

# INVESTIGATING THE IMPACT OF NON-PERFORMANCE FINANCING ON PROFITABILITY: AN EMPIRICAL ANALYSIS OF ISLAMIC BANKS IN INDONESIA

Achmad Fauzi <sup>1\*</sup>, Ety Murwaningsari <sup>2</sup> and Tatik Marjanti <sup>3</sup>

<sup>1,3</sup> Islamic Economic & Finance, Trisakti University, Jakarta, 11440, Indonesia.

<sup>2</sup> Accounting, Trisakti University, Jakarta, 11440, Indonesia.

Email: <sup>1</sup>achmad221021902002@std.trisakti.ac.id (\*Corresponding Author),

<sup>2</sup>etty.murwaningsari@trisakti.ac.id, <sup>3</sup>tatik.mariyanti@trisakti.ac.id

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## Abstract

**Background:** The growth of consumer financing at Islamic banks in Indonesia is more aggressive than productive financing. The emphasis on the consumer sector is anticipated to pose challenges for Islamic banks and could significantly impact customer behavior in the future. **Aims:** This study examines the influence of non-performing financing on the Profitability of Islamic banks in Indonesia through empirical evidence in the context of productive and consumptive financing and the dynamics of the cost of loans. **Research Methode:** This study used Structural Equation Model-Partial Least Square (SEM-PLS) to test and analyze the influence of several structural equations (regression equations). The variables used in this study are Non-Performing Productive Financing, Performing Productive Financing, Non-Performing Consumer Financing, Performing Consumer Financing, Cost of Loan, and Profitability. Control Variables include Loan Pricing, Money Market Pricing, Third-Party Fund Pricing, Third-Party Funds, and Operational Costs. The data used are time series data, which are monthly aggregated data of the Islamic banking industry in Indonesia from January 2010 to July 2023. **Results and Conclusion:** This study indicates full mediation, where Non-Performing Productive Financing significantly negatively affects Profitability through Performing Productive Financing and the Cost of the Loan. For Non-Performing Consumer Financing, remediation occurs, where the Cost of the Loan does not prove to mediate the negative influence of Non-Performing Consumer Financing on Profitability. Non-performing productive financing directly affects Profitability negatively but insignificantly. Non Performing Consumer Financing directly affects Profitability. Performing Consumer Financing proves to mediate the influence of Non-Performing Consumer Financing on Profitability. This indicates partial mediation has occurred. Non-performing consumer financing directly affects performing consumer financing negatively, and performing consumer financing positively affects Profitability. **Contribution:** Theory: This study reinforces the concept that a balance between productive and consumer financing is important for economic stability. It also demonstrates the importance of maqashid sharia principles in managing bank risk and Profitability. Practice: Islamic banks should develop a more balanced policy in disbursing financing. Improved risk management is needed to manage both productive and consumer financing. Adjusting the profit strategy with forming a regulated loan cost can increase long-term stability.

**Keywords:** Nonperformance Financing, Productive, Consumer, Cost of Loan, Profitability.

## INTRODUCTION

Maqashid Syariah in Islam aims to maintain the wellbeing of the community. Besides being expected to make a profit, the management of Islamic banks is also required to base their operations on the Shariah goal or Maqasid Sharia. The measurement of Islamic Bank performance in Indonesia is inversely proportional to CAMEL and Maqashid Syariah. The implementation is also still classified (Sutrisno & Widarjono, 2018)

Taufik et al. (2023) evaluated the factors and impacts of Islamic Bank performance in Indonesia and Malaysia related to Maqashid Syariah's (MSP) performance. In Indonesia, the Sharia Supervisory Board (SSB) education level lowers MSP, while other characteristics have a minor influence. In Malaysia, SSB's size, education, and

reputation strengthen MSPs, while other factors could be more effective. MSPs in both countries tend to be pseudo-Islamic, making customers ignore the religious aspect. MSPs in Malaysia can increase Profitability thanks to better sharia transparency, while in Indonesia, this is not the case due to the lack of sharia transparency.

Islamic Bank, as an institution that carries Islamic values, is the locomotive of Islamic economics in contributing to the community's welfare. Islamic banks must have a social orientation, namely improving the community's welfare. This spirit must color the performance of Islamic banks, which will differentiate them from conventional banks (Sutrisno & Widarjono, 2018). There are 6 (six) elements for the creation of the Islamic economic system, one of which is the guarantee of value-based bank credit allocation that can grow and develop the production and distribution sector for goods and services needed by the community and business circles (Chapra, 1979). One of the important aspects of Islamic banking is its emphasis on social responsibility, which is evident in the management and distribution of its resources to various sectors of the economy. Islamic Bank is encouraged to invest in projects that benefit the community, such as infrastructure development, education, and health. This approach promotes economic growth and improves society's overall well-being (Ahsan & Qureshi, 2022). Islamic banks in the world grew faster than conventional banks during the period 2006–2021. Islamic banks take out more credit, where more than seventy percent of their profits come from loans (Sidaoui et al., 2022).

Financing in the productive sector provides a multiplier effect on the economic system. Bank loans in the productive sector have significant potential to boost economic growth. Productive credit is given for business purposes, such as working capital or investment, which can increase business productivity and efficiency. Thus, productive credit can increase people's income and welfare, as well as strengthen economic growth (Chabachib et al., 2019)

The banking sector's function in the economy is very important. Banks act as intermediaries between fund owners and productive sectors. The Bank minimizes risks and maintains moral hazards when conducting its intermediation function. Islamic Bank financing and savings significantly influence Malaysia's economic growth (Bayar, 2019).

Productive credit can increase investment, production, and employment and strengthen economic growth. It can help companies finance investments and increase productivity, increasing people's income and welfare (Gazi et al., 2021). Productive financing, such as loans for small and medium-sized enterprises (SMEs), infrastructure development, and innovation, can stimulate economic growth by increasing productivity, employment, and output. Companies with better access to finance achieve higher productivity (Ahamed et al., 2023).

Islamic banks in Indonesia are currently more aggressive in distributing financing to consumptive financing than productive financing, so it has the potential to cause problems in the future. From December 2015 to July 2023 in Indonesia, the Compound Annual Growth Rate / CAGR of Islamic Bank's productive financing was 8.01%. Meanwhile, Islamic Bank's consumptive financing is much more aggressive, at 14.42%. The phenomenon of financing growth shows that there is a tendency for Islamic banks to be more comfortable managing their consumptive financing portfolios. This is confirmed by the composition of consumptive financing, which continues to increase from 38.2% in December 2015 to 50.96% in July 2023. Meanwhile,

productive financing composition continues to decline from 61.8% in December 2015 to 49.04% in July 2023 (*Sharia Banking Statistics, 2015-2019*, n.d.).

The quality of Islamic Bank's Productive Financing is worse than that of Consumptive Financing, so Islamic Banks are very cautious and do not tend to refrain from distributing Productive Financing. Every business activity will not be separated from considering benefits and risk factors (Markowitz, 1991). Risks in Islamic Banks are one of the financing risks measured by Non-Performing Financing (NPF) (Modelling, 2016). The NPF of Islamic Bank's productive financing in Indonesia in July 2023 was 4.01% higher than the NPF of consumptive financing of 1.93%. Albrahimi (2020) researched that if banks have non-performing financing, then in accordance with regulations and IFRS 9, banks must form a loss reserve. NPF in Islamic Banks or NPLs in conventional banks have an impact on various things in banking, including CAR (Nugroho et al., 2021), cost delivery (Bolognesi et al., 2020), bank efficiency (Phung et al., 2022), growth rate performing loans (Serrano, 2020), and Profitability (Chabachib et al., 2019).

The settlement of Nonperformance Productive Financing tends to be more complex than Problematic Consumptive Financing, so using Cost of Loan in Productive Financing tends to be more wasteful. The use of Cost of Loan or Loan Lost Provision (LLP) will undoubtedly affect the Bank's performance. Return on average equity (ROAE) significantly moderated LLPs with negative interactions on solvency (Zheng et al., 2019). LLP was also found to negatively affect Islamic banks' performance (Zulfikar & Sri, 2019). Risk-based capital ratios affect the provision of loan losses in the US (Abbas et al., 2021). LLPs are also used to plan the performance of banks in Jordan (Alqudah et al., 2020).

As long as the prospective customers are eligible, Islamic Bank will distribute consumptive financing to customers without paying attention to further sharia maqashid values. Al Juwayni's Theory of Needs explains that consumptive in Islam is sufficient at the *daruriyat needs level*. Because of that, it will endanger the safety of the purpose of *Maqashid Sharia* (Auda, 2019). Non-performing loans have a negative effect on the SDGs. Banking stability will increase SDGs funding, and banks will be stable if they finance the SDGs (Amadi et al., 2021). Ease of customer access will further increase the distribution of consumptive financing as happened to Fintech Peer to Peer Lending companies (Meiryani et al., 2022). Online loans, currently popular in consumer loans, are very influential in the growth of consumer loans. In China, the demand for online consumer credit positively relates to the school year, monthly living expenses, financial support from students' universities, and consumption preferences. However, other factors, including major fields of study, the highest parental education rates, and advertising in the media and on campus, negatively influence students' online consumer credit (Hao et al., 2019).

Likewise, in Indonesia, ease of use, security, economic benefits, and financial capabilities simultaneously have a positive and significant effect on the sustainability of the intention to use financial technology in the Greater Jakarta region (Meiryani et al., 2022). In the face of the current global pandemic crisis, the future of household finances is uncertain. Factors such as the ratio of mortgage debt to assets, age, marital status, credit constraints, salary loans, or payments that have matured more than 60 days in the past year will increase the risk of bankruptcy (Brygała, 2022)

Banks hold back growth on high-risk financing due to the obligation to form the cost of loans, but on the other hand, banks often plan profits by forming the cost of loans beyond regulations. Banks in Southeast Europe divide the provision of credit losses into two components: discretionary and non-discretionary. The LLP component influences the growth of bank loans (Shala et al., 2020). LLP is used by management as one of the tools to manage the Bank's profits (Zheng et al., 2019). Discretionary loan loss provisions can be used in sharia financing (Zulfikar & Sri, 2019). The provision for credit losses and bank stability in the previous period positively correlates with the current bank stability (My, 2020). There are simultaneous differences between the Capital Adequacy Ratio, Profit Before Tax, Loan Loss Provision, Non-Performing and Variable Loans, and Company Size as a determinant of profit management between Islamic and conventional banks. As part of Risk Management, Islamic Bank regulates loan loss reserves as one of the mitigation of investment risks and income smoothing in the profit-sharing system (Suripto & Supriyanto, 2021).

This research is important because it will determine the direct influence of problematic financing on Profitability according to the productive and consumptive segments. It will also determine the indirect influence of Nonperformance Loans per segment on Profitability mediated by each segment's Cost of Loans or Performance Loans.

From the explanation of the theory and previous research mentioned above, this study proposes the following hypotheses:

- H1: Nonperformance Productive Financing has a negative effect on Performance Productive Financing at Islamic Banks.
- H2: Nonperformance Productive Financing positively affects the *cost of loans* (CL) at Islamic banks.
- H3: Nonperformance Consumer Financing positively affects *the Cost of Loan* (CL) at Islamic Bank.
- H4: Nonperformance Consumer Financing has a negative effect on the Performance of Consumer Financing in Islamic Bank
- H5: Performance Productive Financing has a positive effect on Profitability at Islamic Bank
- H6: *Cost of Loan* has a negative effect on Profitability in Islamic Bank.
- H7: Performance Consumer Financing has a positive effect on Profitability at Islamic Bank
- H8: Nonperformance productive Financing has a significant negative effect on Profitability
- H9: Nonperformance Consumer Financing has a negative effect on Profitability.

In addition to the direct relationships mentioned above, this study also aims to examine indirect relationships. Several indirect relationships (IR) are as follows:

1. Performance Productive Financing mediates the negative influence of Nonperformance Productive Financing on Profitability
2. *Cost of Loan* mediates the negative influence of Nonperformance Productive Financing on Profitability.

3. *Cost of Loan* mediates the negative influence of Nonperformance Consumer Financing on Profitability.
4. Performance Consumer Financing mediates the negative influence of Nonperformance Consumer Financing on Profitability

## RESEARCH METHOD

### a) Research Design

This study is a quantitative research using time series data regression with the Structural Equation Model – Partial Least Square (SEM-PLS) which aims to test and analyze the influence of several structural equations (regression equations).

### b) Population and sample

The population in this study uses data from the Islamic banking industry, which is consolidated in statistical data at the Financial Service Authority (FSA) and Central Bank in Indonesia from January 2010 to July 2023 monthly. Thus, the overall number of samples is 163. To meet the minimum sample requirements of 110 samples from 11 variables, namely using a ratio of 10: 1 (Hair Jr. et al., 2019).

### c) Data Analysis

The investigation is carried out by forming an Inner Model, which is then converted into an equation. The Path Diagram of this study is shown in Figure 2.1.

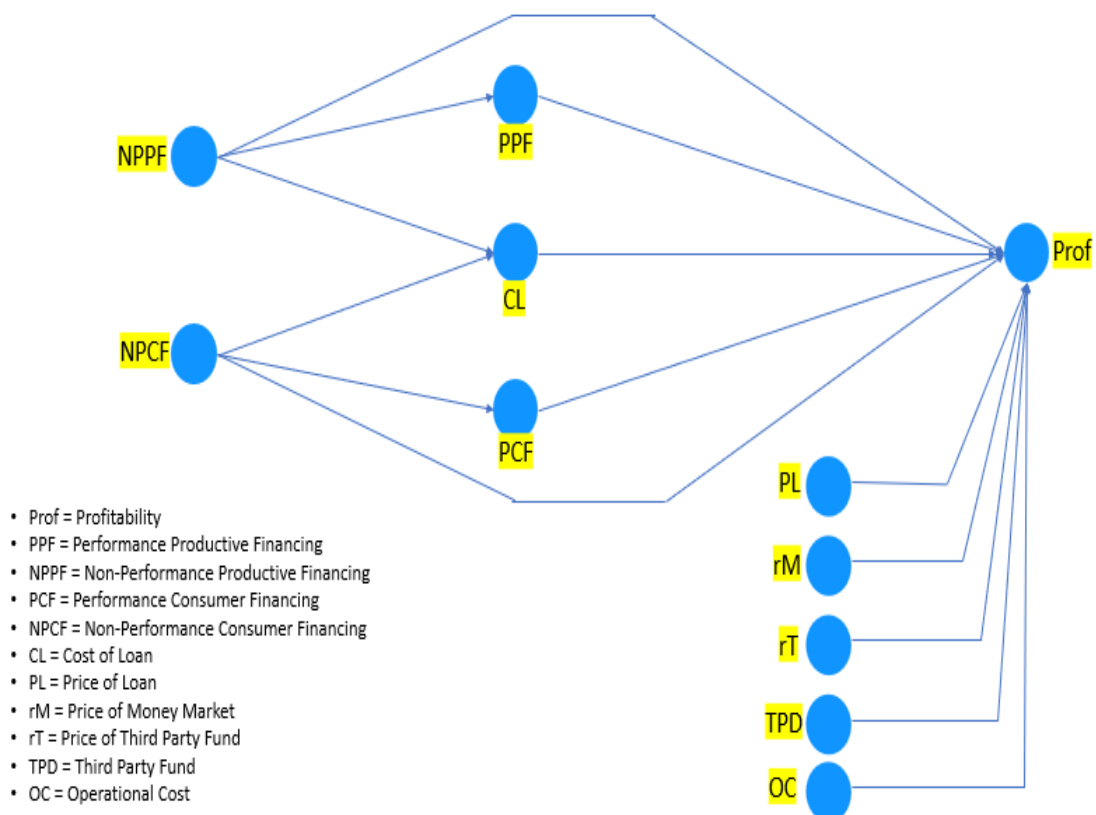


Figure 2.1: Path Diagram

**a) Model**

As stated by Freixas & Rochet (2008) that, banks in forming Profit are influenced by various factors, namely as the basic formula is as follows:  $\pi = rL - L - rM - rD - D - C(D, L)$  where  $\pi$  = Profit;  $rL$  = Loan Pricing;  $r$  = Money Market Pricing;  $M$  = Net Money Market;  $rD$  = Funding Pricing;  $CL$  = Cost of Loan;  $CD$  = *Cost for Deposit/* Operational Cost.

Furthermore, since  $M = (1-\alpha) D - L$ , if  $M$  is included in the basic formula mentioned above, the equation is as follows:

$$\pi(D, L) = (rL - r) L + (r(1 - \alpha) - rD) D - C(D, L).$$

Furthermore, because:  $L = PF + CF$ , where  $L$  = Loan,  $PF$  = Productive Financing,  $CF$  = Consumer Financing, where  $PF = PPF + NPPF$  and  $CF = PCF + NPCF$ , where  $PPF$  = Performance Productive Financing,  $NPPF$  = Nonperformance Productive Financing,  $PCF$  = Performance Consumer Financiers,  $NPCF$  = Nonperformance Consumer Financing.

Therefore, the formula is further derived into a research formula that can be used to determine the following research variables:

$$\pi = (rL-r) [(PPF + NPPF) + (PCF + NPCF)] + [r(1-\alpha) - rD] D - C(D, L),$$

The equation model is derived into a research model according to the framework of thinking as follows:

Model 1: Performance Productive Financing (PPF)

$$PPF = \alpha_0 + \alpha_1 NPPF + \epsilon_1$$

Model 2: Cost of Loan (CL)

$$CL = \beta_0 + \beta_1 NPPF + \beta_2 NPCF + \epsilon_2$$

Model 3: Performance Consumer Financing (PCF)

$$PCF = \delta_0 + \delta_1 NPCF + \epsilon_3$$

Model 4; Profitability (Prof)

$$\text{Prof} = \phi_0 + \phi_1 PPF + \phi_2 CL + \phi_3 PCF + \phi_4 NPPF + \phi_5 NPCF + \phi_6 LP + \phi_7 rM + \phi_8 rT + \phi_9 TPD + \phi_{10} OC + \epsilon_4$$

$$\text{Prof} = \phi_0 + \phi_1 PPF + \phi_2 CL + \phi_3 PCF + \phi_4 NPPF + \phi_5 NPCF + \phi_6 LP + \phi_7 rM + \phi_8 rT + \phi_9 TPD + \phi_{10} OC + \epsilon_4$$

Where:

NPPF= Non Performance Productive Financing	Control Variabel:
PPF= Performance Productive Financing	LP = Loan Pricing
CL = <i>Cost of Loan</i>	rM = Money Market Pricing
NPCF=Non Performance Consumer Financing	rT = Third Party Fund Pricing
PCF = Performance Consumer Financing	TPF = Third Party Fund
Prof = Profitability	OC = Operational Cost

## RESULT

### a) Description & Goodness of Fit

The results of the processing for *descriptive* statistics can be seen in table 3.1

**Table 3.1: Descriptive Statistics of Research Variables**

Variable	N	Minimum	Maximum	Mean	Std. Deviation
Prof	163	0.0800	2.517	1.464	0.5829
PPF	163	31870.680	252718.900	133488.067	58431.874
NPPF	163	2.5574	6.450	4.305	1.012
PCF	163	13215.8130	268122.552	112278.555	66825.903
NPCF	163	0.9011	3.314	1.844	0.552
CL	163	385.569	16472.920	5047.372	3424.633
PL	163	8.570	14.592	11.568	1.721
rM	163	0.840	7.300	4.633	1.567
rT	163	2.461	6.721	4.522	1.001
TPD	163	52811.377	628567.611	292617.150	163803.744
OC	163	28.9525	21534.090	6201.714	5095.375

Source: processed data

The results of *multicollinearity* processing can be seen in Table 3.2. The information from the table shows:

**Table 3.2: Multicollinearity Testing**

Independent Variables	PPF	PCF	CL	Prof
NPPF	1.000		1.885	4.536
NPCF		1.000	1.885	3.066
PPF				53.772
CL				4.186
PCF				213.176
LP				25.817
rM				2.405
rT				5.501
TPD				274.457
OC				5.138

Source: processed data

*Multicollinearity* in regression models is a problem when the results of partial tests are many or insignificant. In contrast, in the resulting model the existence of individual tests that are produced is significant so that the existence of *multicollinearity* can be accepted.

The processing results for the determination coefficient can be seen in table 3.3. The information from the table can be explained as follows:

**Table 3.3: Determination Coefficient Testing**

Model Structural	R Square	R Square adjusted
PPF	0.021	0.014
CL	0.079	0.067
PCF	0.032	0.026
Prof	0.744	0.727

Source: Output SmartPLS

- i. The R2 adjusted value for the PPF, CL, PCF models appears small. This is because the model only involves 1 independent variable. The rest are variations of other independent variables that affect PPF, CL and PCF but are not included in the model
- ii. The R2 value adjusted for the *profit* variable is 0.727 shows that the variation of the independent variable is able to explain the variation of the dependent variable, namely Profitability by 72.7%, while the other variable is 27.3% is the variation of other independent variables that affect Profitability but are not included in the model. The R square adjusted value for the profit model which is the final goal of this study, namely *the profit* model of 72.7%, shows that the resulting model has a good fit model

**b) Data Targeting Results**

The processing results for the determination coefficient test can be seen in table 3.4. The information from the table can be explained as follows:

**Table 3.4: Partial Icing (t-test)**

No	Hypothesis	Sign Hypothesis	Estimate	Statistics	P-value	Conclusion
H1	There is a negative influence of Non Performance Productive Financing (NPPF) on Performance Productive Financing (PPF)	(-)	0.143	2.370	0.009	Hypothesis not supported
H2	There is a positive influence of Non Performance Productive Financing (NPPF) on <i>Cost of Loan</i> (CL)	(+)	0.347	3.479	0.000	Hypothesis supported
H3	There is a positive influence of Nonperformance Consumer Financing (NPCF) on <i>Cost of Loan</i> (CL)	(+)	-0.116	1.234	0.109	Hypothesis not supported
H4	There is a negative influence of Nonperformance Consumer Financing (NPCF) on Performance Consumer Financing (PCF)	(-)	-0.179	-2.742	0,003	Hypothesis supported
H5	There is a positive influence of Performance Productive Financing (PPF) to Profitability (Prof)	(+)	-1.139	3.475	0,000	Hypothesis not supported
H6	There is a negative effect of <i>Cost of Loan</i> (CL) on Profitability	(-)	-0.296	3.996	0,000	Hypothesis supported
H7	There is a positive effect of Performance Consumer Financing (PCF) on Profitability.	(+)	1.849	3.460	0,000	Hypothesis supported



H8	There is a negative influence of Nonperformance Productive Financing (NPPF) on Profitability.	(-)	-0.019	0.237	0,407	Hypothesis not supported
H9	There is a negative influence of Nonperformance Consumer Financing (NPCF) on Profitability.	(-)	-0.143	1.961	0,025	Hypothesis supported

Source: processed data

**1. Hypothesis 1: There is a negative effect of Nonperformance Productive Financing (NPPF) on Performance Productive Financing (PPF)**

Hypothesis 1 was carried out to test the negative influence of Nonperformance Productive Financing on Performance Productive Financing. From the results of the processing, an estimated coefficient value of 0.143 with a statistical t of 2.370 and a p-value of  $0.009 < 0.05$  which means that  $H_0$  is accepted and  $H_a$  is rejected, indicating that the hypothesis that Nonperformance Productive Financing has a negative effect on Performance Productive Financing is not proven.

**2. Hypothesis 2: There is a positive effect of Nonperformance Productive Financing (NPPF) on Cost of Loan (CL)**

Hypothesis 2 was carried out to test the positive influence of Non-Performance Productive Financing on Cost of Loan (CL). From the results of processing, an estimated coefficient value of 0.347 and a statistical t-value of 3.479 resulted in a p-value of  $0.000 < 0.05$ , which means that  $H_0$  was rejected and  $H_a$  was accepted so that it can be concluded that Non Performance Productive Financing has a positive effect on the Cost of Loan (CL).

**3. Hypothesis 3: There is a positive effect of Non-Performing Consumer Financing (CPA) on the Cost of Loan**

Hypothesis 3 was carried out with the aim of testing the positive influence of Nonperformance Consumer Financing on the Cost of Loan. The results of the processing obtained an estimated coefficient value of -0.116 and produced a statistical t of 1.234 with a P value of  $0.109 > 0.05$  and the sign of the coefficient that was not in accordance with the theory showed that  $H_0$  was accepted and  $H_a$  was rejected, so that the hypothesis that Non-Performing Consumer Financing had a positive effect on the Cost of Loan (CL) was not proven.

**4. Hypothesis 4: There is a negative influence of Non-Performing Consumptive Financing (PKB) on Current Consumptive Financing (PKL)**

Hypothesis 4 was carried out with the aim of testing the negative influence of Non Performance Consumer Financing (PKB) on Current Consumer Financing. From the results of the processing, an estimated coefficient value of -0.179 with a statistical t-value of -2.742 resulted in a p-value of  $0.003 < 0.05$  which means that  $H_0$  was rejected and  $H_a$  was accepted, so it can be concluded that the hypothesis that Non Performance Consumer Financing has a negative effect on Performance Consumer Financing is proven.

### **5. Hypothesis 5: There is an effect of Performance Productive Financing (PPF) on Profitability**

Hypothesis 5 was carried out to test the positive influence of Performance Productive Financing (PPF) on Profitability. The processing results obtained an estimated coefficient value of -1.139 and a P Value of  $0.000 < 0.05$ . This shows that  $H_0$  was accepted and  $H_a$  was rejected, so it can be concluded that the hypothesis that Performance Productive Financing has a positive effect on Profitability is not proven.

### **6. Hypothesis 6: There is a negative effect of Cost of Loan (CL) on Profitability**

Hypothesis 6 was carried out to test the negative influence of Cost of Loan (CL) on Profitability. The results of the processing obtained an estimated coefficient value of -0.296 and a statistical t-value of 3.396, resulting in a p-value of  $0.000 < 0.05$  which means that  $H_0$  is rejected and  $H_a$  is accepted so that a hypothesis stating that there is a negative influence of Cost of Loan (CL) on Profitability can be proven.

### **7. Hypothesis 7: There is a positive effect of Performance Consumer Financing (PCF) on Profitability**

Hypothesis 7 was carried out to test the positive influence of Performance Consumer Financing (PCF) on Profitability. The results of the processing showed that the value of the estimation coefficient was 1.849 with a statistical t-value of 3.460, resulting in a p-value of  $0.000 < 0.05$  which means that  $H_0$  was rejected and  $H_a$  was accepted, so that a hypothesis that stated that there was a positive influence of Performance Consumer Financing (PCF) on Profitability was proven.

### **8. Hypothesis 8: There is a negative influence of Nonperformance Productive Financing on Profitability**

Hypothesis 8 was carried out to test the negative influence of Nonperformance Productive Financing on Profitability. The results showed that the value of the estimation coefficient was -0.019 with a statistical t-value of -0.237, resulting in a p-value of  $0.407 > 0.05$ , which means that  $H_0$  was accepted by  $H_a$  and rejected so that the hypothesis that there was a negative influence of Nonperformance Productive Financing on Profitability was not proven.

### **9. Hypothesis 9: There is a negative influence of Nonperformance Consumer Financing on Profitability**

Hypothesis 9 was carried out to test the negative influence of Nonperformance Consumer Financing on Profitability. The results of the processing showed an estimated coefficient value of -0.143 with a statistical t-value of 1.961, resulting in a p-value of  $0.025 < 0.05$  which means that  $H_0$  was rejected and  $H_a$  was accepted so that the hypothesis that there was a negative influence of Nonperformance Consumer Financing on Profitability was proven.

### **10. Indirect Influence 1: Performance Productive Financing (PPF) mediates the influence of Non-Performance Productive Financing (NPPF) on Profitability.**

The results of the hypothesis test of the direct influence of Nonperformance Productive Financing on Profitability resulted in the finding of a negative influence as shown by the estimated coefficient value of -0.019 with a p-value of t statistics of 0.407. The results of testing the influence of Nonperformance Productive Financing on Profitability with Performance Productive Financing as a mediating variable resulted in findings

proving that there is a negative influence, as seen from the estimated coefficient value of -0.162. With a statistical t-value of -1.965 and a p-value of  $0.024 < 0.05$ , Current Productivity Financing is proven to mediate the negative influence of Nonperformance Productive Financing on Profitability. The results of these findings show that there is full mediation where Nonperformance Productive Financing has a significant negative effect on Profitability through Performance Productive Financing. At the same time, there is no direct evidence of a negative influence of Nonperformance Productive Financing on Profitability.

#### **11. Indirect Influence 2. Cost of Loan (CL) mediates the influence of Nonperformance Productive Financing (NPPF) on Profitability.**

The results of the hypothesis testing of the direct influence of non-performance productive financing on profitability produced an insignificant negative influence, as shown by the estimated coefficient value of -0.019 with a p-value of 0.407. The results of testing the influence of Nonperformance Productive Financing on Profitability with Cost of Loan as a mediating variable resulted in findings proving that there is a negative influence, as seen from the estimated coefficient value of -0.103. With a statistical t-value of -2.621 and a p-value of  $0.004 < 0.05$ , the Cost of Loan is proven to mediate the negative influence of Nonperformance Productive Financing on Profitability. These findings show that the influence of nonperformance productive financing on profitability is full mediation, which is the cost of loan variable that must mediate.

#### **12. Indirect Influence 3. Cost of Loan (CL) mediates the influence of Nonperformance Consumer Financing (NPCF) on Profitability.**

Testing the hypothesis of the direct influence of Non Performance Consumer Financing on Profitability resulted in a significant negative influence, as shown by the estimated coefficient value of -0.143 with a p-value of  $0.025 < 0.05$ . Testing the indirect influence of Nonperformance Consumer Financing on Profitability mediated by the Cost of Loan resulted in no significant negative relationship, as shown by the estimated coefficient value of 0.034 with a statistical t-value of 1.179 and a p-value of  $0.119 > 0.05$ . The results of these findings show that the relationship that occurs is unmediation.

#### **13. Indirect Influence 4. Performance Consumer Financing (PCF) mediates the influence of Nonperformance Consumer Financing (NPCF) on Profitability.**

The direct hypothesis testing of Nonperformance Consumer Financing on Profitability produced the findings of a significant negative influence, as shown by the estimated coefficient value of -0.143 with a p-value of  $0.025 < 0.05$ . Testing the influence of Nonperformance Consumer Financing on Profitability with Performance Consumer Financing as a mediating variable resulted in findings proving that there is a negative influence as can be seen from the value of the estimated coefficient of -0.330 with the p-value of the statistical t -2.155 of  $0.015 < 0.05$ . The results of this finding show that partial mediation, namely non-performance consumer financing, affects profitability both directly and indirectly through performance consumer financing as a mediation variable.

The conclusion from the results of 4 mediation tests based on the explanation above can be seen in Table 3.5.

**Table 3.5: Indirect Influence**

	<b>Indirect Influence (II)</b>	<b>Sign</b>	<b>Estimate</b>	<b>C.R.</b>	<b>P</b>	<b>Conclusion</b>
II.1	Performance Productive Financing (PPF) mediates the negative influence of Non-Performance Productive Financing (NPPF) on Profitability (Prof)	(-)*(+) = (-)	-0,162	-1,965	0,024	Allegations supported
II.2	Cost of Loan (CL) mediates the negative influence of Non-Performance Productive Financing (NPPF) on Profitability (Prof)	(+)*(-)	-0,103	-2,621	0,004	Allegations supported
		= (-)				
II.3	Cost of Loan (CL) mediates the negative influence of Non-Performance Consumer Financing (NPCF) on Profitability (Prof)	(+)*(-)	0,034	1,179	0,119	Allegations are not supported
		= (-)				
II.4	Performance Consumer Financing (PCF) mediates the negative influence of Non-Performance Consumer Financing (NPCF) on Profitability (Prof)	(-)*(+)	-0,330.	-2,155	0,015	Allegations supported
		= (-)				

Source: processed data

As for variable control, it is as shown in Table 3.6. Of the 5 (five) variable controls, only 2 (two) variables are proven to affect Profitability (Prof) according to the hypothesis, namely Third third-party fund Pricing (rT) and Third Party Fund (TPF). The other variables did not match the hypothesa, although 2 (two) variables, namely Loan Pricing (LP) and Operational Cost (OC), produced a significant p value of <0.05, but the direction was not appropriate. Meanwhile, Money Market Pricing (rM) results in the right direction but not significant.

**Table 3.6: Control Variables**

<b>No</b>	<b>Influence</b>	<b>Sign Hypothesis</b>	<b>Estimate</b>	<b>Statistics</b>	<b>P-value</b>	<b>Conclusion</b>
1	Loan Pricing (LP) has a positive effect on Profitability (Prof)	(+)	-0,618	-2,346	0,01	Hypothesis not supported
2	Money Market Pricing (rM) has a positive effect on Profitability (Prof)	(+)	0.004	0.063	0.475	Hypothesis not supported
3	Third Party Fund Pricing (rT) has a negative effect on Profitability (Prof)	(-)	-0.575	-6.830	0.000	Hypothesis supported
4	Third Party Fund (TPF) has a negative effect on Profitability (Prof)	(-)	-2.003	-2.857	0.002	Hypothesis supported
5	Operational Cost (OC) affects Profitability (Prof)	(-)	0.166	1.945	0.026	Hypothesis not supported

## DISCUSSION & CONCLUSION

Islamic banks must balance between Productive Financing and Consumer Financing to encourage overall economic prosperity. An excessive focus on Consumer Financing can run counter to the goals of economic justice and sustainable growth (Choudhury, 2020). Nonperformance Consumer Financing has a negative impact on Profitability, while Performance Consumer Financing has a positive impact. This shows the importance of maintaining the quality of Consumer Financing. The mediating effect of CL and Performance Financing on Profitability shows that managing loan quality and costs is critical to sustainable Profitability. Dilek et al (2018) explain the Islamic Approach To Consumption Theory that the Quran and Islamic principles encourage households to use only necessary items. Individuals are expected to allocate their expenses to essential needs. The remaining funds should be donated to charitable causes or spent on activities that support religious values. According to Xiao and Tao (2021), in conventional economic theory, consumers are expected to have a stable consumptive level throughout their life cycle. In this view, access to credit is considered a measure of financial well-being. The more loan options available, the more favorable they are considered for consumers. However, it should be noted that the use of loans should not be excessive. If there is too much debt, consumers can experience a heavy financial burden and even risk facing severe financial bankruptcy.

Nonperformance Productive Financing that does not affect performance productive financing shows that problems in productive financing do not directly hinder ongoing financing performance. However, problems in productive financing increase the cost of loss reserves, which indicates higher risks. Nonperformance Consumer Financing has a negative effect on Performance Consumer Financing, indicating that problems in Consumer Financing tend to interfere with ongoing financing performance. Performance Consumer Financing has a positive effect on Profitability, showing that healthy Consumer Financing can provide benefits for banks. Islamic Bank is more cautious in distributing Productive Financing due to the higher risks associated with loss reserve costs. Nonperformance Consumer Financing has a more direct negative impact on Profitability than Nonperformance Productive Financing. The poor quality of productive financing has caused Islamic Bank to be more cautious in distributing this financing, while Nonperformance Consumer Financing shows a direct impact on Profitability.

Financing distribution in the productive sector must still be a concern of the Bank. Finance and Growth Theory highlights the importance of long-term economic growth. This theory affirms that a thriving financial system forms a strong foundation for economic growth. An effective financial system not only provides access to financial resources, but also facilitates risk transfer, provides payment services, and supports long-term investments. Of course, all of this can ultimately have an impact on the Profitability of related financial institutions (Levine, 1993).

The complexity in completing Nonperformance Productive Financing is reflected in the significant positive influence on CL. This implies that more resources and costs are required to manage and resolve these issues, thus making the process more wasteful. In contrast to Productive Financing, Non Performance Consumer Financing does not have a significant impact on CL, but shows a negative influence on Performance Consumer Financing. This signifies that although the settlement cost is lower, the impact is more direct on the performance of consumptive loans. Although more

complicated, it is important for banks to continue to support productive sectors with better policies and effective risk management. The quality of Productive Financing settlements that are more complicated and wasteful than Consumer Financing leads to higher use of CL, negatively impacting Profitability.

Jayasurya said that the Transaction Cost Theory initiated by Ronald Coase stated that in a market economy, the main goal of the legal system must be to minimize transaction costs and reduce government intervention. Hubbard Douglas (2020) stated that an assessment from experts is needed on key aspects of risk management, including risk assessment and evaluation methods, strategies to reduce risks, frequent errors in quantitative models, and other relevant matters. Islamic Bank focuses more on the feasibility of customers in distributing consumptive financing without considering the values of sharia maqashid which emphasizes balance, justice, and avoidance of waste. In fact, Islamic banks that carry Islamic values should prioritize this (Sutrisno & Widarjono, 2018). Nonperformance Consumer Financing has a negative effect on Performance Consumer Financing, indicating a high risk in the consumptive financing portfolio. Nonperformance Productive Financing does not have a negative impact on Performance Productive Financing, but has a positive impact on CL, indicating that there are high costs in handling it. CL that has a negative effect on Profitability shows that the high cost of completing Non-Performing Financing is detrimental to the Bank's Profitability. Consumer Financing performance which has a positive effect on Profitability shows that banks are more profitable by focusing on healthy Consumer Financing. Nonperformance Consumer Financing has a negative effect on Profitability, indicating a high risk of Nonperformance Consumer Financing. The dominant distribution of Consumer Financing and lack of attention to the values of Islamic maqashid shows that there is a significant risk to the quality of Islamic Bank's financing portfolio. Better management and adherence to the principles of sharia maqashid are needed to increase Profitability and reduce long-term risks.

CL that has a negative effect on Profitability indicates that high loss reserve costs erode the Bank's Profitability. This is the main consideration for banks in restraining financing growth in high-risk sectors. Consumer Financing performance, which has a positive effect on Profitability, shows that banks are more focused on Consumer Financing which is considered safer and more profitable. Banks that plan profits by establishing a cost of loan beyond regulation can be a strategy to anticipate future risks. However, this also shows that banks have a tendency to channel more Consumer Financing which is considered safer and more profitable than Productive Financing. Banks need to strike a balance between Productive Financing and Consumer Financing while still complying with regulations and prudential principles. Islamic banks face a gap in distributing high-risk financing because of the obligation to form a large cost of loan. However, excessive profit planning in shaping the cost of loans beyond regulation indicates the need to balance financing policies with better risk management. Adjustments to financing strategies and improved risk management are needed to optimize Profitability without neglecting regulatory obligations.

Ajupov et al. (2019) states that the theory of risk management is based on three main principles: utility, regression, and diversification Hubbard (2020) explains that the failure of Risk Management provides an effective solution to significant shortcomings in current risk analysis methods. In terms of credit risk, Chamberlain, Hidayat, and Khokhar (2020) found that Islamic banks in GCC countries have lower credit risk than conventional banks.

Furthermore, related to variable control. Practically, the negative relationship between Loan Pricing and profit is possible in types of financing that have a price-sensitive target market. The increase in Loan Pricing can reduce the attractiveness of financing products for customers, so that financing demand decreases. The impact is a reduction in financing margin income, which can ultimately reduce the Bank's Profitability. If the Bank raises the Loan Pricing due to the increase in the cost of funds, but the increase in the cost of funds is not proportional (the percentage of expensive funds is higher), then the Bank's profit margin will decrease. This has the potential to reduce the Bank's net profit and ultimately reduce its Profitability.

Regarding Money Market Pricing, in practice, Islamic banks often focus on financing and investment as the main focus. Therefore, Islamic Bank's revenue and Profitability are more influenced by the performance of its financing and investment portfolios, rather than by income from placements in other banks. In addition, Islamic Bank has a different business strategy, which does not prioritize revenue from placements in other banks. They are more likely to focus on developing products and services to meet the needs of their customers.

Related, Third Party Fund Pricing, An increase in Third Party Fund Pricing may result in an increase in bank operating costs. Banks need to pay higher profit shares to depositors or other sources of funds, which can then increase overall operational costs. If operating costs increase more than revenue increases, this can decrease Profitability.

Likewise for the Third Party Fund itself. The use of Third Party Funds, especially if banks have to pay a higher profit-sharing rate to withdraw those funds, may lower the Bank's net margin. This is especially true if the profit sharing rate payable on the Third Party Fund exceeds the rate of return obtained from the investment or financing disbursement.

As for Operational Cost (OC), increasing Operational Cost (OC) for investment in new technology or improving bank information technology infrastructure can improve overall operational efficiency. Advanced technology can reduce transaction costs, improve service speed, and allow banks to offer new products and services to customers, which in turn can increase revenue and Profitability.

From the discussion, the following conclusions can be drawn:

- 1) There is full mediation where Non Performance Productive Financing has a significant negative effect on Profitability through Performance Productive Financing and Cost of Loan. This empirically proves that the Non Performance Productive Financing of Islamic Bank in Indonesia has a negative effect on Profitability only through the mediation of Performance Productive Financing and Cost of Loan. Meanwhile, directly, Non Performance Productive Financing has a negative effect on Profitability, but it is not significant.
- 2) Cost of Loan has not been proven to mediate the negative influence of Nonperformance Consumer Financing on Profitability. Nonperformance Consumer Financing does not directly have a positive effect on the Cost of Loan, and the Cost of Loan has a negative effect on Profitability. Nonperformance Consumer Financing has a direct effect on Profitability. Performance Consumer Financing has been proven to mediate the influence of Nonperformance Consumer Financing on Profitability. This shows that partial mediation has

occurred. Nonperformance Consumer Financing directly has a negative effect on Performance Consumer Financing and Performance Consumer Financing has a positive effect on Profitability.

- 3) Nonperformance Productive Financing settlements are more complicated and wasteful, indicating greater resource requirements. Non Performance Consumer Financing has a more direct impact on Profitability despite lower settlement costs.
- 4) Banks often ignore the values of sharia maqashid in Consumer Financing. Nonperformance Consumer Financing has a negative impact on Profitability, signaling high risk. It is important for banks to comply with the principles of sharia maqashid to reduce long-term risks.
- 5) High CL erodes Profitability, becoming the main consideration for banks in holding back high-risk financing growth. Banks need to balance productive financing and consumer financing with better risk management strategies to optimize Profitability without ignoring regulations.
- 6) Control variables need to be managed properly. Thrid Party Fund and TPF Pricing have proven to have a significant negative impact on Profitability. Meanwhile, other variables, namely Loan Pricing and Operational Cost (OC), need to be ensured that if the Bank uses these two variables in managing the Bank, it must be ensured that it has a positive impact on Profitability.

## Impact

### Theory:

- This research reinforces that the balance between productive and consumer financing is important for economic stability.
- Showing the importance of the principles of sharia maqashid in managing risk and Profitability of banks.

### Practice:

- Islamic banks must develop more balanced policies in distributing financing.
- Improved risk management is needed to manage productive and consumer financing financing.
- Adjusting profit strategies with the establishment of a regulated cost of loan can increase long-term stability.

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