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Factors Affecting Indonesian Sharia Commercial Bank Financial Performance

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Abstract

Purpose: *This research aims at analyzing the effect of Fund from Third Party (FTP), Non-Performing Financing (NPF), and Financing to Deposit Ratio (FDR) both partially and simultaneously on Bank Profitability of the Indonesia Sharia Commercial Banks during the 2013-2017 periods.*

Design/methodology/approach: *This research employs quantitative method by involving Sharia Commercial Banks listed on the Financial Services Authority of Indonesia (OJK, Otoritas Jasa Keuangan) as the population. The sample was selected using purposive sampling method resulted in 11 banks. The data were analyzed using multiple regression analysis with a 5% level of significance with a classical assumption test.*

Findings: *The findings revealed that (1) Partially FTP and FDR had an insignificant positive influence on bank profitability, and NPF had a significant negative influence on bank profitability in Sharia Commercial Banks listed on OJK and (2) FTP, NPF, and FDR simultaneously had a significant influence on bank profitability in Sharia Commercial Banks listed on OJK.*

Research limitations/implications: *The factors studied are limited to internal financial factors*

Practical implications: *Bank managers should not use third party funds for investment assets or other expenses.*

Originality/value: *Financial performance of Indonesian Islamic banks*

Keywords*: Fund from Third Party, Non-Performing Financing, Financing to Deposit Ratio, Bank Profitability*

i. INTRODUCTION

Financial institutions, especially banks, have a vital role in the economy of a country. In specific, as business entities. One of a financial institution having significant role is Islamic banking, which has been widely spread in the global era (Antonio, Sanrego, & Taufiq, 2012; M.Moshin Hafeez, 2018). Since the financial crisis, the economy has been increasingly moving towards a more accountable and fairer world of finance. Based on Islamic transaction ethics and law, Islamic finance is part of this movement while putting the actual economy at the heart of the system. To compete with conventional finance, financial sharia faces challenges that are comparable to conventional financial performance (A.Mallum, 2016; Nadia, Sonia, & Jaleleddine, 2014). Various studies have recorded that Islamic banks' financial performance is better than conventional banks (Alharbi, 2016; Elsiefy, 2013; Fayed, 2013; Hadriche, 2015; Ibrahim, 2015; Islam & Ashrafuzzaman, 2016; Milhem & Istaiteyeh, 2015; Moin, 2013; Onakoya & Onakoya, 2013;Rozzani & Rahman, 2013; Usman & Khan, 2012).

Islamic banking is definitely able to show its resilience in facing the crisis of global financial and initially developed as a response from a group of economists and Muslim banking practitioners who attempt to accommodate the demands financial transaction services to be in line with Islamic moral values and principles (Razak & Amin, 2016). In addition to purely sharia-based banks, there are also many conventional banks issuing sharia-based financial products (Antonio et al., 2012; Arshed, Riaz, Khan, & Aziz, 2017; Nadia et al., 2014; Singh & Yadav, 2013). In its rapid development, Islamic banking has great potential and opportunities as a source of financing for economic results.

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The development of Islamic banks in Indonesia began in 1990. Indonesian Islamic banks have not shown a good enough performance. Therefore, good financial performance is a vital requirement that must be achieved by Islamic banking reflected in the financial statements (Wanke, Kabir Hassan, & Gavião, 2017), from which the soundness of a bank can be seen.

Profit growth in Islamic banking can be supported in terms of various factors including capital and fund management with how many Islamic banks can raise public funds in the form of Fund from Third Party (Yanti, Arfan, & Basri, 2018). In this case, the banks are obliged to prepare strategies for the use of funds collected in accordance with the allocation plan based on the policies outlined in order to achieve sufficient levels of profitability with a low level of risk (Buchory, 2017).

Factors affecting the soundness of Islamic banks seen from productive assets quality are Non-Performing Financing (NPF) and Financing to Deposit Ratio. Higher FDR means more funds channeled to third parties. The bank's income (Return on Assets) will increase with the distribution of large Third-Party funds, so FDR has a positive effect on bank profitability (Buchory, 2017). The ratio can be used as a benchmark for Islamic banks in making decisions regarding financing, whether Islamic banks can expand financing or not and become a factor that determines the size of the level of profit earned.

ii. LITERATURE REVIEW AND HYPOTHESIS FORMULATION

2.1 Fund from Third Party and Bank Profitability

Every business owned has the main purpose of benefiting from business activities. The profit is the difference between the incomes earned from the business activities, minus all the expenses. The profits obtained are not only used to finance the daily business activities of a company but can also be used to expand the company in order to increase company profits in the future. To help realizing the goals of the company in developing its business activities in the future, each business entity requires financial services in carrying out its operations. One business entity that provides financial services is a company engaged in banking or better known as a bank (Setyawati, Suroso, Suryanto, & Nurjannah, 2017).

In addition, Muhamad (2017) affirms that Islamic banks are operating without relying on interest. In meaning that Islamic banks are operating like conventional banks, but the difference is on the principles used in carrying out its operations, where Islamic banks use sharia principles based on Islamic law (Anthony Mariadas & Murthy, 2017). Based on that notion, generally Islamic banking has the same objectives as conventional banks. Moreover, having the same purpose with conventional banks, Islamic banks also have a function in collecting public's funds and then channeling it back (intermediary function). As an intermediary financial institution, Islamic banks are required to meet the criteria of demand, brand image, and market share in the creation of their businesses (Tauseef et al., 2018). Therefore, Islamic banks should build the people's trust their existence will benefit the general public, so it must be managed on the basis of a strong vision to empower the people's economy. For that a broad that has the same view of risk, prudence must the bank and wealth so as to encourage the board to function effectively and in the end will increase bank profitability (Oleksandr Talavera et al, 2018).

The soundness of a bank can be seen from the financial ratios in the financial statement (Daoud & Kammoun, 2017). Factors to be considered in the assessment of the soundness of banks in general and Islamic banks in particular are quality of productive assets, capital, profitability, management, and liquidity. The fifth focus of this assessment is often referred to as the abbreviation CAMEL (Capital, Asset, Management, Earnings, and Liquidity). The first aspect of soundness assessment is in terms of profitability. Profitability is a significant aspect in the survival of a business entity, especially banking. Even though Islamic banks do not apply the principle of interest, they are expected to generate optimal profits from the results of their ongoing operations. The good and bad profitability of an Islamic bank is seen from the ratios of profitability being produced. The profitability ratio shows the level of effectiveness achieved through the bank's operational efforts on its ability to generate profits (Yusuf & Surjaatmadja, 2018).

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Profit achievement is a dominant indicator because the result of business operations always leads to pre-tax profit. Since profit before tax is a rupiah value, and each business entity is different in for the capital, the amount of profit before tax cannot show profit performance, thus other indicators need to be used, one of which is total assets. In terms of capital and management, Fund from Third Party have significant role, since the capital of Islamic banks comes from their own capital and deposits from other parties. In addition, Fund from Third Party are an important aspect in the management of funds of an Islamic bank (Sumachdar & Hasbi, 2011). Fund from Third Party collected from the public are the most reliable funds source by banks (reaching 80% - 90% of all funds managed by banks). Considering this, the Fund from Third Party of Islamic banks and conventional banks have the same source of fund, which are base on current accounts, deposits, and savings.

After the Third-Party Fund has been collected, then as the intermediary financial function, the bank is obliged to channel the funds in the form of financing. In this case, the bank must prepare a strategy for using funds collected in accordance with the allocation plan based on the policies outlined in order to achieve sufficient levels of profitability with a low level of risk. Arrangement of allocation of funds from appropriate third parties with little risk will have an impact on liquidity that is not too high which will ultimately result in high profitability (Vuong Thao Tran et al, 2016). This is in accordance with the results of Sumachdar and Hasbi (2011), our hypothesis is that Fund from Third Party had a significantly positive effect on bank profitability.

H_1 : Fund from Third Party has a significant positive effect on bank profitability

2.2 Non Performing Financing and Bank Profitability

One factor affecting the soundness of Islamic banks seen from productive assets quality is Non-Performing Financing (NPF), or in conventional banks known as Non-Performing Loans (NPL). Non-Performing Financing (NPF) is the ratio used for problematic financing in an Islamic bank. The problematic financing referred to financing with substandard, doubtful, and congested quality (Al-tamimi, 2010). The bank's management ability to arrange troubled financing is analyzed from the Non-Performing Financing ratio generated by Islamic banks. In line with the Bank Indonesia's regulation, the best ratio for Non-Performing Financing (NPF) is below 5%. This means that the maximum limit of the ratio is 5%. One of the impacts of an unnatural Non-Performing Financing (NPF) ratio is missing the opportunity to obtain income from the provided finance, which resulted in reduced profitability and disturbing bank's profitability. This problematic financing will have an impact on the durability of the company, including its liquidity, profitability, reliability, bank soundness, and working capital. The effect of NPF on profitability is in line with the research findings conducted by (Sutrisno, 2016) showing that NPF had a significant negative effect on bank profitability, whereas according to (Al-Tamimi, 2010), NPF has no significant effect on bank profitability.

H_2 : Non Performing Financing (NPF) has no significant effect on bank profitability

2.3 Financing to Debt Ratio and Bank Profitability

Meanwhile, the third aspect of evaluation in assessing the bank's soundness is liquidity represented by Financing to Debt ratio (FDR). Liquidity is the bank's management ability to provide sufficient funds to fulfill their obligations at any time. The above obligations include unpredictable withdrawals such as commitment loans and other unexpected withdrawals. FDR is a comparison or ratio of Fund from Third Party (FTP) that have been collected (implementation of the intermediary function of raising funds) to fund distribution in the form of financing (Yanti et al., 2018). As the bank's key activity, funding has become the main source of income. Compared to deposits or community savings in bank, larger funds distribution in the form of financing may result in a greater risk. Higher FDR means higher funds channeled to third parties. A higher ratio leads to lower liquidity ability of the bank because the amount of funding needed for financial activities increases (a bank lends all its funds (loan up) or is relatively illiquid). Conversely, lower FDR means the lack of bank effectiveness in channeling financing.

H_3 : Financing to Debt Ratio had significant effect on bank profitability

iii. RESEARCH METHODOLOGY

3.1 Research Design

In this research, the Fund from Third Party (FTP), Non Performance Financial (NPF), and Financial Debt Ratio (FDR) are the independent variables, and the dependent variable is represented by bank profitability. The subjects of this research are Sharia Commercial Bank companies listed on Financial Services Authority (OJK) in the 2013-2017 periods. Research data sourced from secondary data relating to the latest financial condition of all banks.The direction and strength of the relationship between the independent variables and the dependent variable are depicted in figure below:

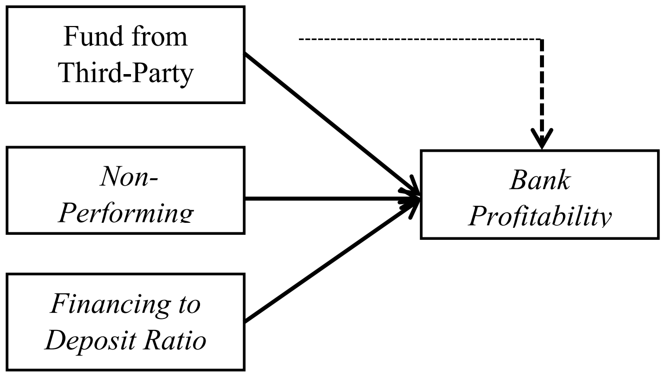

Figure 1. Research Model

Based on the above sampling method, samples in this research were 14 Islamic Commercial Banks during the 2013-2017 periods. Data analyzed by classical assumption, and the hypothesis tested using multiple regression and coefficient of determination.

1.2 Operational Definition and Measurement

There are 4 (four) variables used in this study and they are Fund from Third Party (FTP), Non-Performing Financing (NPF), Financing To Debt Ratio (FDR) and Bank Profitability. According to Bank Indonesia Regulation Number 6/21 / PBI / 2004, Bank Third Party Funds, here in after referred to as DPK, are bank obligations to residents and non-residents in rupiah and foreign currencies.

According to the Financial Services Authority Circular Letter Number 18 / SEOJK.03 / 2015:

1. Non Performing Financing or problematic financing is financing with substandard, doubtful, and bad quality.
2. Financing to Deposit Ratio is the ratio between the financing provided and the total Third Party Funds.
3. Bank profitability determined by return on assets. Return on Assets (ROA) is a ratio that assesses how the rate of return of assets owned."

1.3 Data Analysis

Data analyzed by classical assumption, and the hypothesis tested using multiple regression and coefficient of determination.

iv. FINDINGS

Fund from Third Party that had been successfully collected from the public by Sharia Commercial Banks listed on OJK in 2013-2017 periods showed an increasing development from year to year. This shows that public trust in sharia commercial banks was increasing. The funds development sets are depicted in the graph below:

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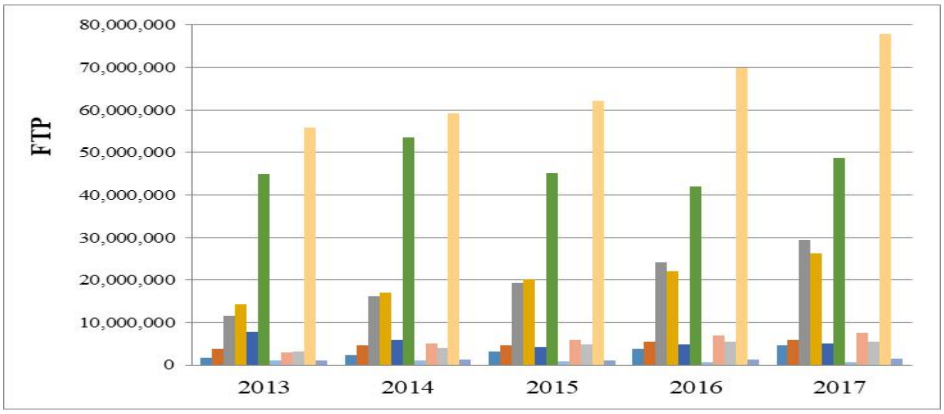

Figure 2: Total of Fund from Third Party (FTP) of Islamic Commercial Banks in the 2013-2017 periods

Figure 2 above illustrates that the development of Fund from Third Party in Islamic Commercial Banks increased every year as a whole for five periods. In addition, the FTP growth was currently very good at the level of 20.54% year on year. The composition of Islamic banking FTP was still dominated by deposits (60.30%), savings (28.61%), and current account savings (11.09%) with a total of 20 million. FTP accounts held by Islamic Commercial Banks. NPF data also increased, which was influenced by internal and external factors of Islamic banks. Increasing bad credit can be due to circumstances beyond customer control, or it can also be due to the small size of sharia banking, which can be affected as a whole if the customers drop.

The above table and explanation show that the average total of NPF in Sharia Commercial Banks listed on OJK in 2013-2017 periods can be illustrated as follows:

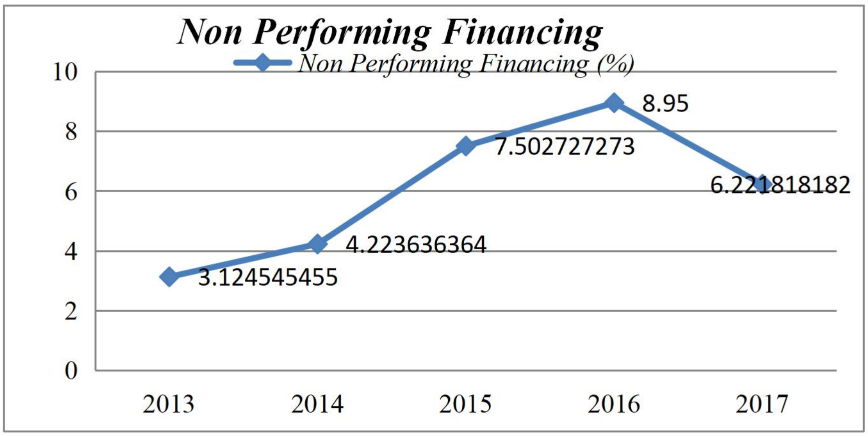

Figure 3: Total Average of the Non-Performing Financing (NPF) of Islamic Commercial Banks in the 2013-2017 period

The high NPF caused by macroeconomic factors that stagnated at 5% growth and depressed the real sector. Figure 3 depicts that the percentage of NPF numbers with unsafe conditions increased significantly in 2014 compared to 2013, and decreased in 2016. Therefore, Islamic banking can be said to experience bad financing conditions in the 2014 to 2017 period. The average total of Financing to Deposit Ratio (FDR) in Sharia Commercial Banks listed on OJK in 2013-2017 periods are presented in the following graph:

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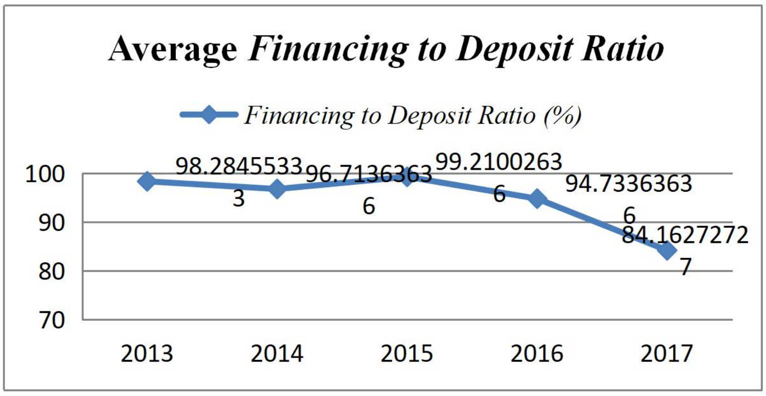

Figure 4: Average FDR of Islamic Commercial Banks in 2013-2017 period

Figure 4 depicts that the percentage of Islamic banks that had FDR values in safe conditions increased over the last five periods. In 2013 and 2014 periods, banks that had FDR values with safe conditions were as much as 36%, then increased in 2015 and 2016 to 55%, and again increased sharply to 91% in 2017. Based on the table and explanation in the above graph, the average total bank profitability in Sharia Commercial Banks listed on OJK in the 2013-2017 periods is as follows:

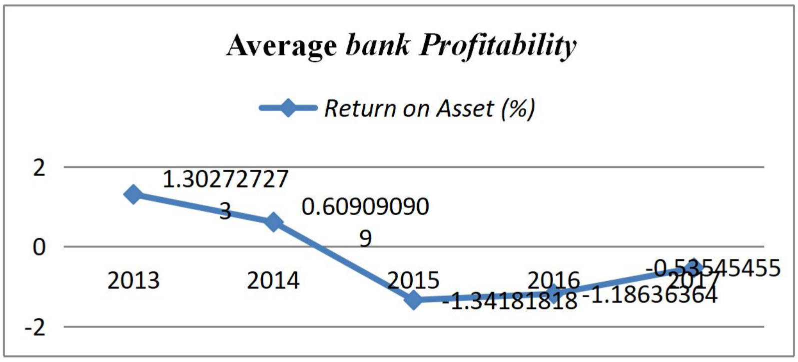

Figure 5: Average Bank Profitability of Islamic Commercial Banks in 2013-2017 Periods

Figure 5 depicts that the development of bank profitability in Islamic Commercial Banks decreased every year and increased in 2017 even though the increase was still below the reasonable limit. Based on the data above, Indonesian Islamic banks are generally categorized as unhealthy banks in terms of the profitability they obtain. Therefore, the Financial Services Authority recommends that there is additional capital to fix bad loans. Below are the multiple linear regression analysis results:

Table 1 :Results of Multiple Linear Regression Analysis

Model		B	Std. Error
1	(Constant)	-0.00003780	.093
	FTP	.171	.118
	NPF	-.751	.099
	FDR	.168	.118

The analysis from resulted in the following equation:

Y = -0.0000378 + 0.171 FTP–0.751 NPF + 0.168 FDR

The results of processing data from testing Pearson Product Moment correlation analysis are as follows:

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Table 2 : Results of Multiple Correlation Analysis

		DPK	NPF	FDR	ROA
FTP	Pearson Correlation	1	.111	-.558**	-.006
	Sig. (2-tailed)		.420	.000	.966
	N	55	55	55	55
NPF	Pearson Correlation	.111	1	.116	-.713**
	Sig. (2-tailed)	.420		.399	.000
	N	55	55	55	55
FDR	Pearson Correlation	-.558**	.116	1	-.015
	Sig. (2-tailed)	.000	.399		.915
	N	55	55	55	55
ROA	Pearson Correlation	-.006	-.713**	-.015	1
	Sig. (2-tailed)	.966	.000	.915	
	N	55	55	55	55

The relationship level among variables from the testing results of the correlation analysis above is presented in the following table:

Table 3: Interpretation Results from Correlation Tests

Variable X	Correlation coefficient	Coefficient Interval	Relationship Level
FTP	-0.006	0.40-0.599	Very Low
NPF	-0.713	0.60-0.799	Strong
FDR	-0.015	0.00-0.199	Very Low

Table 3 above presents that the relationship between Funds from Third Party with Bank profitability was moderate and had a negative correlation coefficient, indicating that any increase in deposits would be accompanied by decreasing bank profitability. Meanwhile, the relationship between Non-Performing Financing and profitability was strong and had a negative coefficient value indicating that any increase in NPF would be followed by a decrease in bank profitability. The relationship of Financing to Deposit Ratio with Bank profitability was very low, and it had a negative coefficient value, which means that any increase in FDR would be accompanied by a decrease in bank profitability. The testing result the coefficient of determination is as follows:

Table 4 : Determination Coefficient Analysis Results

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.729a	.532	.504	.6919549

Below is the F-test statistical analysis result:

Table 5: F-Statistics Test Results

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	27.729	3	9.243	19.304	.000b
	Residual	24.419	51	.479		

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Total	52.148	54

The testing results of the two variables indicate that the t count value was 1.450 with significance value of 0.153. Since the t count value is positive and the significance value> significance level (0.153> 0.050), it can be inferred that the first hypothesis was accepted, and the results of this research indicated that Fund from Third Party had a positive and insignificant effect on bank profitability. The significance shows that FTP did not have a profound effect on Bank profitability, while positive values indicated that on the object of this research, higher FTP value accompanied higher bank profitability produced. When the value of FTP rises, the Islamic Commercial Banks' ability to generate profits would also increase, although not significantly. This might happen because the increase in Fund from Third Party was not always accompanied by effective financing distribution of the Islamic bank. The findings of this research were not in line with the proposed research hypothesis that Fund from Third Party partially had a positive and significant effect on Bank profitability in the Sharia Public Bank listed on OJK. The effect of FTP on profitability caused by the allocation of funds collected by banks has not been fully optimized to generate profit for banks, which results in the deposition of funds. From the data obtained, the allocation of funds collected from the public is not only used for lending that can generate profits for banks, but also for adding assets to companies and investing in securities. In other words, the allocation of third party funds collected by banks has not yet been fully optimized to produce profits for banks, which results in the deposition of funds.This is contrary to what was said by Vuong Thao et al (2016), Muhammad Said (2016), Didik R (2018) and Sumachdar & Hasbi (2011). These results are consistent with research by Irma (2015), Hardeep (2019), Victor Curtis (2013) and Hermuningsih (2019)

The second hypothesis testing was done on the Non-Performing Financing and Bank profitability variables. The testing results of the two variables indicated that the t count value was 1.422 with a significance value of 0.161. Since the value of t count was negative and the significance value > significance level (0,000> 0.050), it can be inferred that the first hypothesis was rejected. The findings of this study indicated that NPF had a negative and significant effect on Bank profitability. The significance shows that the NPF had a profound effect on Bank profitability, while the negative value indicated that on the object of this research the higher the NPF value, the lower the profit that can be generated by Islamic Commercial Banks as seen from the low bank profitability. One of the impacts of a problematic NPF is the opportunities loss to obtain income from financing, which resulted in reduced profitability and affecting bank profitability. Meanwhile, this problematic financing would have an impact on the durability of the company, including liquidity, profitability, bank soundness level, and working capital. However, the findings of this research are in accordance with the proposed research hypothesis, namely NPF partially had a significant positive effect on Bank profitability in Sharia Commercial Banks listed on OJK. These results are consistent with Irma (2015), but Muhammad said (2016) and Wahyu Intan (2019) said that Non Performing Financial not effect on bank profitability.

The testing result of the third hypothesis that has been done in this study stated that the variable FDR partially had a significant positive effect on bank profitability. The testing results the two variables indicated that the value of t count was 1.450 with a significance value of 0.153 with the value of t count was positive and the significance value > significance level (0.161> 0.050). The significance here showed that FDR did not have a profound effect on Bank profitability, while positive values indicated that on the object of this study the higher the FDR value the higher the bank profitability produced. When the FDR value rises, the ability of the Islamic Commercial Bank to generate profits would also increase, although not significantly. This might happen because the increase in financing carried out by Islamic banks was overshadowed by the risk of non-performing financing that would increase. Furthermore, the findings of this study were not in accordance with the proposed research hypothesis stating that FDR partially has a positive and significant effect on bank profitability in Sharia Commercial Banks listed on OJK. FDR had a positive effect, although very low (not significant) on Bank profitability. Therefore, the high funding made by banks did not necessarily increase bank profits because the high level of financing was still overshadowed by the possibility of a

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high level of bad financing. These results are consistent with research by Didik R (2018) and Irma (2015), but contrary to Muhammad Said (2016), Abu Hanifa (2016) and Nicolae (2015).

The results of the tests above showed that together Funds from Third Party, Non-Performing Financing, and Financing to Deposit Ratio had a significant effect on Bank profitability. Moreover, the significance value of the regression model simultaneously at 0.000 was smaller than the significant level of 0.05%, namely 0.000 <0.05, hence, it can inferred that simultaneously the variables of Funds from Third Party, Non-Performing Financing, and Financing to Debt Ratio had a significant effect on Bank Profitability. Funds from Third Party, Non Performing Financing, and Financing Deposits Ratio had an influence on Bank Profitability by 53.2%, while the remaining 46.8% was influenced by other variables not included in this research. In other words, together the value of Funds from Third Party, Non-Performing Financing, and Financing to Deposit Ratio influenced Islamic banks in earning profits.

v. DISCUSSION AND CONCLUSION

Fund from Third Party and Financing to Debt Ratio had an insignificant positive effect on bank profitability in Sharia Commercial Banks listed on Financial Services Authority in 2013-2017 periods. Non-Performing Financing had a significant negative effect on bank profitability. Fund from Third Party, Non-Performing Financing, and Financing to Debt Ratio had a significant effect on bank profitability in Sharia Commercial Banks listed on Financial Services Authority in 2013-2017 periods. Therefore, if there is an increase in FTP, NPF, and FDR, bank profitability will also increase, and vice versa. In addition, if there is a decrease in FTP, NPF, and FDR, bank profitability will also decrease.

The results of this study recommend that the management of third-party funds should be further optimized to generate profits by effective lending to other parties. Bank managers should not use third party funds for investment assets or other expenses.

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