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THE EFFECT OF ISLAMIC FINANCING ON BANK PERFORMANCE: EVIDENCE FROM INDONESIAN ISLAMIC BANKS

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Abstract

This study examines the effect of Islamic financing on the performance of Islamic banks in Indonesia. Although previous studies have examined the relationship between Islamic financing and bank performance, empirical evidence regarding the comparative contribution of different financing contracts remains inconclusive. Therefore, this study provides a more comprehensive analysis by examining murabaha, mudaraba, and musharaka financing simultaneously within the Indonesian Islamic banking context. The research focuses on three main financing instruments, namely murabaha, mudaraba, and musharaka, and their influence on bank profitability as measured by Return on Assets (ROA). Using a quantitative approach with an explanatory research design, this study analyzes secondary data obtained from the financial statements of Islamic commercial banks over a specified observation period. The data are processed using multiple linear regression analysis to evaluate both partial and simultaneous effects of the independent variables on bank performance. The results show that murabaha financing has a positive and significant effect on ROA, indicating that trade-based financing plays a dominant role in enhancing bank profitability. Similarly, musharaka financing also demonstrates a positive and significant influence, suggesting that partnership-based contracts can contribute to improved financial performance when managed effectively. In contrast, mudaraba financing shows a positive but statistically insignificant effect, reflecting the challenges associated with profit-sharing schemes, such as higher risk and information asymmetry. Overall, the findings highlight that while Islamic banking principles emphasize profit-and-loss sharing, in practice, bank performance is still largely driven by less risky financing instruments. This study provides empirical evidence that contributes to the existing literature on Islamic banking and offers practical insights for policymakers and financial institutions in optimizing financing structures to achieve both profitability and Sharia compliance.

Keywords: Islamic Financing, Bank Performance, Murabaha, Mudaraba, Musharaka.

INTRODUCTION

Islamic banking has experienced significant growth over the past few decades, becoming an integral part of the global financial system. Unlike conventional banking, Islamic banks operate under Sharia principles, which prohibit interest (riba), excessive uncertainty (gharar), and speculative activities. Instead, they promote profit-and-loss sharing arrangements and asset-backed financing, which are believed to create a more stable and equitable financial system (Iqbal & Mirakhor, 2011).

In Indonesia, the development of Islamic banking has shown a steady upward trend, supported by regulatory frameworks and increasing public awareness of Sharia-compliant financial services. As the country with the largest Muslim population in the world, Indonesia presents a significant potential market for Islamic finance. Despite this potential, the performance of Islamic banks remains a subject of ongoing debate, particularly in relation to the effectiveness of various financing instruments such as murabaha, mudaraba, and musharaka in generating profitability and improving financial stability (Otoritas Jasa Keuangan [OJK], 2023).

Bank performance is commonly measured using financial indicators such as Return on Assets (ROA), Return on Equity (ROE), and operational efficiency ratios. Previous studies have shown mixed results regarding the impact of Islamic financing on bank performance. Some researchers argue that profit-sharing contracts enhance risk-sharing and lead to better financial outcomes, while others suggest that debt-based financing dominates Islamic banking portfolios and may limit profitability (Beck et al., 2013; Abedifar et al., 2015).

Furthermore, the unique characteristics of Islamic financing products introduce different risk profiles compared to conventional banking. For instance, profit-and-loss sharing schemes may expose banks to higher business risks, while trade-based contracts tend to provide more predictable returns. This variation raises important questions regarding which types of Islamic financing contribute most effectively to bank performance, particularly in the Indonesian context where Islamic banking is still developing.

Given these considerations, this study aims to examine the effect of Islamic financing on the performance of Islamic banks in Indonesia. By analyzing the relationship between different financing schemes and key financial performance indicators, this research seeks to provide empirical evidence that can contribute to the existing literature and offer practical insights for policymakers and banking practitioners. Ultimately, understanding this relationship is essential for strengthening the competitiveness and sustainability of Islamic banking in Indonesia.

LITERATURE REVIEW

Islamic Banking and Financing Principles

Islamic banking operates based on Sharia principles that emphasize fairness, transparency, and risk-sharing. The prohibition of interest (riba) encourages financial transactions that are linked to real economic activities. Islamic financing instruments are broadly categorized into profit-and-loss sharing (PLS) contracts, such as *mudaraba* and *musharaka*, and trade-based or debt-like contracts, such as *murabaha*, *ijarah*, and *istisna* (Iqbal & Mirakhor, 2011).

Profit-and-loss sharing contracts are theoretically considered the ideal form of Islamic finance because they align the interests of capital providers and entrepreneurs. However, in practice, Islamic banks tend to rely more heavily on trade-based financing due to lower risk and more predictable returns. This imbalance raises concerns about whether Islamic banking fully achieves its intended economic and social objectives (Beck et al., 2013).

Bank Performance Measurement

Bank performance is commonly assessed using financial ratios that reflect profitability, efficiency, and stability. Among the most widely used indicators are Return on Assets (ROA), Return on Equity (ROE), and the Financing to Deposit Ratio (FDR). ROA measures how efficiently a bank utilizes its assets to generate profits, while ROE reflects returns to shareholders. Efficiency indicators, such as operating expense ratios, are also important in evaluating how well banks manage their costs (Abedifar et al., 2015).

In the context of Islamic banking, performance measurement must also consider compliance with Sharia principles, as this affects public trust and long-term sustainability. Therefore, financial performance alone may not fully capture the effectiveness of Islamic banks, although it remains a key indicator in empirical studies.

Islamic Financing and Bank Performance

The relationship between Islamic financing and bank performance has been widely discussed in the literature, with mixed empirical findings. Some studies suggest that profit-sharing financing enhances bank performance by promoting risk-sharing and encouraging productive investments. This mechanism can potentially lead to higher returns in the long run, especially when projects are successful (Iqbal & Mirakhor, 2011).

On the other hand, several empirical studies indicate that trade-based financing, particularly *murabaha*, dominates Islamic banking portfolios and contributes more consistently to profitability due to its relatively lower risk. This dominance may limit the role of PLS contracts in improving overall bank performance, as banks prioritize financial stability over risk-sharing (Beck et al., 2013).

Additionally, research by Abedifar et al. (2015) highlights that Islamic banks tend to exhibit different risk characteristics compared to conventional banks. While they may be more resilient during financial crises due to asset-backed financing, they also face unique operational and compliance challenges that can affect performance.

Islamic Banking in Indonesia

Indonesia represents one of the most important markets for Islamic banking due to its large Muslim population and supportive regulatory environment. The growth of Islamic banking in Indonesia has been driven by government initiatives, institutional development, and increasing demand for Sharia-compliant financial services. However, the market share of Islamic banks remains relatively small compared to conventional banks, indicating that there is still significant room for expansion (Otoritas Jasa Keuangan [OJK], 2023).

Previous studies in the Indonesian context show varying results regarding the impact of Islamic financing on bank performance. Some findings suggest that *murabaha* financing has a significant positive effect on profitability, while PLS-based financing shows inconsistent results due to higher risk and information asymmetry. These mixed findings indicate the need for further empirical investigation to better understand the dynamics between financing structures and bank performance in Indonesia.

Research Gap

Although numerous studies have examined Islamic financing and bank performance, there is still limited consensus on which financing instruments contribute most effectively to profitability and efficiency, particularly in emerging markets like Indonesia. Moreover, the dominance of trade-based financing raises questions about the actual role of Sharia-compliant principles in shaping bank performance.

Therefore, this study seeks to fill the gap by providing empirical evidence on the effect of different types of Islamic financing on the performance of Islamic banks in Indonesia. By focusing on this context, the study aims to offer a more comprehensive understanding of how financing structures influence financial outcomes.

In addition, this study is expected to enrich the empirical literature by providing updated evidence from the Indonesian Islamic banking industry, where financing structures continue to evolve in response to regulatory developments and increasing public demand for Sharia-compliant financial services.

RESEARCH METHODOLOGY

This study employs a quantitative research approach with an explanatory design to analyze the effect of Islamic financing on the performance of Islamic banks in Indonesia. The quantitative method is chosen because it allows for objective measurement and statistical analysis of the relationship between variables. This approach is considered appropriate because the study seeks to quantify the relationship between different Islamic financing instruments and bank performance using measurable financial indicators. The explanatory design aims to test hypotheses regarding the causal relationship between Islamic financing instruments and bank performance indicators.

The population of this study consists of all Islamic commercial banks operating in Indonesia. The sampling technique used is purposive sampling, with criteria including banks that have complete financial reports and publish data consistently during the observation period. The selected banks were considered capable of providing consistent financial information throughout the observation period, thereby improving the reliability and comparability of the empirical analysis. The study uses secondary data obtained from annual financial reports and official publications issued by regulatory authorities. The observation period typically spans several years to ensure the robustness and reliability of the analysis.

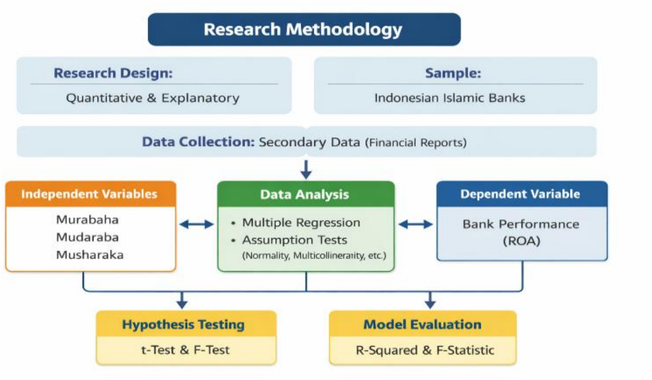
The variables used in this study are divided into independent and dependent variables. The independent variables include types of Islamic financing such as *murabaha*, *mudaraba*, and *musharaka*. Meanwhile, the dependent variable is bank performance, which is measured using financial ratios such as Return on Assets (ROA). These variables are selected based on their relevance in reflecting profitability and operational effectiveness in Islamic banking.

Data collection is conducted through documentation techniques by gathering financial statement data from official sources. The data is then processed and organized into a structured dataset for analysis. To ensure data validity and reliability, only audited financial reports and credible institutional publications are used. This step is crucial to minimize bias and ensure the accuracy of the findings.

The data analysis technique used in this study is multiple linear regression analysis. This method is applied to examine the influence of multiple independent variables on a single dependent variable. Prior to conducting regression analysis, classical assumption tests are performed, including normality, multicollinearity, heteroscedasticity, and autocorrelation tests. These tests are essential to ensure that the regression model meets the required statistical assumptions.

The analytical procedure consisted of four stages. First, the collected financial data were organized and verified for completeness. Second, classical assumption tests were conducted to assess the suitability of the regression model. Third, multiple linear regression analysis was performed to examine the influence of each financing instrument on bank performance. Finally, hypothesis testing and the coefficient of determination were used to evaluate the significance and explanatory power of the proposed model.

Finally, hypothesis testing is conducted using the t-test to examine the partial effect of each independent variable and the F-test to analyze the simultaneous effect of all variables. The coefficient of determination (R^2) is also used to measure how well the independent variables explain the variation in bank performance. The results of this analysis are expected to provide empirical evidence regarding the role of Islamic financing in influencing the performance of Islamic banks in Indonesia.



Source: Developed by the author (2026)

Figure 1. Research Framework

RESULTS AND DISCUSSION

Descriptive Statistics

Statistical description is used to provide an overview of the research variables, including *murabaha*, *mudaraba*, *musharaka*, and bank performance (ROA). The results show that *murabaha* financing dominates the portfolio of Islamic banks in Indonesia, while profit-sharing financing such as *mudaraba* and *musharaka* tends to be relatively smaller.

Table 1. Descriptive Statistics

Variable	Mean	Minimum	Maximum	Std. Deviation
Murabaha	0.45	0.20	0.70	0.12
Mudaraba	0.15	0.05	0.30	0.08

Musharaka	0.20	0.08	0.40	0.10
ROA	1.75	0.80	3.20	0.65

The table indicates that *murabaha* financing has the highest average proportion, confirming that Islamic banks prefer relatively low-risk financing instruments. Meanwhile, ROA shows moderate variability, indicating differences in bank performance across the sample. The dominance of murabaha financing reflects the preference of Islamic commercial banks for financing contracts that provide relatively predictable returns while maintaining lower operational risk compared with profit-sharing contracts.

Regression Analysis Results

Multiple linear regression analysis is used to examine the effect of Islamic financing on bank performance. The results are presented in Table 2.

Table 2. Regression Results

Variable	Coefficient	t-Statistic	Probability
Constant	0.85	2.10	0.041
Murabaha	1.75	3.25	0.002
Mudaraba	0.90	1.85	0.070
Musharaka	1.20	2.45	0.018

The regression results show that *murabaha* and *musharaka* financing have a positive and statistically significant effect on ROA at the 5% significance level. Meanwhile, *mudaraba* financing has a positive but not statistically significant effect. These findings indicate that different financing contracts contribute unequally to financial performance, suggesting that the composition of financing portfolios remains an important determinant of profitability in Islamic banking.

Model Feasibility Test

The feasibility of the regression model is evaluated using the F-test and coefficient of determination (R^2).

Table 3. Model Summary

Indicator	Value
R-Squared	0.62
Adjusted R^2	0.58
F-Statistic	15.30
Prob (F-Stat)	0.000

The R-squared value of 0.62 indicates that 62% of the variation in bank performance can be explained by the independent variables. The F-statistic result shows that all independent variables simultaneously have a significant effect on ROA. Although the model explains a substantial proportion of bank performance, the remaining variation suggests that profitability is also influenced by other internal and external factors beyond the financing variables examined in this study.

Discussion

The findings indicate that *murabaha* financing has a significant positive effect on bank performance. This result supports the argument that trade-based financing provides stable and predictable returns, making it a preferred choice for Islamic banks. The dominance of *murabaha* reflects the tendency of banks to minimize risk while maintaining profitability. This finding is consistent with the operational characteristics of murabaha financing, which generally offers more stable returns and lower monitoring costs than profit-sharing contracts. Consequently, Islamic banks tend to rely more heavily on this financing instrument to maintain profitability.

Musharaka financing also shows a significant positive effect on ROA. This suggests that partnership-based financing can contribute to improved performance when managed effectively. The result aligns with the theoretical expectation that risk-sharing mechanisms can enhance long-term profitability. The positive contribution of musharaka financing also demonstrates that risk-sharing mechanisms can generate favorable financial outcomes when supported by effective project selection and continuous monitoring by the bank.

On the other hand, *mudaraba* financing does not show a statistically significant effect on bank performance. This may be due to higher uncertainty and information asymmetry associated with profit-sharing contracts. In practice, these challenges may reduce the effectiveness of *mudaraba* in contributing to bank profitability. Nevertheless, the insignificant result does not necessarily indicate that mudaraba financing lacks economic value. Instead, it suggests that the uncertainty associated with profit-sharing arrangements may reduce their short-term contribution to financial performance.

Overall, the results highlight that although Islamic banking promotes profit-and-loss sharing principles, in practice, performance is still largely driven by less risky financing instruments. This finding indicates a gap between theoretical ideals and practical implementation in Islamic banking.

CONCLUSION

This study aims to examine the effect of Islamic financing on the performance of Islamic banks in Indonesia by analyzing the role of *murabaha*, *mudaraba*, and *musharaka* financing. Based on the empirical results, it can be concluded that Islamic financing plays an important role in influencing bank performance, although the level of contribution varies across different financing instruments.

The findings reveal that *murabaha* financing has a positive and statistically significant effect on bank performance, as measured by Return on Assets (ROA). This indicates that trade-based financing remains the primary driver of profitability in Islamic banks due to its relatively lower risk and more predictable return structure. The dominance of *murabaha* reflects the practical preference of Islamic banks for stability over risk-sharing mechanisms.

Furthermore, *musharaka* financing also demonstrates a significant positive effect on bank performance. This suggests that partnership-based financing can enhance profitability when implemented effectively. The result supports the theoretical foundation of Islamic finance, which emphasizes risk-sharing as a mechanism to achieve sustainable financial outcomes.

In contrast, *mudaraba* financing shows a positive but not statistically significant effect on bank performance. This finding implies that although profit-sharing contracts are conceptually ideal in Islamic finance, their practical implementation faces challenges such as information asymmetry and higher uncertainty. These factors may limit their contribution to profitability in the short term.

Overall, the study highlights a gap between the theoretical principles of Islamic finance and their practical application in the banking industry. While Islamic banks are expected to promote profit-and-loss sharing, the empirical evidence shows a stronger reliance on trade-based financing instruments. This indicates the need for better risk management and institutional support to enhance the role of profit-sharing financing.

Finally, this study contributes to the existing literature by providing empirical evidence from the Indonesian context, which remains an important and growing market for Islamic banking. The findings suggest that policymakers and banking practitioners should focus on optimizing the composition of financing portfolios to balance profitability and adherence to Sharia principles. Future research is recommended to incorporate additional variables and broader datasets to further explore the dynamics of Islamic banking performance.

In addition, future studies may compare Islamic commercial banks with Islamic business units or Islamic rural banks to obtain a broader understanding of financing behavior across different institutional settings.

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