit ratio (LDR) did not influence profitability. High NPF may cause high Net Interest Margin (NIM), and in addition it could decrease business continuity (Husni & Rahim, 2017). NPF becomes the Islamic banks' core business (Anggraeni, 2016).

Experts have researched to elaborate on the cause of NPF. Setiawan & Bagaskara (2016) used the growth variables of gross domestic product (GDP), capital adequacy ratio (CAR), operational efficiency ratio, and financing to deposit ratio (FDR) to predict NPF. The research found that GDP growth rate, inflation, and CAR negatively and significantly influenced NPF, and moreover, exchange rate and operational efficiency ratio (OER) positively and significantly influenced NPF. The research findings also showed that there was no relationship between FDR and NPF (Setiawan & Bagaskara, 2016)

Nearly the same variables were also used by Said & Ali, (2016), they used CAR, third party fund ratio, FDR, operation cost operating income (OCOI),

**Table 1.** Assets of Islamic and Conventional Banking at Indonesia 2012–September 2017

Performance Indicators	2012	2013	2014	2015	2016	Sep-17	Average
<b>Islamic bank</b>							
Σ Asset (Billion Rp)	195,018	242,276	272,343	296,262	356,504	395,093	292,916
Asset increase	34.06%	24.23%	12.41%	8.78%	20.33%	10.82%	18.44%
<b>Conventional Bank</b>							
Σ Asset (Billion Rp)	4,262,587	4,954,467	5,615,150	6,095,908	6,729,799	7,150,388	5,801,383
Asset increase	16.69%	16.23%	13.34%	8.56%	10.40%	6.25%	11.91%

Source: Statistics of Islamic Banking (September 2017)

net operating margin (NOM), GDP, inflation, and return on asset (ROA) as variables in their study. The CAR, NPF, FDR, and NOM variables did not influence profitability, while OCOI negatively influenced profitability. In addition, GDP and inflation positively and significantly influenced profitability (Said & Ali, 2016).

Al-Wesabi & Ahmad (2013) and Sukmana (2015) explained that there were two factors that affected NPF, namely internal and external factors. Corporate external variables are GDP, BI Rate, and inflation. This external factor is also called a macroeconomic factor. Macroeconomic conditions will affect the bank's NPF level. So that the government needs to regulate macroeconomic conditions to support the low NPF and NPL (Sukmana, 2015).

While internal variables are used to predict NPF are CAR, NIM, FDR, and third-party fund (TPF) as used by Said & Ali (2016), Setiawan & Bagaskara (2016), Buchory (2017), and Laryea, Ntow-Gyamfi, & Alu, (2017) in their research. Meanwhile, Alandejani & Asutay (2017) and Mustafidah & Mukhibad (2018) used the type of financing and the GCG mechanism in predicting NPF. The novelty of this research is that the researcher used more comprehensive GCG measurement (as a complement to the GCG mechanism). The reason is that poor GCG implementation indicates poor management, bad management causes low credit quality (Karim, Chan, & Hassan, 2010). Moreover, the researcher would develop new variables that were supposed to be able to affect NPF, namely the temporary *syirkah* fund ratio (TSFR) variable. TSFR is a unique funding source and is only owned by sharia entities because it uses a profit-sharing system. The funding structure is one of the factors that cause NPF (Hussain, 2017; Waqas, Fatima, & Khan, 2017). Even Ghosh (2005) considered that the leverage ratio could function as a marker of the quality of assets (credit) owned by a bank.

This study aims to examine the effect of Good Corporate Governance (GCG), the number of

shariah supervisory boards (DPS), Financing to Deposit Ratio (FDR), Profit and Loss Sharing (PLS) financing ratio, the level of revenue sharing, and the ratio of temporary *syirkah* funds on the performance of Non-Performance Financing (NPF) and Return On Assets (ROA). In addition, this study also examined the effect of NPF on ROA.

## HYPOTHESES DEVELOPMENT

GCG is a set of rules which organize the relationship among corporate management, commissioners, shareholders, and other stakeholders (Ghayad, 2008). This arrangement is needed to ensure that a company has fulfilled all stakeholders' interest. This is because the ownership concentration of a company tends to assign a director who is able to fulfill the company controlling owner's interest (Rehman & Mangla, 2010) and may ignore other stakeholders' interest. Hence, it is quite necessary to assign an independent commissioner in order to control the management in ruling the company (Pathan & Faff, 2013) which may positively affect performance (Javed, 2006; Harjoto & Jo, 2011; Heenetigala, 2011).

Arouri, Hossain, & Muttakin (2014) stated that GCG was needed to reduce agency problems, with regard to board of commissioners, debt financing, equity ownership, and company control. The existence of a board of commissioners may increase the effectiveness, and they may control and give a recommendation, which may eventually improve the performance (Arouri, Hossain, & Muttakin, 2014). Some research by Rehman & Mangla (2010), Heenetigala, (2011), and Cheema & Din (2013), revealed that there was a significant relationship between GCG and performance.

In some research, there are lots of models for GCG measurement, such as board size, board independence, board meeting, ownership structure, family ownership, and dual role of CEO (Rehman & Mangla, 2010), GCG disclosure index (Fitrijanti & Alamanda, 2013), GCG self-assessment, and GCG

rating value issued by independent organization. In this research, GCG was measured by using GCG disclosure index used by Fitrijanti & Alamanda (2013). This is because GCG disclosure index measurement covers all of GCG indicators based on Regulation of Bank Indonesia Number 11/33/2009 about the Implementation of Good Corporate Governance for Sharia/Islamic Commercial Bank and Sharia Business Unit. Thus, the following hypothesis may be developed as follows:

H<sub>1</sub>: GCG positively influences profitability

In a broad sense, financial performance means a company's ability to generate economic profitability. In addition to indicators measured from ROA and ROE, the bank's financial performance may be assessed by NPL. In the context of an Islamic bank, NPL is called non-performing financing. Ahmad et al. (2016) proved that corporate governance implementation affected NPL. Furthermore, corporate governance also affected bank risk management (El-Masry et al., 2016). Thus, the following hypothesis may be developed as follows:

H<sub>2</sub>: GCG negatively influences NPF of Islamic bank

In addition to using corporate governance, this researcher, in this study, also conduct sharia supervisory board (SSB) as an independent variable in assessing a bank's performance. The reason for utilizing this variable is that SSB is basically included in bank management. Director may consult SSB related to the bank's performance of compliance with Islamic principles, which basically cannot be separated from bank's commercial performance. SSB ensures that bank has complied with Islamic principles in accordance with what customer's desire. Thus, SSB is like an internal audit within a bank (Mersni & Othman, 2016). Besides, AAOFI wishes that Islamic bank has SSB proficient in sharia finance and sharia law (Mersni & Othman, 2016). Marwan et al. (2016) considered SSB as one that controls and

is influential in the performance and performance stability of Islamic bank.

In relation to some research that correlates SSB to performance, there were differences in the research findings. Matoussi & Grassa (2012) in their research found that there was no significant impact between SSB with bank performance. Meanwhile, Shittu, Ahmad, & Ishak (2016) affirmed that the size of SSB simply influenced bank performance. Based on this explanation, the following hypothesis may be developed as follows:

H<sub>3</sub>: number of sharia supervisory board positively influences profitability of Islamic bank

In the context of an Islamic bank, financing is divided into two types, which are profit-sharing and non-profit sharing (fixed cost) based financing. Profit-sharing financing means financing which uses *mudharabah* and *musyarakah* covenants. Non-profit sharing financing means financing which uses *murabahah*, *istishna*, *salam*, *ijarah*, and *ijarah muntahiyah bittamlik* covenants.

The differences of both types of financing above are the profit-sharing system between customer and bank as well as the risk level. The division of profit sharing between customer and bank is based on profit sharing ratio multiplied with real profit earned by the customer. The primary characteristic of this transaction is that the bank and the customer may receive profit sharing if the customer, in managing the bank's fund, earns a profit. If the customer loses, such loss may be borne by the bank except if the loss is caused by the customer's negligence (Ikatan Akuntan Indonesia, 2017). The difference between both systems can lead to a difference in risk. Profit sharing system has a higher risk than another type of financing (Huda, 2012; Abdulrahman & Nor, 2016). Al-Wesabi & Ahmad (2013) and Anggraeni (2016) found that a high risk enlarged the NPF. However, Alandejani & Asutay (2017) pointed out that Islamic bank's NPF increased in line with increased financing that generates fixed

income higher than profit sharing financing. Therefore, the following hypothesis may be developed as follows:

H<sub>4</sub>: profit sharing financing ratio positively influences NPF of Islamic bank

Financing is distributed in order to earn income. Thus financing that is able to generate high income may result in increased financing as well. However, high income also brings about high financing risk level. High financing income may result in customer's increasing difficulty to return the fund the customer has received, which may eventually increase NPF. Dhar (2015) in his research underlined that net interest margin significantly influenced NPL. Thus, the following hypothesis may be developed as follows:

H<sub>5</sub>: profit sharing income ratio positively influences NPF of Islamic bank

FDR means a ratio to measure the amount of third party's fund collected by an Islamic bank that has been distributed in the form of financing. High FDR ratio indicates the higher amount of third party's fund distributed by the bank. High financing distribution may result in bank's profitability increase. Nevertheless, high financing distribution may also lead to bank's NPF increase. However, Havidz & Setiawan (2015) and Setiawan & Bagaskara (2016) stated that FDR did not influence NPF significantly. Diverse results are found by Anggraeni (2016), in which there was significant influence between risk-taking (measured from financing ratio divided by the amount of assets) with NPF. Said & Ali (2016) in their research mentioned that there was no significant influence between FDR with profitability. The discrepancy of previous research findings to the theory above becomes the basis of conducting further research. Thus, the following two hypotheses may be developed as follows:

H<sub>6</sub>: FDR level positively influences Islamic bank's NPF

H<sub>7</sub>: FDR level positively influences Islamic bank's profitability

The funding structures of an Islamic bank and conventional bank are quite different. In a conventional bank, the funding structure (liability component) consists only of liability and equity, while in Islamic bank there is new additional source, which is temporary *syirkah* fund. Temporary *syirkah* fund means fund received by the bank as an investment and the bank has the right to its management and investment (Ikatan Akuntan Indonesia, 2017). One of the funding sources (saving, deposits, or other products) classified as the temporary *syirkah* fund is a product that uses *mudharabah* and *musyarakah* covenants. *Mudharabah* and *musyarakah* transactions use profit sharing system in distributing the income. Consequently, the benefit or return of these transactions depends on the bank's profit.

Theoretically, when temporary *syirkah* fund increases, there is bank's additional ability in increasing bank financing as well. In addition, the increase of temporary *syirkah* fund demands the bank improve its income. Islamic bank's high income would also provide high profit sharing for saving and deposit. Thus, the following hypothesis may be developed as follows:

H<sub>8</sub>: temporary *syirkah* fund ratio positively influences NPF of Islamic bank

Anggraeni (2016) in her research stated that when leverage is high, the bank may reduce given financing. This is a form of the bank management's precaution in distributing its financing. Decreasing financing may result in decreased NPF. Thus, the following hypothesis may be developed as follows:

H<sub>9</sub>: temporary *syirkah* fund ratio positively influences profitability of Islamic bank

NPF is the ratio used to measure the percentage of bad financing. Bank Indonesia classifies bank's

## Financial Performance Determinant of Islamic Banking in Indonesia

*Hasan Mukhibad & Muhammad Khafid*

collectability into five categories; they are current, special mention, substandard, doubtful, and loss/bad. The types of collectability acknowledged in NPF are substandard, doubtful, and bad. The amount of NPF indicates the amount of non-productive or bad financing. The NPF may reduce cost efficiency (Karim, Chan, & Hassan, 2010), from now on, NPF negatively influences profitability (Said & Ali, 2016). Thus, the following hypothesis may be developed as follows:

H<sub>10</sub>: NPF level negatively influences Islamic bank's profitability performance

### METHODS

The population of this research is Islamic banks in Indonesia that have conducted spin-off with their parent bank. The observation period of the research is six years, from 2009-2016. The samples are determined by using a purposive sampling method.

The variables used in this research are: (1) good corporate governance (GCG), is measured based on disclosure index value in bank GCG report. The index is calculated by using the formula the number of GCG's score divided by maximum score. The formula was adopted from the research conducted by Fitrijanti & Alamanda (2013) and Mukhibad, Kiswanto, & Jayanto (2017); (2) SSB is measured with the number (person) of SSB owned by bank; (3) profit sharing financing ratio measured

from the ratio of *mudharabah* and *musyarakah* financing toward total financing. This measurement was adopted from the researchers conducted by Hameed, et al. (2004) and Kuppusamy, Saleh, & Samudhram (2010); (4) profit sharing income ratio is measured the ratio of *mudharabah* and *musyarakah* income toward total income; (5) financing to deposit ratio (FDR) is measured the ratio of total financing toward the total of third party fund; (6) temporary *syirkah* fund ratio is measured total temporary *syirkah* funds divided total assets; (7) non-performance financing is measured the ratio of bad financing divided total financing; and (8) profitability performance is measured from ROA and ROE.

The data were analyzed by using a structure equation model assisted with WarpPLS program. Acceptance or rejection of the hypotheses is based on the significance value generated from the statistic tool. If the significance value is higher than 10 percent, the hypothesis is rejected.

### RESULTS

The descriptions of variables are as shown in Table 2.

The description of all variables in use (Table 2) shows that the average value of GCG disclosure is 76.76 percent and the SSB value is ranging between 2-3. This is by Bank Indonesia regulation that the number of Dewan Syariah Nasional in Indonesia (National Sharia Board) is maximum three people. FDR ratio has an average value of 76.41 percent,

**Table 2.** Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
GCG	71	0.37	0.97	0.7676	0.13333
SSB	71	2.00	3.00	2.4507	0.50111
FDR	71	0.42	1.23	0.7641	0.12949
TSFR	71	0.03	0.41	0.1719	0.06998
PLSFR	71	0.00	0.80	0.0787	0.14221
PLSRR	71	0.06	0.27	0.1072	0.04123
ROA	71	0.16	2.54	1.0435	0.56102
NPF	71	0.00	0.91	0.3276	0.20730
Valid N (listwise)	71				

and temporary *syirkah* fund ratio is 76.41 percent. The average value of profit-sharing financing ratio is 10.72 percent with profit sharing income ratio as many as 7.87 percent.

Hypothesis testing of the model developed in this study. Hypothesis test result can be displayed in Table 3.

**Table 3.** Hypothesis Test Results

Dependent Variable	Independent Variables	R <sup>2</sup>	β	Sig.
NPF	GCG	0.60	0.08	0.26
	PLS Financing		0.72	<0.01*
	PLS Revenue		-0.01	0.47
	Financing to Deposit Ratio		-0.04	0.36
	Temporary <i>syirkah</i> fund Ratio		-0.19	0.06**
Profitability (ROA and ROE)	GCG	0.45	-0.18	0.07**
	SSB		0.33	<0.01*
	Financing to Deposit Ratio		0.11	0.20
	Temporary <i>syirkah</i> fund Ratio		0.18	0.07**
	NPF		-0.46	0.01*

\* Significant at 5%. \*\* Significant at 10%

**Table 4.** Model Test Results

Model Fit and Quality Indices	Result (Score)	Fit Criteria*	Conclusion
APC	0.228. while p = 0.014	If P score < 0.05	Good
ARS	0.527. while P < 0.001	If P score < 0.05	Good
AARS	0.485. while p < 0.001	If P score < 0.05	Good
AVIF	1.304	Acceptable if <=5. and Ideal <=3	Good
AFVIF	1.610	Acceptable <=5. and Ideal <=3.3	Ideal
R-squared contribution ratio (RSCR)	0.948	Acceptable if >= 0.9.	Acceptable
Statistical suppression ratio (SSR)	1.000	Acceptable if >= 0.7	Acceptable

\* Source: Solimun & Fernandes (2017)

**Table 5.** Hypotheses Acceptance or Rejection

Hypothesis	Decision
H <sub>a1</sub> : GCG positively influences Islamic bank's profitability	H <sub>a1</sub> is accepted (Negatively)
H <sub>a2</sub> : GCG negatively influences Islamic bank's NPF	H <sub>a2</sub> is rejected
H <sub>a3</sub> : number of sharia supervisory board positively influences profitability	H <sub>a3</sub> is accepted
H <sub>4</sub> : profit sharing financing ratio positively influences Islamic bank's NPF	H <sub>4</sub> is accepted
H <sub>5</sub> : profit sharing income ratio positively influences Islamic bank's NPF	H <sub>5</sub> is rejected
H <sub>6</sub> : FDR positively influences Islamic bank's NPF	H <sub>6</sub> is rejected
H <sub>7</sub> : FDR level positively influences Islamic bank's profitability	H <sub>7</sub> is rejected
H <sub>8</sub> : temporary <i>syirkah</i> fund ratio positively influences Islamic bank's NPF	H <sub>8</sub> is accepted (Negatively)
H <sub>9</sub> : temporary <i>syirkah</i> fund ratio positively influences Islamic bank's profitability	H <sub>9</sub> is accepted
H <sub>10</sub> : NPF negatively influences Islamic bank's profitability	H <sub>10</sub> is accepted

A validity test of this model is used to find out whether the tested model is fit. The results of the model validity test can be presented in Table 4.

Table 4 shows that all indicators that measure are valid. It means, the result of model test is good and acceptable and the results of the data processing can be used to answer the hypothesis.

### Hypothesis Test Results

Based on Table 4, it could be concluded the acceptance or rejection of hypothesis in Table 5.

## DISCUSSION

Corporate governance means a set of principles or rules that governs corporate management system. This organizing system is needed for a company to perform beneficially for all of its stakeholders. Implementation of good corporate governance (GCG) may lead to improved quality of financing given by a bank and may result in reduced NPF. Poor GCG indicates poor management and poor management leads to low credit quality (Karim, Chan, & Hassan, 2010). Reduced NPF may lead to improved profit-sharing income from distributed financing and reduce allowance for bad debt.

However, the results of study support the findings of Mustafidah & Mukhibad (2018) who found that GCG did not affect bank's NPF. The indicators used by Mustafidah & Mukhibad (2018) in measuring GCG was based on the GCG mechanism. Vice versa, this research used the index of GCG disclosure. It means that the implementation of GCG as measured by the GCG mechanism and disclosure of GCG did not have an effect on the decline in the bank's NPF.

The results show that GCG has a significant influence on bank's profitability. The results of this study support the results of Rehman & Mangla (2010), Heenetigala (2011), Cheema & Din (2013), and Ahmed (2017) who determined a significant

relationship between GCG and profitability performance. However, if we look at the beta value, the results of the study found a negative beta value. It indicates that the implementation of high GCG causes a low level of bank's profitability. The difference between the findings of this study with Rehman & Mangla (2010), Heenetigala (2011), Cheema & Din (2013), and Ahmed (2017) is that the use of GCG mechanism in measuring GCG, while in this research used GCG disclosure index in measuring GCG. Measurement of variables based on disclosure variables has weaknesses, because good disclosure does not mean that the company has a good GCG implementation as well. The disclosure is more based on the bank's information transparency to stakeholders.

The second indicator that affects performance is SSB. SSB is part of Islamic bank management. The duty of SSB is to ensure the operations bank is accordance with with Islamic principles (Islamic law). In conducting tasks, the supervisory board may supervise and provides consultation service on products or transactions provided by the bank. Bank-owned products are products which are profitable and comply with Islamic principles.

This research results prove that there is significant and positive relationship between number of SSB and profitability performance measured using ROA and ROE. This research results confirm the findings of Mollah & Zaman (2015), Shittu, Ahmad, & Ishak (2016), and Nawaz (2017) that number of SSB influences bank's performance positively. This research results identifies that number of SSB influences bank's ROA achievement. Higher size of SSB more effectively to doing the task as a supervisor and adviser functions, so that approved products are not only in accordance with Islamic principles as well as the market. Subsequent impact is that Islamic bank's profit may increase.

Mollah & Zaman (2015) explained that in reality, SSB not only has a role in monitoring the suitability of bank products and services to Islamic prin-



ciples, but also conducting consulting services and subsequently having an impact on increasing the value of the bank. SSB in carrying out its duties always coordinates with other boards and is always together to improve company performance. SSB is also part of bank management that has the task to improve performance and value for stakeholders.

This research also reveals that there is significant influence of PLS financing ratio on NPF and there is no significant relationship of PLS financing income on NPF. The result means that PLS financing does trigger NPF. PLS financing has a high risk (Abusharbeh, 2014). Profit sharing has a high agency conflict between banks (*shohibul maal*) and customers (*mudharib*). Agency conflict in *mudharabah* transactions due to separation between *mudharib* and *shohibul maal*, in which *shohibul maal* cannot intervene *mudharib* in the managing the *mudharabah* funds. Besides, profit-sharing schemes that depend on the business run by customers increase the possibilities that the capital provided by the bank will not return (Mustafidah & Mukhibad, 2018). *Mudharabah* risk (part of PLS Financing) is also high because *mudharabah* income is fluctuating rather than *musharakah* (Ernawati, 2016). This high risk will potentially promote NPF.

High risk of PLS financing should be anticipated by Islamic bank management by selectively analyzing the financing, thus PLS financing may be provided to appropriate customer. The results of this study are in line with the research of Abusharbeh (2014), Ernawati (2016), and Mustafidah & Mukhibad (2018). This research results are different from the research of Alandejani & Asutay (2017) claimed that the increase of Islamic bank's NPF was caused by the increase of financing that generates fixed income higher than profit-sharing financing.

FDR ratio, statistically, did not have impact significantly on bank's NPF and bank's profitability. Yet, this research result supports Havidz & Setiawan (2015) and Setiawan & Bagaskara (2016).

Banks that have a high FDR indicate that the banks give greater credit. This large loan is due to the amount of funds received from third parties (customers). Large third-party funds cause banks to have demands to obtain greater income so that income or profit sharing is provided by banks to third party fund owners remains competitive. A policy in providing credit largely, demands for competitive profit-sharing has caused banks to be less careful in extending the financing and will subsequently have an impact on increasing NPF. Furthermore, PLS financing that has a high risk requires a more comprehensive feasibility analysis than fixed income financing.

It was argued that FDR does not have an impact on profitability. The results support the result study of Said & Ali (2016) who found no significant relationship between FDR and profitability. The study indicates that the distribution of financing conducted by Islamic banks has not been able to increase bank's profitability. This condition is strengthened by the high NPF of Islamic banks. Bank Indonesia year 2012-2017 shows that Islamic banks in Indonesia have an average NPF of 4.035 percent. This NPF is higher than the average of the conventional bank NPL as many 2.24 percent (Mustafidah & Mukhibad, 2018).

The high of NPF caused by the high of FDR was also supported by other research findings that have empirically proved that the ratio of temporary *syirkah* funds has a negative impact on NPF. The resources of bank funds as temporary *syirkah* funds are deposits, savings and other types of funding using *mudharabah* and *musyarakah* (PLS Funding) contract. *Mudharabah* and *musyarakah* contract have the consequence of not paying a fixed income by banks. The income paid by the bank to consumers depends on the bank's income at a certain period (profit-sharing income). This means that banks are not burdened with fixed costs. As a result, banks in extend of temporary *syirkah* funds are more carefully. This precautionary make the bank has a low NPF.

The results also show that NPF has a negative effect on profitability. High NPF may lead to bank's reduced financing income. Bank income collected from the distribution of profit-sharing and fixed income financing is delayed because customers do not make payments. High NPF may also lead to banks' increased operational costs (accumulated depreciation expense). This research confirms the findings of Karim, Chan, & Hassan (2010) and research of Said & Ali (2016).

## CONCLUSION AND SUGGESTIONS

### Conclusion

The results showed that GCG disclosure does not affect NPF. NPF bank is influenced by PLS financing and temporary *syirkah* fund ratio. PLS income and FDR financing does not affect NPF. This

means that the high NPF is more influenced by the structure of assets and funding owned by banks rather than the condition of bank management. GCG disclosure has a negative influence on profitability. The number of SSBs and temporary *syirkah* funds also affects profitability. Furthermore, NPF has a negative influence on profitability.

### Suggestions

The weakness of this research is the use of GCG disclosure index as a variable in measuring the effectiveness of GCG. Large disclosures do not reflect that the bank has implemented GCG properly. It is suggested for next researcher use more comprehensive and operational measurements in measuring GCG implementation.

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## Financial Performance Determinant of Islamic Banking in Indonesia

Hasan Mukhibad & Muhammad Khafid

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