

THE IMPACT OF RISK AND REPUTATION ON FINANCIAL PERFORMANCE IN ISLAMIC BANKING: EVIDANCE FROM INDONESIA

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Abstract

This study aims to examine the impact of risk and reputation on financial performance. More specifically, we use financing risk, liquidity risk, reputation with rewards, and growth in profit-sharing based financing as our variable of interests. We also assign bank size as a control variable. Our data is analyzed using Generalized Least Square (GLS) regression. Islamic Commercial Banks listed in Sharia Banking Statistics (Statistik Perbankan Syariah - SPS) published by OJK in 2015–2019 are selected as our sample. We find that financing risk has a negative effect on financial performance; and both reputation with rewards and bank size have a positive effect on financial performance. However, liquidity risk and growth in profit-sharing based financing do not affect financial performance. Several research implications are the importance of risk mitigation, the importance to maintain the reputation of the Islamic bank's stakeholders, and creating innovative funding and financing products.

Keywords: Bank size; Financial performance; Levels of risk; Reputation

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I. Introduction

The financial performance of banking industry has important implications for a country's economic growth. For instance, the main function of banking industry, i.e., collection and distribution of funds, provides support to the welfare of the society. Weak management, non-performing loan, and insufficient capital to cover all risks can reduce the bank's performance (Supiyadi et al., 2019). Poor bank's performance increases risk, reduces

profitability, and discourage society, investors, business society and government in having relationship with the bank. One of bank performance indicators is profitability. The higher the level of profitability, the better the performance of the banks (Ongore & Kusa, 2013).

Sustainable profitability has a very important role to maintain the stability of Islamic banking (Idris et al., 2011). A stable financial system has an important effect on both banking operations and growth Haris,

Yao, Tariq, Malik, & Javaid (2019). In addition, profitability ratio can be used not only to evaluate the performance of Islamic banks but also to help management to take advantage in a competitive market (Krisnawati et al., 2019). Harisa et al. (2019) argue that the main objective of Islamic bank is not only to generate profit, however the ability to generate profit is an important indicator for measuring long-term competitiveness and maintaining the operational sustainability of Islamic bank.

The information from financial performance which reflects firm's fundamentals can be a basis for investment decision (Agustiniingsih et al., 2016). Financial performance in the Islamic perspective does not only pursuing profit but also controlling and evaluating Islamic bank to ensure that their financial performance is in line with Islamic instruction (Adib & Khalid, 2010).

Makhdalena (2018) explains that there are four approaches to measure financial performance. First, accounting profit with ratio approach. Second, the cash flow approach, i.e., calculation based on net cash flow for a period. Third, Economic Value-Added approach or residual wealth-based measurement. Fourth, Tobin's Q approach, i.e., the ratio between the market value of physical assets and their replacement value.

Islamic Bank in its development has experienced several obstacles, such as low asset quality and limited bank capital. For instance, the increase in non-performing financing affects the quality of the assets. Limited capital triggers Islamic banks to improve liquidity risk management. Rafsanjani (2016) shows that profitability is strongly affected by liquidity risks and credit risks.

Bank Muamalat Indonesia (BMI) from 2017 to 2019 shows the trend of increasing non-performing financing and decreasing distribution of financing. This condition has drastically decreased the assets and net income of BMI. On the contrary, the financing risk at BRI Syariah (BRIS) is skyrocketed with a stable distribution of financing and the increasing assets and net income.

In term of reputation, BCA Syariah (BCAS), from 2016 to 2018 has improvement on its realization of Corporate Social Responsibility (CSR) funds which is directly proportional to its net income. A similar case can be found in Bank Syariah Mandiri (BSM) and BNI Syariah (BNIS). Both of them have a fluctuation in the realization of CSR funds but positive trend of net income. On the contrary, BRI Syariah with had improvement in CSR funds, but a negative trend of net income. The different phenomenon occurred in Bank Aceh which

had negative trend of CSR funds and but positive trend of net income.

Masrur et al. (2019), Supiyadi et al. (2019), and Ulina & Abd Majid (2020) find a negative effect of financing risks and a positive effect of liquidity risk on financial performance. A negative effect of financing risk is also shown by Sabrina & Muharam (2015) and Meyrantika & Haryanto (2017). However, they found different finding in liquidity risks. Sabrina & Muharam (2015) show that liquidity risk is negatively associated with financial performance, while Meyrantika & Haryanto (2017) do not find any effect of liquidity risk on financial performance. Furthermore, Weng & Chen (2017) find the positive effect of companies' rating in Taiwan on financial performance. Lusambo (2017) also verifies the interrelation of reputation and the firm's financial performance in the microfinance industry in Kenya. Budihariyanto, Afifudin, & Junaidi (2018) find the positive effect of profit-sharing-based financing on Islamic Commercial Bank (BUS). While Inayatillah & Subardjo (2017) and Nuha & Mulazid (2018) do not find any effect of profit-sharing-based financing on financial performance.

Based on the phenomena and findings from previous studies, Our study tries to

show empirical evidence with regards to the antecedents of the financial performance of Islamic banks. More specifically, we examine the impact of financing risk, liquidity risk, bank reputation, growth of profit-sharing-based financing, and bank size on the financial performance of Islamic banking in Indonesia.

Method

We use a quantitative method with the target population of Islamic Commercial Bank (BUS) listed in the OJK Sharia Banking Statistics in 2015-2019. We collected the data from the BUS website.

There are 12 BUS in 2015, 13 BUS in 2016, 16 BUS in 2017 and 14 BUS in 2018. Islamic bank that meets our criteria has been selected as our sample. The criteria to select sample is Islamic bank publishes an annual report that shows the required information. The final sample consist of 43 observations.

The current study uses the level of risks, which consist of financing risk and liquidity risk and reputation, which consists of bank reputation and growth in profit-sharing-based financing. The control variable in this study is bank size. The definition and formula to measure the variables are summarized in Table 1.

Table 1
Variable Definition and Measurement

Variable	Definition	Measurement
Dependent		
Profitability	Capital capacity to generate profits and overall operational efficiency through the use of banking capital (Mukhibad & Khafid, 2018).	$ROE = \frac{\text{Net Income}}{\text{Equity}} \times 100\%$
Independent		
Financing Risk	The level of non-performing financing as the result of failure to meet all of the due liabilities for all financing provided by the bank (Masrur et al., 2019).	$FINR = \frac{\text{Non Performing Finance}}{\text{Total Financing}} \times 100\%$
Liquidity Risk	Bank's ability to fund the increase in assets and meet its liabilities on time, without experiencing unacceptable losses (Sheefeni & Nyambe, 2016).	$LIQR = \frac{\text{Financing}}{\text{Total Deposit}} \times 100\%$
Bank Reputation	Integration of expectation and perception toward the bank developed overtime surrounding the quality, characteristics, and behavior according to the observation of past performance (Abimayu, Mukharudfa, & Lubis, 2019).	$BREP = \text{Total Awards}$
Growth in profit-sharing-based financing	Annual projection of profit-sharing based financing that consists of <i>mudharabah</i> and <i>musyarakah</i> (Trotta, Iannuzzi, & Pacelli, 2016).	$PLSFG = \frac{PLSF_t - PLSF_{t-1}}{PLSF_{t-1}} \times 100\%$
Control		
Bank Size	The level of income generated by the bank (Dahmash, 2015).	$SZE = \log \sum \text{Operating Income}$

Notes: ROE is Return on Equity, FINR is Financing Risk, LIQR is Liquidity Risk, BREP is Bank Reputation, PLSFG is Profit Loss Sharing Finance Growth, $PLSF_t$ is Profit Loss Sharing Financing of the base year, $PLSF_{t-1}$ is Profit Loss Sharing based Financing of the previous year, and SZE is Size.

Masrur et al. (2019), and Supiyadi et al. (2019) mention that non-performing financing has a negative effect on the bank's financial performance. Non-performing financing reduces the opportunity of Islamic banks in generating income. In addition,

non-performing financing also forces Islamic banks to increase the number of reserve funds that must be provided by Islamic banks. Consequently, the profit generated by the bank will be decreased.

Non-performing financing decreases Islamic bank's income which in turn affect Islamic bank's profitability. Besides that, the provision of losses decreases Islamic bank's income. This is because the reserved fund increases expenses. Consequently, if Islamic bank's income is lower than its expenses, it leads to a decline in financial performance.

H₁: Financing risk has a negative effect on financial performance

Masrur et al. (2019) and Supiyadi et al. (2019) show that liquidity risk has a positive effect on financial performance. The more financing is channeled by a bank, the less amount of liquid assets owned by the bank. The decline of liquid assets affects Islamic bank's performance to pay off their due liabilities. The increase in liquidity risk indicates the number of disbursed financing, while the increase in financing increases Islamic bank's income.

The high level of liquidity risk (FDR) shows that the volume of disbursed financing is larger than the number of customer deposits. When a bank has a large number of financing but has a small number of deposit (saving), the bank is illiquid. Consequently, Islamic banks are exposed to high risk. This is because the Islamic banks will have difficulty when a customer withdrawing their funds. At the same time, a

large volume of financing leads to the improvement of financial performance.

H₂: Liquidity risk has a positive effect on financial performance

Weng & Chen (2017) mention that reputation affects profitability. Additionally, Solikhin and Lubis (2019: 28) explain that a bank with good financial performance have a better opportunity to grow as long as the bank has a good reputation.

Bank with high reputation has an opportunity to generate greater profitability. High reputation means the bank obtaine high level of trust from its stakeholder. Consequently, banks may obtain additional capital and deposit, which can be used to increase financing amount and generate more income. Additional capital, deposit, financing and income supports Islamic bank's development and affect profitability.

H₃: Bank reputation has a positive effect on financial performance

Budihariyanto et al. (2018) show that profit-sharing based financing is positivieiy associated with financial performance. Customers who receive financing from the bank will manage the funds well, thus, *mudharabah* and *musyarakah* contract can be resolved. The bigger number of profit-sharing based financing, the higher the

opportunity for Islamic bank to obtain profit from profit-sharing financing activities.

The high level of growth of profit-sharing based financing indicates a high level of completion on the profit-sharing financing contracts. The more contracts completed, the greater the profits will be obtained by Islamic banks.

H₄: The growth of profit-sharing based financing has a positive effect on financial performance

II. Discussion

We show the number of observations, mean, standard deviation, maximum, and minimum of samples in Table 2.

Table 2
Descriptive Statistics (n = 43)

Variable	Mean	Std. Dev.	Min	Max
ROE	0,048	0,044	0,002	0,179
FINR	0,039	0,020	0,003	0,079
LIQR	0,862	0,079	0,719	1,048
BREP	0,019	0,014	0,000	0,047
PLSFG	0,190	0,189	-0,175	0,613
SZE	12,20	0,501	11,195	13,04
	4			3

Source: Data processed using STATA 16

The descriptive statistics shows that the firms' financial performance (ROE) has a mean score of 0.048. This means that on average, Islamic banks have a 4.8% ability to generate after-tax profit. The financial performance (ROE) has a shorter data range compared to other variables. This can be observed from the difference between the

maximum score in BTPN Syariah and the minimum score in Bank Bukopin Syariah.

The average score of Non-Performing Financing is 3.9%. Financing risk also has a considerably shorter data range compared to other variables. This can be seen from the difference between the maximum score in Bank Bukopin Syariah and minimum score in BCA Syariah.

The average proportion of financing provided by Islamic banks to the third-party (LIQR) is 86.2%. This variable has a considerably longer data range compared to other variables in the model. This can be seen from the difference between the highest liquidity ratio in Bank Jawa Barat Banten Syariah and the lowest liquidity ratio in BRI Syariah.

The average reputation score is of 0.019 which means each bank receives 16 awards per year. Islamic bank reputation is measured from the awards received by Islamic bank compared to the total awards received by all Islamic banks. Islamic banks reputation has the shortest data range compared to other variables. This is shown by the difference between the highest number of awards that were received by BNI Syariah and the smallest number of awards that were received by Bank Mega Syariah, Bank Panin Dubai Syariah, and Bank Victoria Syariah.

On average *Mudharabah* and *Musyarakah* financing grew 19% annually. From the data range, the growth of profit-sharing based financing has considerably long range compared to other variables. The highest growth can be found in Bank Mega Syariah, while the lowest growth can be found in Bank Muamalat Indonesia.

Bank size is measured using operating income. The mean score is IDR 12.204 trillion. Operating income (SZE) has the longest range compared to other variables. The lowest operating income can be found in Bank Victoria Syariah, while the highest operating income can be found in Bank Syariah Mandiri.

It was decided that the Random Effect Model (REM) is the most appropriate model to be used in this study. Following on that, we also perform the classical assumption test for normality, multicollinearity, and autocorrelation test.

Jarque-Bera Test is selected to check the normality of our data (Table 3). Table 3 shows that financial performance, level of risk, and reputation have p-value higher than 0.05. Our results indicate that all variables have normally distributed data with no outlier.

Table 3
The Result of Normality Test

Variable	Jarque-Bera	Chi (2)
ROE	5.382	0.0678
FINR	0.599	0.7411
LIQR	1.108	0.5747
BREP	2.608	0.2714
PLSFG	1.026	0.5988
SZE	2.054	0.3581

Source: Data processed using STATA

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Multicollinearity test is performed using the Pearson Test (Table 4). The correlation between the level of risk and the reputation is less than 0.8. All in all, we have no multicollinearity problem in our model.

Table 4
The Result of Multicollinearity Test

	ROE	FINR	LIQR	REPB	PLSFG	SZE
ROE	1.0					
FINR	-0.4	1.0				
LIQR	-0.2	-0.2	1.0			
BREP	0.7	-0.2	-0.4	1.0		
PLSFG	0.4	-0.4	0.1	0.3	1.0	
SZE	0.5	0.1	-0.5	0.5	0.2	1.0

Source: Data processed using STATA 16

Autocorrelation test was performed by using *Wooldridge Test* (Table 5). Table 5 shows that Prob > F lower than 0.05 which

indicates that the error term in the current period and previous period are correlated.

Table 5
The Result of Autocorrelation Test

F (1, 6)	19.331
Prob > F	0.0046

Source: Data processed using STATA 16

Since the regression model has autocorrelation problem, we select Generalized Least Square (GLS) regression method (Table 6).

Table 6
The Result of Generalized Least Square (n = 43) Regression

R-sq:				
<i>within</i>		0.3457		
<i>between</i>		0.4829		
<i>overall</i>		0.4407		
Wald chi2 (6)		19.11		
Prob > chi2		0.0040		
ROE	Koef.	Std. Err.	z	P> z
_kons	-0,358	0.200	-1.79	0.073
FINR	-0,533	0.209	-2.55	0.011
LIQR	0,069	0.058	1.20	0.229
BREP	0,639	0.303	2.11	0.035
PLSFG	-0,021	0.021	-1.00	0.318
SZE	0,029	0.014	2.05	0.040

Source: Data processed using STATA 16

Table 6 shows the R-squared within 0.3457, which means that with overtime dimension, the level of risk and reputation explains 34.57% of the variation in financial performance. The R-squared between is 0.4829, which means that with between individual dimension, the level of risk and reputation contributes to 48.29% on the

variability of financial performance. Next, the R-squared overall is 0.4407, which means that with overtime and individual dimension, the level of risk and reputation contributes to 44.07% on the variability of financial performance, while the rest 55.93% is explained by other independent variables outside the model.

F-statistics test is significant at 1% level. This result indicates that the panel data regression model is good.

T statistics shows that the financing risk has a negative effect on financial performance. Reputation and bank size are positively associated with financial performance. In contrast, liquidity risk and the growth of profit-sharing based financing do not affect financial performance.

Financing Risk on Financial Performance

In the Islamic perspective, all parties (stakeholders) are affected by the firm's operational activities, directly and indirectly (Iqbal & Mirakhor, 2017: 92; Iqbal & Molyneux, 2016: 119).

Our results show that financing risk is negatively associated with financial performance. Therefore, the first hypothesis is supported. Our findings are consistent with the previous studies: e.g., Masrur et al. (2019), and Supiyadi et al. (2019). Non-performing financing leads to loss. Not only that, Islamic banks need also to provide reserves.

Islamic Stakeholder Theory explains that the firm's sustainability needs support from all stakeholder. The stronger the stakeholder, the further the firm needs to adjust itself (Meutia & Febrianti, 2017). Better long-term financial performance can be resulted from the quality relationships with related parties (Freeman, 2015). If Islamic banks maintain a good relationship with the stakeholders, the stakeholders will provide support for Islamic banks in achieving vision and mission. Puncheva & Michelotti (2010) explain that reputation can be measured generally from stakeholder's impression toward the bank as a whole.

Furthermore, this theory also explains that Allah Swt. prohibits people to harm themselves and others. Financing is the main source of income, therefore, non-performing financing can lead to a potential of loss for the bank. The loss is caused by the failure of contract settlement on the part of the customer. The increase in reserve cost will reduce financial performance since Islamic needs to forgo some parts of their income for reserve.

Liquidity Risk on Financial Performance

Ravindy et al., (2019) explain that in Islamic perspective, uncertain condition contributes to the higher risk of the Islamic banking operation. The general concept of risk is explained in *al- Ghurmu bil-Ghunmi*

principle which means that every profit will always be associated with risk.

Ganiyy et al., (2017) mention that risk and human behavior is related. Some people avoid risk, while others choose to take risk.

Our results indicate that any increase or decrease in liquidity risk will not affect financial performance. Therefore, the second hypothesis is not supported.

Our result is consistent with Rafsanjani (2016) and Meyrantika & Haryanto (2017). Bank can channel all of its funds to the customer to generate more income. However, channeling too many funds has a high risk because there is always a probability of non-performing financing. On the contrary, if Islamic bank provide too little financing, Islamic bank cannot meet its function as financing provider. Our result is inconsistent with the finding from Masrur et al. (2019) and Supiyadi et al. (2019) who found that liquidity risk is positively associated with the profitability.

Islamic Stakeholder Theory states that Islamic bank has a responsibility to meet its liabilities. The responsibility includes the obligation for the bank to implement Islamic principles within its operation. Bank can control the liquidity of its assets at the safe level. Moderate level of risk indicates that financing cannot be fully channeled. This causes liquidity risk to fall short in affecting Islamic bank's profitability. This is in line

with the vision of Islamic bank that carries out its activities in a healthy, strong, and *istiqomah* way towards Sharia principles. Therefore, liquidity risk does not affect Islamic Bank's profitability.

Bank Reputation on Financial Performance

Auge et al. (2016: 120) describe reputation as a potential core competency of a bank. New customers cannot assess bank services if they do not get adequate information. A good reputation of Islamic bank motivates the existing customer to recommend Islamic bank to new customers. Therefore, reputation is important when service quality cannot be fully observed.

Our study shows that bank reputation (measured by the number of awards) affects financial performance. This is shown by the positive association between awards and profitability. We support the third hypothesis.

Our findings consistent with the findings from Lusambo (2017) and Weng & Chen (2017). Bank with good reputation has high level of trust and expectation from its stakeholders. High level of trust and expectation stimulate all stakeholders to strengthen Islamic bank's capital which in turn increases Islamic bank's profitability.

Islamic Stakeholder Theory emphasizes that Allah Swt. bestows rewards, blessings, and high degrees to the faithful and pious

people as a form of appreciation. Islamic bank that always pays attention to product and service quality, financial performance, work environment, and social responsibility according to sharia guidelines gets high trust from the community. This trust will attract the community to deposit/save money as well as apply financing in Islamic banks. The large amount of deposit/saving increases Islamic bank's resources and increases the amount of financing. Thus, trust from the community has a positive impact to Islamic bank, i.e., to generate more profits.

The Growth of Profit-Sharing Based Financing on Financial Performance

Our results show that the growth of profit-sharing-based financing does not affect profitability. Thus, the fourth hypothesis is not supported.

The result is consistent with Inayatillah & Subardjo (2017) and Nuha & Mulazid (2018). Ineffective profit-sharing financing increases the number of non-performing financing and fluctuating the amount of profit that needs to be shared. This imply that the growth of profit-sharing-based financing does not affect profitability. This result is inconsistent with Budihariyanto et al. (2018) who find that profit-sharing financing affects financial performance.

Islamic Stakeholder Theory explains that the bank has a responsibility to

implement Islamic bank's mission which is different from a conventional bank. Islamic bank's mission is to collect and channel funds in the form of profit-sharing-based financing based on the agreed *nisbah*.

Profit-sharing based financing must be based on the agreed *nisbah*, thus, all future risks will be shared between the Islamic bank and its customer. Uncertainty over the success of the business leads to the fluctuating amount of profit that needs to be shared to Islamic banks which in turn Islamic bank's income also fluctuated. All in all it has no significant effect on profitability.

Bank Size on Financial Performance

We find that bank size is positively associated with the performance. Our result indicates that the fifth hypothesis is supported.

The result of the study is consistent with the finding from Dahmash (2015) and Trad et al. (2017). Operational income is one of the proxies of Islamic bank's size. The income derived from various Islamic sharia-based transactions conducted by the bank.

Islamic Stakeholder Theory states that Islamic bank's profit is positively associated with the responsibility and *amanah* that the bank needs to bear. This is because the higher the operating income, the more funds that need to be collected and channeled to the customers. We might argue that

development of products and services can be supported by operating income. The development of products and services increases Islamic bank's profitability. Therefore, operating income is positively associated with profitability.

III. Conclusion

We conclude that reputation with rewards and bank size have positive effects on financial performance. We also find that financing risk has a negative effect on financial performance. On the contrary, liquidity risk and the growth of profit-sharing-based financing do not affect the financial performance of Islamic Banks in Indonesia.

This study offers practical and theoretical implications. The implications are (1) The needs of mapping the mitigation of risks by understanding the characters of customers who apply for financing; (2) The needs of maintaining Islamic bank's reputation; (3) Increasing Islamic bank's operating income by creating innovations in funding and financing products to meet the needs of the customers.

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