Financial Performance and Profitability Of Islamic Banking On Economic Growth In Indonesia

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ABSTRACT: *Since the enactment of the law No. 21 of 2008 concerning Sharia Banking, the development of the Islamic banking industry in Indonesia increasingly and has an adequate legal basis so that it will encourage growth faster. Recorded total assets of Sharia Commercial Banks and Sharia Business Units continue to increase every year. With the progress of the increasing development, it is expected that the role of the Islamic banking industry in supporting the national economy will be increasingly significant.*

The purpose of this study is to analyze the effect of Islamic banking financial performance on economic growth in Indonesia through mediation of profitability. The data which is used to measure Islamic financial performance are Capital Adequacy Ratio (CAR), Non Performing Financing (NPF), Financing to Deposit Ratio (FDR), and Operational Costs to Operating Income (BOPO). While the profitability of Islamic banking use data Return On Assets (ROA). The data sourced from Islamic banking financial reports and Indonesian economic growth reports during the 2005 – 2018 periods. This research method uses Path Analyze.

The result shows that partially, CAR, NPF, FDR, and BOPO give a negative and not significant direct effect on ROA. But ROA has a posiive and significant direct effect on economic growth in Indonesia.

KEYWORDS: Financial Performance, Islamic Banks, Profitability, and Economic Growth

I. INTRODUCTION

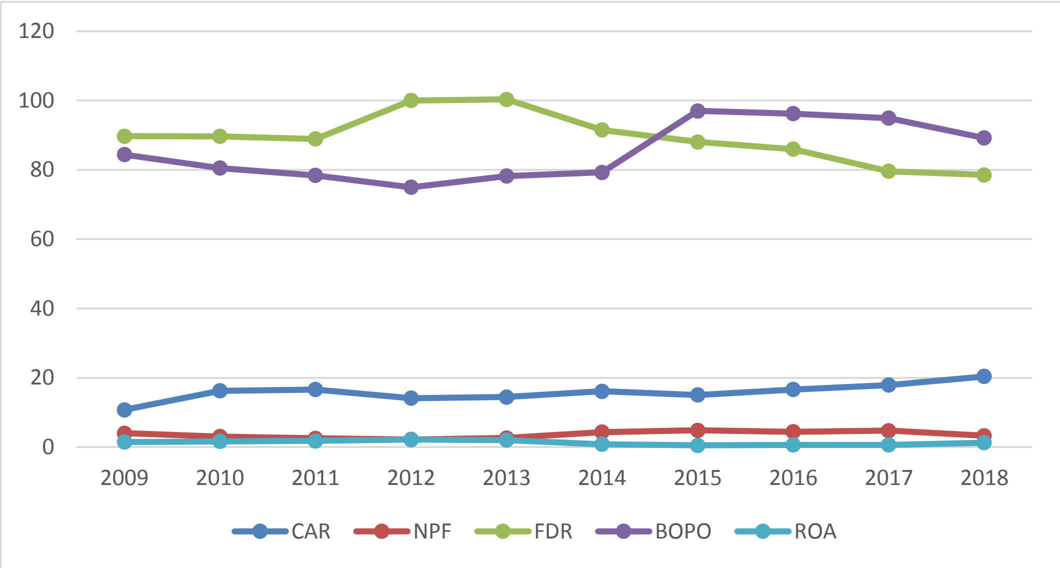
In Schumpeter's opinion (1911), entrepreneurship and banking are two key sources of economic development. Bankers provide loans to the most productive entrepreneurs so that they play a role that can encourage growth. The role of large banks often makes the banking world one of the factors seen in measuring the economic capacity of a country. The development of bank functions that run from year to year makes the banking world grow and has an increasingly significant influence on the national economy. In addition, the number of banks also increased along with the large banking market share. In Indonesia itself, the bank's financial institution system is divided into two types, namely conventional bank systems and sharia banks consisting of Sharia Commercial Banks and Sharia Business Units.

Based on the Islamic Finance Country Index (IFCI) issued by the Global Islamic Financial Report in 2017, Indonesia ranks seventh with a score of 23.98 after Malaysia, Iran, Saudi Arabia, United Arab Emirates, Kuwait, and Pakistan (www.gifr.net, 2019). This means that Indonesia has potential and conducive in the development of the Islamic finance industry. Islamic banks can mitigate financial exclusion and bring financial service to a wider population. This can also promote better strategies for poverty alleviation (Rabaa & Younes, 2016).

The development of the Islamic banking system in Indonesia is carried out within the framework of a dual-banking system or a dual banking system within the framework of the Indonesian Banking Architecture (API), to present an increasingly comprehensive alternative banking services to the Indonesian people (ojk.go.id, 2019). Not only Islamic banking, but also the Islamic non-bank financial industry has developed. For example, Islamic insurance, Islamic pension funds, Islamic finance companies, Islamic bonds (sukuk), Islamic mutual funds, and other Islamic capital market activities.

By sector, the global Islamic finance industry is currently still dominated by the Islamic banking sector with total assets reaching US $ 1.6 trillion or 72% of the total assets of the global Islamic finance industry. The second largest contribution to the Islamic finance industry is in the sukuk sector with a proportion of 16% or US $ 0.34 trillion. Positive developments in Islamic banking are also indicated by several key indicators of Islamic banking, among others, improvement in the condition of Islamic bank capital, improving the quality of financing channeled and improving the level of efficiency and liquidity of Islamic banking (ojk.go.id, 2019).

The development trend of the ratio of Islamic banking financial performance and profitability of Islamic banking in the last ten years can be seen from the following figure:



Source : (ojk.go.id, 2019)

Figure 1. Trends of CAR, NPF, FDR, BOPO and ROA Ratios of Islamic Banking in Indonesia, 2009 – 2018

Improved capital of Islamic banking is reflected in the value of the 2018 Capital Adequacy Ratio (CAR) which reached 20.39% or an increase of 2.48% compared to 2017 which reached 17.91%. While the increase in the quality of financing channeled by Islamic banks was shown by the improvement in the Non Performing Financing (NPF) ratio in 2018 which decreased by 1.5% to 3.26% in 2018 from 4.76% in 2017. Likewise with improvements Islamic banking operational efficiency reflected in the decrease in the value of the BOPO ratio of 5.73% from 94.91% in 2017 to 89.18% in 2018.

In terms of liquidity, Islamic banking experienced an increase, as indicated by the Financing to Deposit Ratio (FDR) which decreased by 1.08% from 79.61% in 2017 to 78.53% in 2018. Then in terms of profitability indicated by the ratio Return on Assets (ROA) increased by 0.65% from 0.63% in 2017 to 1.28% in 2018.

From the explanation above, the purpose of this study is to look at the effect of Islamic banking financial performance as indicated by CAR, NPF, FDR, and BOPO ratios on economic growth in Indonesia with ROA as a mediating variable.

II. LITERATURE REVIEW

Capital Adequacy Ratio (CAR)

Is the ratio to measure the capital adequacy of the bank that shows the ability of bank management to identify, measure, supervise, and control the risks that arise and can influence the size of bank's capital. Banks that are considered healthy if they have a CAR ratio of at least 8%. The greater value of CAR reflects the better banking ability in facing the possibility of risk of loss.

Non Performing Financing (NPF)
Is loans that do not have good performance and are classified as substandard, doubtful and loss loans (Maidalena, 2014). Bank Indonesia as the central bank provides a measure of the rating of the soundness of the bank, one of them is NPF, which must be less than 5%.
Financing to Deposit Ratio (FDR)
Is a ratio between financing provided with total third party funds. Financing in question is financing provided to third parties (not including financing to other parties), namely, among others, demand deposits, savings and deposits (not including interbank). FDR is good if the ratio is 90 – 110%.
Operational Costs to Operating Income (BOPO)
Is a ratio that describes banking efficiency in carrying out its activities. BOPO includes rentability ratios to measure the ability of bank management to control operational costs against operating income. The smaller value of BOPO means the more efficient the banking operates. Bank Indonesia sets the best rate for the BOPO ratio below 90%, because if the BOPO ratio exceeds 90% to close to 100%, the bank can be categorized as inefficient in carrying out its operations.
Return On Asset (ROA)
Is the ratio used to measure the ability of bank management to obtain profits as a whole. Its function is to see how effective banks are in using their assets in generating income. The greater value of ROA is the greater level of profit achieved by the bank and the better the position of the bank in the use of assets.
Economic Growth
Economic growth can be defined as the development of activities in the economy which causes the goods and services produced in society to increase. The problem of economic growth can be seen as a long-term macroeconomic problem. From one period to another period the ability of a country to produce goods and services will increase. This increased ability is due to production factors that will always experience an increase in the quantity and quality. Investment will increase the amount of capital goods. The technology used is developing. Besides that labor is increasing as a result of population development, and work experience and education add to their skills (Sukirno, 2012).

III. RESEARCH METHODS

The population used in this study is all Islamic banking in Indonesia which consists of Sharia Commercial Banks and Sharia Business Units. The analytical method used in this study is path analyze. The variables observed were financial performance seen from CAR, NPF, FDR, and BOPO ratios, profitability ratios seen from ROA, and economic growth. The data used are time series from 2005 to 2018. The conceptual framework in this study is described as follows :

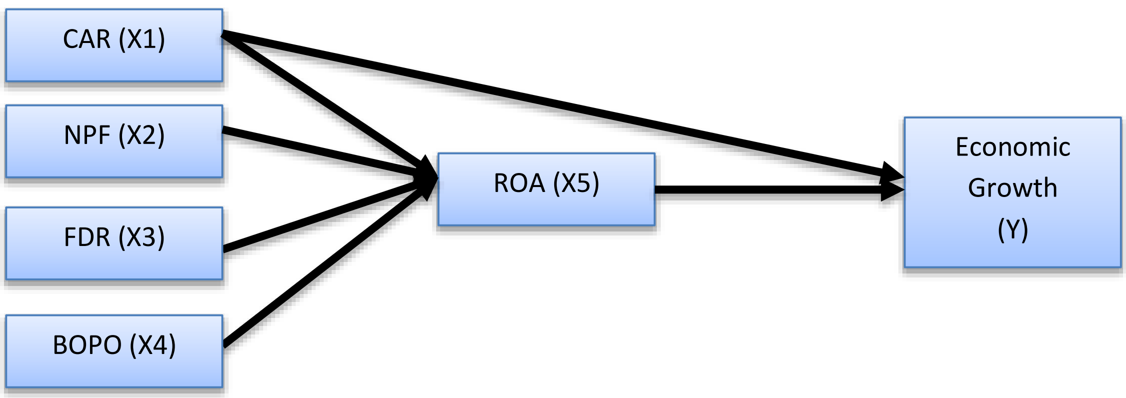


Figure 2. Research Concept Framework

The structural equation models are as follows:

$$X5 = P5X5X1 + P5X5X2 + P5X5X3 + P5X5X4 + e$$
$$Y = PyYX1 + PyYX5 + e$$

IV. RESULTS

1. Variable ROA (X5)

Variables	Coefficient	t - sig
CAR (X1)	-0,046	0,374
NPF (X2)	-0,255	0,059
FDR (X3)	-0,005	0,827
BOPO (X4)	-0,039	0,069
F – sig	0,003	
R^2	0,805	

Interpretation of t – Test:

a. CAR variable coefficient value is -0.046 with a significance of 0.374> 0.05. This means that the CAR variable has a negative effect that is not significant to ROA at the 95% confidence level.
b. NPF variable coefficient value is -0.255 with a significance of 0.059> 0.05. This means that the NPF variable has a negative effect that is not significant to ROA at the 95% confidence level.
c. FDR variable coefficient value is -0.005 with a significance of 0.827> 0.05. This means that the FDR variable has a negative effect that is not significant to ROA at the 95% confidence level.
d. BOPO variable coefficient value is -0.039 with a significance of 0.069> 0.05. This means that the BOPO variable has a negative effect that is not significant to ROA at the 95% confidence level.

Interpretation of F Test:

F - statistical probability value of 0.003 < 0.05, means that there is a significant effect simultaneously. This means that together the variables CAR, NPF, FDR, and BOPO have a significant effect on ROA at a confidence level of 95%.

Interpretation of the coefficient of determination:

The R-square value is 0.805 or 80.5%. This means that together the variables CAR, NPF, FDR, and BOPO are able to explain variations in the ROA variable of 80.5% while the remaining 19.5% is explained by other variables not included in the estimation model.

2. Variable Economic Growth (Y)

Variables	Coefficient	t – sig
CAR (X1)	0,038	0,466
ROA (X5)	0,899	0,004
F – sig	0,01	
R^2	0,572	

Interpretation of t – Test :

a. CAR variable coefficient value is 0.038 with significance of 0.466> 0.05. This means that the CAR variable does not have a significant positive effect on economic growth at a 95% confidence level.

b. ROA has a positive and significant effect on economic growth with a coefficient of 0.899 at a confidence level of 95%. The coefficient of 0.899 means that if the ROA increases by 1 percent it will increase economic growth by 0.899 percent (ceteris paribus).

Interpretation of F Test :

F-statistic probability value is 0.01 <0.05, meaning that there is a significant effect simultaneously. This means that together both variables CAR and ROA have a significant effect on economic growth at a confidence level of 95%.

Interpretation of the coefficient of determination :

R-square value is 0.572 or 57.2%. This means that together the CAR and ROA variables are able to explain variations in the variable economic growth by 57.2% while the remaining 42.8% is explained by other variables not included in the estimation model.

V. DISCUSSION

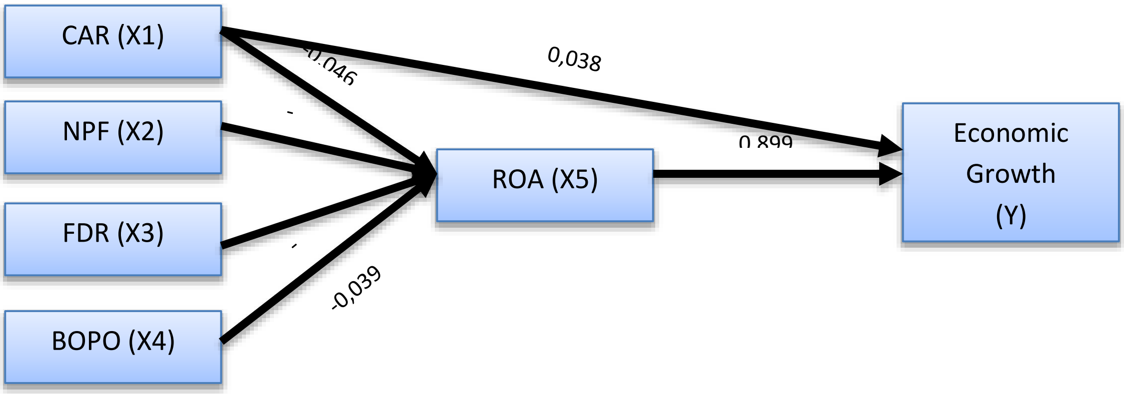


Figure 3. Value of Path Analysis Coefficient

1. **Effect of CAR on ROA**

   Based on the results of CAR testing directly to ROA the coefficient is -0.046 with a significance level of 0.374 greater than the alpha value of 0.05, which means that CAR directly has a negative effect and is not significant towards ROA. The data from 2005 to 2018, it can be seen that the CAR ratio is above 8%, even up to 20%. So the high CAR ratio has a negative effect on ROA. Due to the small market share of Islamic banking, large capital cannot be channeled to the maximum. The results of this study are in line with the research conducted by (Ubaidillah, 2016) which states that CAR has a negative influence on ROA. The absence of a significant influence between CAR and ROA is also in line with the research conducted by (Prasetyo, 2015), (Armereo, 2015), and (Wibowo & Syaichu, 2013).

2. **Effect of NPF on ROA**

   Based on the results of the direct testing of NPF on ROA the coefficient is -0.255 with a significance of 0.059 greater than the alpha value of 0.05, which means that directly NPF has a negative and not significant effect on ROA. The data from 2005 to 2018, it can be seen that the NPF ratio does not exist above 5%, this means that it is in accordance with the regulations issued by Bank Indonesia. The absence of a significant effect between NPF and ROA is in line with research conducted by (Ubaidillah, 2016) and (Armereo, 2015) which states that NPF does not significantly influence ROA and research conducted by (Ponco, 2008) that NPL does not affect profitability (ROA) bank.

3. **Effect of FDR on ROA**
Based on the results of direct testing of FDR against ROA obtained a coefficient of -0.005 with a significance of 0.827 greater than the alpha value of 0.05, which means that directly FDR has a negative and not significant effect on ROA. If seen from 2005 data until 2018, there has been a decline in recent years. FDR is below the level set by Bank Indonesia in 2017 followed by 2018. The results of this study are not in line with the research conducted by (Siregar, 2018) which states that FDR has a positive and significant effect on ROA. Unlike the research conducted by (Armereo, 2015), that FDR has a significant negative effect on ROA.

4. **Effect of BOPO on ROA**
Based on the results of BOPO's direct testing of ROA the coefficient is -0.039 with significance 0.069 greater than the alpha value of 0.05, which means that BOPO directly has a negative and not significant effect on ROA. The results of this study are in line with the research conducted by (Siregar, 2018). The increasing BOPO ratio shows that the condition is not good because the operational costs incurred by Islamic banking are higher and the net profit is smaller.

5. **Effect of CAR on Economic Growth**
Based on the results of CAR testing directly on economic growth the coefficient is 0.038 with a significance of 0.466 greater than the alpha value of 0.05, which means that directly the Islamic banking CAR ratio has a positive and not significant effect on economic growth in Indonesia. The absence of the influence of CAR on economic growth can be caused as a result of the bank's more selective attitude in lending to avoid high risks. The results of this study are in line with the research conducted by (Anita, 2018) which states that CAR does not affect economic growth in Indonesia.

6. **Effect of ROA on Economic Growth**
Based on the results of direct ROA testing on economic growth the coefficient is 0.899 with significance 0.004 smaller than the alpha value of 0.05, which means that directly the ROA ratio of Islamic banking has a positive and significant effect on economic growth. This is in accordance with Harrod-Domar's theory of growth that investment in this case is lending can increase the economy in a country which will have an impact on increasing economic growth. The results of this study are in line with the research conducted by (Anita, 2018) which states that ROA has a significant positive effect on economic growth in Indonesia.

7. **Effect of CAR through ROA on Economic Growth**
The direct effect of CAR on economic growth is 0.038. While the indirect effect of CAR through ROA on economic growth is: -0.046 x 0.899 = -0.041. Then the total effect given by CAR on economic growth is: -0.046 + 0.899 = 0.853. Based on the results of the calculations above, it can be seen that the value of direct influence is greater than the value of indirect influence.

8. **Effect of NPF through ROA on Economic Growth**
The indirect effect of NPF through ROA on economic growth is: -0.255 x 0.899 = -0.229. While the total effect given by NPF on economic growth is: -0.255 + 0.899 = 0.644.

9. **Effect of FDR through ROA on Economic Growth**
The indirect effect of FDR through ROA on economic growth is: -0.005 x 0.899 = -0.004. While the total effect of FDR on economic growth is: -0.005 + 0.899 = 0.894.

10. **Effect of BOPO through ROA on Economic Growth**
The indirect effect of BOPO through ROA on economic growth is: -0.039 x 0.899 = -0.035. While the total influence given by BOPO on economic growth is: -0.039 + 0.899 = 0.86.

VI. CONCLUSION & SUGGESTION

Based on the results of research and discussion, the conclusions of this study are as follows:

1. Simultaneously, Capital Adequacy Ratio (CAR), Non Performing Financing (NPF), Financing to Deposit Ratio (FDR), and BOPO have a significant effect on Return On Assets (ROA) in Islamic Banking in Indonesia during the period 2005 to 2018 at 95% confidence level.
2. Partially, Capital Adequacy Ratio (CAR), Non Performing Financing (NPF), Financing to Deposit Ratio (FDR), and BOPO have a negative and not significant direct effect on Return On Assets (ROA) in Islamic Banking in Indonesia during the 2005 period up to 2018 at a 95% confidence level.
3. Simultaneously, Capital Adequacy Ratio (CAR) and Return On Assets (ROA) have a significant effect on economic growth in Islamic Banking in Indonesia during the period 2005 to 2018 at a confidence level of 95%.
4. Partially, Capital Adequacy Ratio (CAR) has a positive but not significant effect on Indonesia's economic growth during the period 2005 to 2018 at a confidence level of 95%. While the Return on Assets (ROA) has a significant positive effect on Indonesia's economic growth during the period 2005 to 2018 at a confidence level of 95%.
5. Capital Adequacy Ratio (CAR) has a greater direct effect on Indonesia's economic growth compared to indirect effects through Return On Assets (ROA) on Indonesia's economic growth.

Based on the results of the research and discussion, the suggestions of this study are as follows:

1. To Islamic banking in Indonesia, to maintain banking health remain stable so that the bank's profitability is still fulfilled as expected and the bank's performance continues to increase. In addition, it is expected that Islamic banking will be more maximal in conducting financing distribution that still prioritizes banking’s prudential principal.
2. It is suggested to further researchers to be able to develop similar research by adding macroeconomic variables to determine the level of profitability of Islamic banking. In addition, it might be possible to test using different research methods.

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