At-Tijaroh: Jurnal Ilmu Manajemen dan Bisnis Islam
Volume 9 (2), 2023: 242 - 252
P-ISSN: 2356-492X; E-ISSN: 2549-9270

FINANCIAL PERFORMANCE OF SHARIA COMMERCIAL BANKS IN INDONESIA: DOES CAPITAL STRUCTURE MATTER?

Ahmad Syarif[1], Bisma Maulana[2], Zahro Salsabila[3], Angga Maulana[4]
ahmad.syarif@uinsi[1], bismamaulana71@gmail.com[2], zahrosalsabila91@gmail.com[3], anggamaul@gmail.com[4]

Abstract

Islamic banking has experienced a surge in financial growth in the last decade. Global economic challenges have encouraged many conventional banks to transform into sharia banks. Sharia banking can increase its operational efficiency by applying debt and equity financing methods by trade-off theory. This research investigates the effect of capital structure as measured by the debt-to-asset ratio (DAR) and debt-to-equity ratio (DER) on the financial performance of Sharia Commercial Banks as measured by return on assets (ROA) and return on equity (ROE). This research is quantitative with multiple linear regression analysis techniques. The data source comes from OJK Sharia Banking Statistics for 2017-2021. This study shows that DAR and DER have a significant effect on ROA. Apart from that, DAR has a substantial impact on ROE. However, this study indicates that DER does not significantly affect ROE.

Keywords: Capital Structure, Financial performance, Sharia Commercial Bank

Received: Dec 05nd, 2023; Revised: Dec 07th, 2023; Accepted: Dec 13nd, 2023

[1,3,4] Universitas Islam Negeri Sultan Aji Muhammad Idris Samarinda and Jl. H. A. M. Rifaddin, Harapan Baru, Kec. Loa Janan Ilir, Kota Samarinda, Kalimantan Timur
[2]Universitas Muhammadiyah Kalimantan Timur and Jl. Ir. H. Juanda No. 15, Sidodadi, Kec. Samarinda Ulu, Kota Samarinda, Kalimantan Timur
E-mail: [1]ahmad.syarif@uinsi, [2]bismamaulana71@gmail.com, [3]zahrosalsabila91@gmail.com, [4]anggamaul@gmail.com

Introduction

Indonesia is home to the largest Muslim population in the world, so the Government sees potential in developing Sharia economics and finance. This effect can be seen from the rapid growth in the financial performance of Sharia banking in the last decade, which began with solid sharia banking in the 1997 monetary crisis. Also, when all countries in the world face the impact of the COVID-19 pandemic, Islamic banking is showing positive growth in financial performance even though there is a slight decline (Sohail & Hasan, 2021).

Seeing the above phenomenon, many conventional banks are opening Sharia units within their institutions and even converting their institutions into Sharia banks, so more and more Sharia banks are being established. This event shows that financial performance is a benchmark for seeing how effective management is in managing its funding and its ability to generate maximum profits. Therefore, so that financial performance continuously shows stability and positive performance, Sharia banking must plan an efficient capital structure (Lutfiansyah & Machdar, 2020). The main factors that cause the ups and downs of Sharia banking stability are influenced by internal and external factors. Internal factors also called fundamental factors, originate from within the company and can be controlled by company management. In contrast, non-fundamental external factors can usually be caused by economic conditions such as interest rates and government policies (Hamza & Jedidia, 2020). Capital structure can be explained as the ability of a company to determine the proportion of its capital from various sources to improve its financial performance. Capital structure is optimal if it can balance risk with the expected rate of return in the Islamic banking (Qasim et al., 2021). Companies can increase their operational efficiency by implementing debt and equity financing methods. It can be done using the trade-off theory, which states that corporations must find a balance between the real benefits and costs of debt, and generally, companies are financed with long-term debt and capital structure (Mohammad et al., 2019).

Mohammad et al. (2019) explained the research results that capital structure positively affected financial performance in property companies, but Tretiakova et al. (2021) found a negative effect. (Sivalingam & Kengatharan (2018) found no effect of company size on bank performance in Sri Lanka, but Das & Swain (2018) found that capital structure positively affected manufacturing performance. This effect shows that large companies promise better performance. This research is based on the research gap of previous research by looking at banking in terms of leverage and financial ratios. Based on the differences in the research above, researchers are interested in conducting research that aims to determine the influence of capital structure and financial performance on Sharia Commercial Banks.

Their Islamic banking operations focus on a balance between maximizing profits and upholding Sharia principles in every aspect of their business. As institutions, Islamic banks must set long-term goals for their future, reflected in the financial reports submitted to stakeholders. Submitting this report is a way for Islamic banks to prove their vision, mission, and financial performance (Syarif, 2019). An overview of the financial performance of Islamic banks is known by looking at the level of profitability, such as ROA and ROE (Efendi & Wibowo, 2017). These numbers help determine management's success in creating profits by applying all the resources. ROA compares management's success in financial performance using all assets owned, while ROE is a fundamental indicator of corporate efficiency in generating profits using equity (Ayange et al., 2021).

Improving financial performance cannot always be considered good because management can offer low-return rates to investors from actions taken by Sharia banks, thus potentially giving rise to agency conflicts. This conflict is then discussed in agency theory, which reveals the existence of a conflict of interest where management as agent acts not by the interests of the owner or investor as principal (Ghardallou, 2022). Additionally, agency theory reveals that management as an agent has agreed on the debt that creditors must bear. Hence, the principal is concerned about the potential for increasing the chance of bankruptcy because increasing debt will reduce cash flow. However, management believes this increase in debt will increase the company's value even though management must try hard to keep agency costs from being too high. Therefore, banks with low agency costs will show an ideal capital structure to increase the company value (Mohammad et al., 2019).

The concept of capital structure relates to managing company capital from various sources to maximize the successful implementation of business activities. A company must determine the optimal combination of shares, bonds, long-term third-party loans, retained earnings, and other long-term funding sources needed to meet the company's capital. The MM theory, created by Franco Modigliani and Merton Miller, was the first economist to discuss modern capital structure. It states that the value of a debt-based company is the same as a non-debt-based business in a no-tax context, implying that capital structure has no impact on the company's value. On the other hand, MM believes that company value is determined by profits and the level of business risk rather than investment decisions (Anas, 2021).

Companies can increase their operational efficiency by implementing debt and equity financing methods. This effect can be achieved using trade-off theory, which states that corporations must balance the real benefits and costs of debt. Generally, companies are financed with long-term debt and capital structure (Pradhan et al., 2019). Trade-off theory refers to forming an optimal capital structure that accommodates tax variables, agency costs, and financial difficulties while maintaining market efficiency propositions, so managers must make tax savings and prevent financial difficulties that occur in corporations.

Apart from the trade-off theory, the Pecking Order Theory emerged, which states that corporations with high profits have low levels of debt because the former burdens the trade-off between company owners and managers (Syarif, 2023). Since companies with higher profits can fund their operations through interest on debt rather than equity, this suggests that they will use external financing. However, this must explain how much debt or equity each company must use (Abdullah & Tursoy, 2021). Therefore, companies that use policies based on The Pecking Order Theory will reduce their asset ownership to finance operational plans and pay maturing debts (Syarif, 2023b)

Previous research that has conducted research related to the correlation of capital structure with financial performance has produced a significant effect. Ritonga et al. (2021) stated that funding policies reflected in the debt-to-equity ratio (DER) and debt-to-asset ratio (DAR) significantly influence the company's achievement of profits on assets. Companies with a low solvency ratio can earn large profits before tax on asset ownership. So, the hypothesis in this research is as follows.

H1: DAR has a significant effect on ROA.

H2: DER has a significant effect on ROA.

Rahman (2020) shows that high solvency causes companies to need to manage debt payments to fulfill their obligations and encourage productive asset management. This effect leads to a gradual increase in profitability over time. Companies must pay off interest with net profit; this is shown by Violeta & Linawati (2019). In addition, corporations with high debt values usually have low return on equity (ROE) because additional interest costs are required. Pham (2022) reinforces that capital structure influences ROE, so low capital will cause payment defaults and a decline in corporate financial performance. So, the hypothesis in this research is as follows.

H3: DAR has a significant effect on ROE.

H4: DER has a significant effect on ROE.

Based on the theoretical basis and previous research above, the following research framework can be formulated in Figure 1.

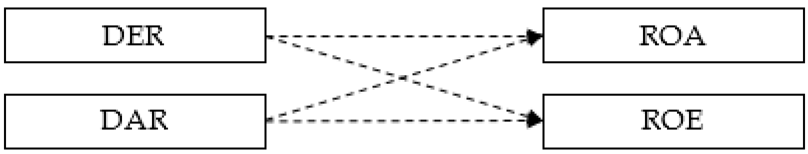

Figure 1. Theoretical framework

This quantitative research uses an associative descriptive approach to investigate the correlation between two variables involving Sharia Commercial Banks in Indonesia. The dependent variable used in this research is financial performance as measured by ROA and ROE, which are formulated as follows:

ROA = Earning after tax/total of asset

ROE = Earning after tax/total of equity

Meanwhile, the independent variable used in this research is capital structure, which is measured by DAR and DER and is formulated as follows:

DAR= Total of debt/total of asset

DER = Total of debt/total of equity

Methods

Using purposive sampling, The sample criteria in this study are Sharia commercial banks registered with the financial services authority, Sharia commercial banks that publish financial reports for the 2017-2021 period, and Sharia commercial banks with positive performance. Based on the criteria above, there are 6 Islamic commercial banks. Data was collected using library methods and documentation methods. The data comes from the Financial Services Authority (OJK), which is then analyzed using multiple linear regression analysis. The model used in this research refers to research Violita & Sulasmiyati (2017), so it can be formulated as follows:

$ROA = \alpha + b_1\, DAR + b_2\, DER + \ldots + e$

Result and Discussion

Result

A description of the capital structure data and financial performance of Sharia Commercial Banks during 2017-2021 can be shown as follows:

Table 1.
Capital Structure and Financial Performance of Sharia Commercial Banks

Rasio	ROA (%)	ROE (%)	DAR (%)	DER (%)
2017	0,63	11,42	18,9	173,70
2018	1,28	10,53	23,8	230,70
2019	1,73	13,54	26,1	276,07
2020	1,40	10,86	31,51	275,19
2021	1,55	12,29	27,25	255,24

Source: SPS OJK, 2023

Table 1 shows that the capital structure and financial performance values of Sharia Commercial Banks experienced fluctuating movements in 2017-2021. DAR showed a significant increase in 2020, while DER showed a substantial increase in 2019. This increase occurred due to the rise in debt from the public savings side, which impacted increasing interest expenses, thus affecting the ability of total assets and capital to meet the amount of debt. Meanwhile, ROA and ROE also showed a significant increase in 2019, although in 2017 and 2018, there was a decline. This decrease shows that net profit has decreased due to the large number of assets used to pay debts that have matured, resulting in reduced asset turnover and equity value.

Next, the researcher carried out partial hypothesis testing in model I, which is shown in table 2 below:

Table 2
Results of Multiple Linear Regression Analysis Model I

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig
	B	Std. Error	Beta		
(Constant)	24287.139	5072.544		4.788	0.000
DAR	-0.769	0.186	-1.004	-4.128	0.000
DER	0.587	0.233	0.612	2.514	0.018

[a] Dependent Variable: ROA

In Table 2, if the DAR value or DER value is 0, then the ROA (Y1) value can be estimated by entering 24287.139 for these two variables. The regression coefficient for the DAR variable shows that if DER increases by 1% while DAR remains constant, ROA will decrease by 0.769. Meanwhile, the DER regression coefficient confirms that if DER increases by 1% and DAR remains constant, ROA will increase by 0.587. The DAR significance value shows that there is a significant influence on ROA (0.000 > 0.05), and the DER significance value indicates that there is a considerable influence on ROA (0.018 > 0.05).

Then, the researchers tested the coefficient of determination in model I to see how much ROA can be explained by DAR and DER, which is shown as follows in Table 3:

Table 3
Determination coefficient result of Model I
Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.644[a]	0.415	0.370	17501.36436

[a]Predictors: (Constant), DER, DAR
[b]Dependent Variable: ROA

Based on Table 3 above, the Adjusted R Square value is 0.370, so the influence of DAR and DER on ROA is only 37.0%, with the correlation value (R) showing a strong relationship between DAR and DER on ROA because the matter is more than 0, 5 (0.644 > 0.5).

After testing the hypothesis for model I has been carried out, the researcher then carries out partial hypothesis testing on model II as follows in Table 4:

Table 4
Multiple Regression Result of Model II

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig
	B	Std. Error	Beta		
(Constant)	203.776	20.397		9.990	0.000
DAR	-0.321	0.127	-0.613	-2.524	0.018
DER	0.057	0.144	0.096	0.396	0.695

[a] Dependent Variable: ROE

Table 4 shows that the DAR regression coefficient confirms that a 1% increase in DAR will decrease ROE by 0.321. On the other hand, the DER regression coefficient shows that an increase in DER of 1% will increase ROE of 0.057 if the DAR value remains constant. The significance of DAR shows a significant influence on ROE (0.018 < 0.05). However, the significance value of DER indicates no considerable effect on ROE (0.695 > 0.05).

Then, the researchers tested the coefficient of determination in model II to see how much ROE can be explained by DAR and DER, which is shown as follows:

Table 5
Determination coefficient result of Model II
Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.545[a]	0.297	0.245	38.05414

[a]Predictors: (Constant), DER, DAR
[b]Dependent Variable: ROE

Based on Table 5 above, the Adjusted R Square value is 0.245, so it can be concluded that the influence of DAR and DER on ROE is only 24.5%, with the correlation value (R) showing a strong relationship between DAR and DER on ROE, because the matter is more than 0.5 (0.545 > 0.5).

Discussion

The influence of DAR on ROA

This study shows that DAR significantly affects ROA; the higher the DAR, the higher the ROA. However, this study found that Islamic banks with increased risk in settling long-term obligations had lower net profits. This is because Islamic bank management uses several assets to pay off maturing debts so that the ability of Islamic banks to earn net profits decreases. This phenomenon causes a conflict of interest with shareholders because they obtain a lower return rate than expected, so this result supports agency theory. This study supports Field Komara et al. (2018) empirical results.

The influence of DAR on ROE

This study shows that DAR significantly affects ROE, where the higher the DAR, the higher the ROE. However, this study found that Islamic banks have low performance due to the increasing amount of debt because Islamic commercial banks use several assets to pay debts that are due, so Islamic banks use equity to increase their ability to generate profits. This shows that Islamic banks are trying to balance the amount of debt with the rate of return that must be obtained to form an optimal capital structure, so these results support the trade-off theory. This study supports the empirical results of Violita & Sulasmiyati (2017).

The influence of DER on ROA

This study concludes that DER affects ROA, where the capital structure of Sharia commercial banks uses more equity. Additionally, increasing equity performance will impact increasing asset performance, increasing Islamic banks' ability to generate maximum profits. This study shows Islamic banks have high net profits with low debt, supporting the pecking order theory. These results are in line with the empirical studies of Abdullah & Tursoy (2021) but contrary to the empirical studies (Lutfiansyah & Machdar, 2020) where DER reduces the proportion of net profit received by investors due to the high amount of debt in the banking sector which could lead to a potential default, so management uses a proportion of net profit to pay the debt.

The influence of DER on ROE

This study concludes that DER does not affect ROE, where the return on equity performance remains stable even though it has a high amount of debt. The performance of Islamic banks with large debts will be similar to that of Islamic banks with low debts, and the capital structure also tends to be stable, so these results support Money Management theory. This result contrasts empirical studies by Banna et al. (2022). Therefore, Romadona & Handayani, (2021) advises avoiding the above possibility; managers are essential in minimizing expenses and maintaining the capital structure to stabilize the company's profits.

Conclusion

Based on the analysis and discussion, DAR and DER partially affect ROA. Furthermore, DAR has a significant influence on ROE, while DER does not have a significant influence on ROE. This study found that some Islamic commercial banks use a number of their assets to pay off all debts, which impacts their ability to provide optimal levels of return, giving rise to agency conflicts. Apart from that, there are Islamic commercial banks that can balance debt with their ability to provide optimal rates of return. However, there are Islamic commercial banks whose financial performance remains stable even though the corporation has an excessively high debt. Through this research, the author advises Sharia Commercial Banks to pay attention to capital structure and manage it appropriately to improve their financial performance so that Sharia Commercial Banks can increase company profits. The author also suggests that future researchers add elements of macroeconomic, intermediation, and efficiency research variables, try other analytical method techniques such as GMM analysis and robust panels, and increase the year period to be studied.

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