

# The Influence of Financial Performance and Types of Financing on the Stability of Indonesian Islamic Rural Bank

1<sup>st</sup> Ahmad Syathiri  
*Economic Faculty*  
*Sriwijaya University*  
 Palembang, Indonesia  
 ahmadsyathiri@fe.unsri.ac.id

2<sup>nd</sup> Umar Hamdan  
*Economic Faculty*  
*Sriwijaya University*  
 Palembang, Indonesia  
 umarhamdan@unsri.ac.id

3<sup>rd</sup> Efva O.D.G  
*Economic Faculty*  
*Sriwijaya University*  
 Palembang, Indonesia  
 efvagozali@unsri.ac.id

**Abstract:** *The purpose of this study was to examine the effect of financial performance and type of financing on the stability of Indonesian Islamic Rural Banks. Financial performance variables are measured using the return on equity ratio. Variable types of financing are measured using the proportion of Murabaha, profit sharing, multi-service contracts, and financing to deposit ratio. Stability was measured by z-score value. The data source used is the Islamic Rural Banks annual financial statements for the 2015-2018 period. The results found that the stability of Islamic Rural banks was influenced by financial performance, the ratio of financing to deposit funding, and equity ratio. The type of financing has no significant effect on stability.*

**Keywords:** *Islamic, rural bank, stability, financial, performance*

## I. INTRODUCTION

Islamic banking is one of the financial institutions that has developed in recent decades. Since the enactment of statute number seven of 1992 and replaced with statute number ten of 1998, which became the basis of sharia-based banking operations, encourage the establishment of new Islamic banks and the change of conventional banks into Islamic banks. In Indonesia, Islamic banking types consist of large and small-scale banks or also known by the commercial banks and Islamic Rural Bank.

Differentiation types of banks were also determined based on ownership of initial capital and operational area coverage. The different types of financial institutions will also have an impact on the ability of banks to maintain bank performance. In certain conditions, such as the 2008 global financial crisis, micro Islamic banking has a better level of stability than Islamic commercial banks [1].

During the financial crisis, in general, Islamic banking was not resistant to shocks in the financial crisis at the level of stability and operational performance [2]. However, Islamic banking has a better standard of performance compared to conventional bank performance [3]; even Islamic banks can keep losses on non-interest-based credit risk [4]. According to Korbi and Bougatef (2017), financial performance such as liquidity ratios and credit risk can affect bank stability. Besides, banks that have financial stability will have an operational risk [6].

The importance of maintaining stability is also one step Islamic banks preserve the level of public confidence in the sustainability of the bank's operations. Islamic banks have an excellent performance supported by the ability of Islamic banks to maintain the level of profitability and risk level. Competition between banks, both conventional and between Islamic banks, also encourages all financial institutions to increase the attractiveness of the public to use banking services.

Banks are also required to keep a balance between funding and financing. The importance of maintaining the balance of financial transactions is also to restrain the level of risk of loss, which fails banks to meet the demand for funds by the public, which triggers liquidity risk (Ismal, 2011: 38). In the aspect of the financing, Islamic banking tends to favor Murabaha-based financing because the financing is carried out with a definite profit agreement [8].

Islamic banking that has a bank branding with the principle of profit and loss sharing should have a larger portion of the profit-sharing based financing. According to [9] that Islamic banks will face a high risk if they have a dominant profit-sharing financing contract. Therefore, the problem that arises is whether this type of financing will affect the level of stability of Islamic micro banks? Also, financial performance factors, especially the level of risk, will have an impact on the level of bank stability [9]. According to Koong et al. (2017), lending (financing) can affect bank stability.

The ability of Islamic banks to obtain high profits also has an essential role in creating bank stability [11]. In addition to managerial capabilities, asset ownership and large capital are also essential factors for banks to increase revenue [12]. Banks that are categorized as small banks tend to give credit to small and high-risk businesses so that it will affect the level of bank profitability [13].

Azam et al. (2018). Conducted a study on the comparative level of stability of Islamic and conventional banks in Malaysia. These results indicate that there is no difference in the level of stability of the two types of banks. [15] try to compare the level of stability of Islamic and conventional banks in Indonesia, and the results show that Islamic banks are more stable than conventional banks. In contrast to the results of a study conducted by [16] that

Islamic banks are more stable than conventional banks in Pakistan.

The research conducted by [17] about factors that influence the level of bank stability. The results showed that stability could be affected by credit growth. The higher the level of credit, the stability of the bank will decrease. In a study conducted by [18], which made stability a determining variable, it was found that the level of stability did not affect financing decisions or lending. A study conducted by [9] shows that credit risk is one of the primary sources of bank instability. [19], in his research, mentioned that the level of good governance could also influence the stability of Islamic banks.

According to [5], the variable bank size is one of the factors that cause the instability of Islamic banks. [20] examine the internal factors that affect the level of stability are profitability, and the level of bank risk. This result is also reinforced by [21] that the level of performance, as measured by efficiency, has a significant impact on the level of bank stability. Based on previous research, the research builds a conceptual framework by forming independent variables in the form of financial performance and types of financing, and the dependent variable in the way of bank stability.

**II. LITERATURE REVIEW**

*A. Financial Performance*

Management performance is defined as the achievement of the actions or behavior of managers. High management performance reflects the results of leadership actions in setting an organization's goals or objectives, employee motivation, and motivation, problem-solving skills [22]. The company's performance is also a measure of management's ability to carry out managerial activities to achieve the company's planned goals and objectives. Performance measurement is essential to drive the implementation of a company's strategy successfully. One good measure of performance is to measure performance in terms of financial measures [23].

Financial performance can be assessed in terms of the ability of financial institutions to generate profits and manage risks. Likewise, according to sudana [24], the risk is a state of uncertain conditions, estimated return or expected return, and an estimate of how much the actual deviation from the expected results. Another financial performance is looking at aspects of the ability of financial institutions to generate profits. According to [25], elements of profitability are also a method of evaluating the company's economic performance.

*B. Stability*

According to [26], bank stability increases if the ratio of equity to assets increases, and the standard deviation of return on assets decreases. [16] describe the condition of stability in a situation where the financial institution has a probability of decreasing profitability that can cause the erosion of equity, causing the financial institution to experience the possibility of insolvency. According to [17], bank stability is the financial condition of a bank that can avoid bankruptcy or default on obligations/debt. Assessment

of financial institution stability can be measured using the z-score ratio that is the ratio of return on assets plus the rate of equity to assets divided by the standard deviation of return on assets [26],[16],[17],[27].

**III. METHOD**

The population of this study is the entire Islamic Rural Bank (BPRS) in Indonesia. The sample of this research is the BPRS that has published a complete financial statement for the 2015-2018 period. For this study, the source of the data was obtained through information on Bank Financial Report Publication at Bank Indonesia and the Financial Services Authority and other documents that were published. Access information on Bank Indonesia and the Financial Services Authority through the websites www.bi.go.id and www.ojk.go.id. The data used is the 2015-2018 period data. The amount of data is 203 observations. Analysis of the data used is the description and regression analysis.

The first test, the variables of this study consisted of independent variables, namely the equity ratio (ETA), return on equity ratio (ROE), the portion of Murabaha financing (Murabaha), the portion of principle profit-sharing financing (PS), the portion of multi-service financing (MS), the ratio of financing to deposit funding (FDR), and the ratio of operating expense to operating revenue (Op\_Ex). The dependent variable is only the stability variable measured by the z-score value that is the rate of return on assets plus the ratio of equity to assets (equity capital / total assets) divided by the standard deviation of ROA. A high Z-score indicates that the bank is far from the risk of failure (default). The next analysis is to test the ROE as the dependent variable, then the ratio of operational load to the dependent variable

**IV. RESULTS AND DISCUSSION**

*A. Statistical Description*

TABLE I. Zscore Value and Equity Ratio

Variable	Obs	Mean	Std. Dev.	Min	Max
zscore	203	2.14578	1.626611	.6979007	10.59937
ETA	203	.1767557	.1487798	.0436319	.9175441

Table 1 shows that the average value of the Islamic Rural Bank z-score is 2.1 points. 62.62 percent of the observation data is below the z-score average cost, and this indicates that most Islamic Rural Banks have a default risk or risk of failing to meet their liabilities. Equity ownership as seen from the average ratio of equity to assets, is 0.17 points or 17 percent. The rate is quite high compared to the percentage of the capital ratio of 8 percent. There is a 64.08 percent equity ratio below the average equity ratio.

**TABLE II. Financial Performance**

Variable	Obs	Mean	Std. Dev.	Min	Max
ROE	203	.1253809	.19488	-.5158074	.8771851
Op_Ex	203	.6126357	.2178189	.285003	1.55363
FDR	203	1.123225	.4492887	.3976992	3.471353

Islamic Rural Bank's performance level in terms of the level of return on equity has an average of 0.12 points or 12 percent. There are 47.09 percent of observational data that are below the average level of return. In other words, the ability to generate profits is not balanced by the growth of assets. Islamic Rural Bank's performance level in terms of the level of return on equity has an average of 0.12 points or 12 percent. There are 47.09 percent of observational data that are below the average level of return. In other words, the ability to generate profits is not balanced with the growth of assets. The level of efficiency of the Islamic Rural Bank is quite high in terms of the average level of the ratio of operating expenses to operating income of 0.61 points, or only 61 percent of operating expenses are met by bank revenue. There are 62 percent observational data ratio of operating expenses that are equal or smaller than average. This shows that Islamic rural banks can reduce costs, so they become more efficient. Islamic Rural Bank financing productivity is also quite high in terms of the ratio of financing to deposit funding of 1.12 points or 112 percent of funding funds sourced from deposit funding and internal bank funds. There are 62.56 percent of observational data that have a financing ratio below ranging from 0.40 - 1.12 points.

**TABLE III. Type of Financing Ratio**

Variable	Obs	Mean	Std. Dev.	Min	Max
murabahah	203	.7456459	.1736687	.1855238	.9908848
PS	203	.1714073	.1544401	.0008287	.7010393
MS	203	.0777943	.1063393	.0001955	.5243472

The kind of Islamic Rural Bank financing has been dominated by Murabaha contracts, which reach an average of 0.74 points, or 74 percent of the total financing is Murabaha financing. A profit sharing-based transaction agreement only has an average of 0.17 points or 17 percent, and a remainder is a multi-service contract. Only 42.86 percent of the observational data had a ratio of Murabaha to the total financing under 70 percent. Most Islamic Rural Banks prefer financing based on the sale and purchase contracts with profit margins compared to profit-sharing based contracts.

**B. Regression Test Results**

**TABLE IV. Regression Results**

Source	SS	df	MS	Number of obs	=	203
Model	530.982436	7	75.8546338	F(7, 195)	=	4247.71
Residual	3.48226613	195	.017857775	Prob > F	=	0.0000
				R-squared	=	0.9935
				Adj R-squared	=	0.9933
Total	534.464703	202	2.64586486	Root MSE	=	.13363

zscore	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
ETA	11.68334	.0857317	136.28	0.000	11.51426 11.85242
ROE	.8552179	.0672327	12.72	0.000	.7226213 .9878145
Op_Ex	-.5596281	.0705329	-7.93	0.000	-.6987333 -.4205229
FDR	.0631429	.0235011	2.69	0.008	.0167939 .1094919
murabahah	.3622092	.3843235	0.94	0.347	-.3957552 1.120174
PS	.4246384	.3863738	1.10	0.273	-.3373696 1.186647
MS	.2976971	.3965415	0.75	0.454	-.4843637 1.079758
_cons	-.1206454	.3884113	-0.31	0.756	-.8866717 .6453809

Table 4 of the regression test results show that all types of financing agreements do not significantly influence the stability of the Islamic Rural Bank. This shows that determining the type of financing will not affect the stability of the bank. Variables that have a significant influence on stability are the equity ratio, return, efficiency, and financing ratio.

The equity ratio has a positive relationship with stability. The higher the equity holdings, the bank will be more stable. The financing ratio also has a positive relationship with stability, so the higher the amount of financing, it will provide an excellent opportunity for Islamic Rural Bank to obtain high profits. The impact is to increase the ratio of return to total assets.

Another variable is the return to equity ratio, which is positively related to stability. This shows that the higher the return, the more stable the bank will be. These results are consistent with the pattern of a negative relationship between the ratio of operating expenses to operating revenue (Op\_Ex) with the stability variable. The higher the operating expenses ratio, the more inefficient the bank will be, thereby minimizing the bank's opportunity to earn high profits. In table 5 shows that the operating expenses ratio variable has a negative relationship with the return ratio.

The more efficient the bank, the higher the return ratio. In the results of this regression test, the only variable that has a significant relationship with the return ratio is the operating expenses ratio variable. These results show that no matter how much financing and any financing does not affect the rate of return if the bank does not improve operational efficiency.

**TABLE V.** Relationship Between Return and Efficiency, Type of Financing and Financing Ratio

ROE	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
FDR	-.038629	.0231135	-1.67	0.096	-.0842106	.0069527
Op_Ex	-.6106917	.0469938	-13.00	0.000	-.7033673	-.5180162
murabahah	.0067563	.4064177	0.02	0.987	-.7947315	.8082441
PS	-.0389825	.4084291	-0.10	0.924	-.8444371	.766472
MS	-.1725446	.416322	-0.41	0.679	-.9935646	.6484753
_cons	.5579686	.4067002	1.37	0.172	-.2440763	1.360013

Table 6 is a regression test that makes the ratio of operating expenses to the dependent variable. These results indicate that the financing ratio has a negative relationship with the ratio of operating expenses. The higher the financing, the higher the chance for Islamic banks to get returns, so the ratio of expenditures to income decreases. A variable type of funding does not affect the level of efficiency. This means that all types of financing have the same opportunity to generate high profits for Islamic banks because the amount of Islamic bank financing determines high returns.

**TABLE VI.** The ratio of Operational Expenses Becomes Dependent Variable

Op_Ex	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
FDR	-.0769636	.034523	-2.23	0.027	-.1450437	-.0088836
murabahah	.1050601	.6145641	0.17	0.864	-1.106871	1.316991
PS	.1817915	.6175161	0.29	0.769	-1.035961	1.399544
MS	.4091158	.6289156	0.65	0.516	-.8311168	1.649348
_cons	.5577583	.6137579	0.91	0.365	-.652583	1.7681

**V. CONCLUSION**

Based on the descriptive test results, there are 62 percent of observational data below the z-score average value. This means that the majority of Islamic Rural banks have default risk. Regression test results found that the z-score or stability of Islamic Rural Banks was influenced by equity ratios, efficiency, return rates, and financing ratios. The types of financing, such as Murabaha, profit sharing, and multi-service agreements do not affect the stability of Islamic Rural Banks.

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