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Editorial

The effect of management policies on financing decisions and performances Empirical Review on Islamic Banks in Indonesia

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Abstract

This study *was* aimed to examine the effect of management policies and financing decisions on the performances of Islamic banks. Islamic bank performance was measured by ROE, ROA and NPM; financing decisions was measured by murabaha, mudaraba, and musharaka financing, while management policy was measured by using the Financing to Deposit Ratio (*FDR*), *Operating Efficiency (OEOI)*, Capital Adequacy Ratio (*CAR*) and liquidity (*reserve requirement*). The tool *of analysis of this study* was Structural Equation Model (*SEM*) supported by AMOS 19.0 program. Based on the analysis, it is known *that the* factors becoming significant indicators of financing *were* murabaha and musharaka financing, while FDR was not a significant indicator as an indicator of management policies. The results showed a significant effect on the management policy of financing policy, *but it* had no effect on financial performance. *Last, financing decisions* have a significant effect on financial performance.

Key words: management policy, financing decisions, murabaha, musharaka, mudharaba

BACKGROUND

Basically, the function of Islamic banks is not much different to the conventional ones, which is as a financial mediator between the society having excessive fund (surplus unit) and the society experiencing a lack of fund (deficit unit). The difference lying on the instrument used by conventional banks is the interest in giving compensation to society both saving their money and receving credits. Meanwhile, Islamic banks freely operate from interest instrument; but using other instruments, such as using instrument of profit sharing and profit margin is not allowed by Islamic banks. Likewise the risk confronted by Islamic banks is also not much different to conventional banks. Each bank will encounter bank risks such as capital, financing risk, liquidity risk, and operating risk (Muhammad, 2011). Masruki, et. al., (2010) encountered that the risk confronted by Islamic banks is higher than conventional banks. For Islamic banks, they also provide financing with profit sharing concept in which the profit depends on the profit rate of customer's business fund. Therefore, the Head of Islamic Bank is demanded to be able to manage Islamic bank professionally, so that it can control the risk being confronted.

Islamic Banks as a financial mediator agency obtains the biggest profit from the fund distribution to the society or financing (at conventional bank it is known as credit). Financing in Islamic banks employs several concepts: (1) based on the trade, (2) based on the profit sharing concept, and (3) based on the leasing concept. Based on the trade concept, Islamic banks issue financing product of *murabaha* which is financing for customers in regard to financing object procurement where the bank will add specific profit percentage to cost and the customers pay in credit (Antonio, 2001). Based on the profit sharing concept, the bank issues products of (a) *mudharaba* financing, that is financing for customers whom the bank provides all financing needs whereas the customers prepare their project and management, and (b) *musharaka* financing is a bank financing by inclusion of capital to a project run by customers. The profit obtained from this profit sharing-based financing is profit sharing ratio agreed between the bank and the customer. Therefore, this financing should strongly influence Islamic bank finance.

Islamic bank performance is influenced by the number of financing given and financing composition. Haron (1996) revealed the positive influence between profit sharing-based financing and profit margin-based financing in Islamic bank performance. Bukhari and Qudus (2012) and Izhar and Asutay (2007) also figured out significant influence between the financing and performance of Islamic banks. Islamic banking is a company which the operation is strongly managed by *Bank Indonesia (BI)* (a very regulated company). Thus, starting from capital, financing, and liquidity are all regulated by BI. Hence, Islamic bank management should be able to manage Islamic bank well. Haron (1996) found a significant influence between management policies and bank performances. Haron (1996) employed fourteen variables as the indicators of management policies. There are several indicators which actually do not belong to management policies but they include to management policies such as bank profit, total of expenses, expenses for staffs, provision expenses, and other expenses. In this study, management policies are measured by the indicators of liquidity policies, capital policies, financing decisions, and operating efficiency.

Bank performance is frequently measured by profit rate obtained by the bank. Haron (1996) measured it with total income to total assets, income for bank to total assets, and net profit before tax to total assets. Akhtar and Sadaqat (2011), Zeitun (2012), and Moin (2008) employed return on assets and return on equity to measure the performance of bank finance. Acaravci et al., (2013), Ani et al., (2012) and Gul et al., (2011) measured bank performance using return on equity, return on assets, and net interest margin. In this study, the author employed three indicators as the measurement of Islamic banking financial performance that is Return on Asset (ROA), Return on Equity (ROE), and Net Profit Margin (NPM). For the explanation, the author was interested in analyzing the influence of management and financing decisions on Islamic bank performance in Indonesia.

PREVIOUS STUDIES

In Indonesia, only few studies are conducted regarding management and financing decisions on Islamic bank performance. Pratin and Akhyar (2005) tested some factors influencing financing. The result was that only the fund of the third party influenced in financing, whereas the magnitude of capital and percentage of profit margin did not give any influence. Rahman and Rochmanika (2012) found that trade-based financing and profit sharing-based financing significantly influenced Islamic banking performance measured with Return on Assets (ROA). Satrio and Subegti (2010) figured out that capital and profitability factors influenced financing. Izhar and Asutay (2007) who studied Islamic banks in Indonesia with a case study conducted in Bank Muamalat Indonesia (BMI) found a significant relationship between financing and Islamic bank performance.

Haron (1996) who conducted a study in several Arabic countries employed Total Income to Total Asset (TITA) to measure Islamic bank performance. Akhter and Sadaqad (2011), Zeitun (2012), Kuppunsany and Samudram (2010), Gul et al., (2011) and Moin (2008) employed Return on Assets (ROA) and Return on Equity (ROE) to measure Islamic bank performance. Meanwhile, Srairi (2009) who conducted a study of Islamic banks in Gulf Countries (GCC) measured the performance by using Return on Assets (ROA) proxy. In addition to Srairi (2009), the researchers employed ROA as a performance proxy were Izhar and Asutay (2007), Rahman and Rochmanika (2012), Al-Qomar and Al-Mutairi (2008) and Syafri (2012).

Haron (1996) conducted a study on 13 Islamic banks in several Arabic countries to identify the factors influencing profitability, using 15 variables which were expected to influence profitability. One of his findings was mark-up–based financing and profit sharing-based financing had significant influences on profitability. Zeitun (2012) who tested factors influencing the performance of Islamic banks and conventional banks also found that there was a significant relationship between loan (financing) and profitability. Bukhari and Kudus (2012) investigated the relationship between internal and external factors influencing Islamic banks in Pakistan. One of the results also found a significant relationship between loan (financing) and profitability.

HYPOTHESIS DEVELOPMENT

1. Management Policies and Financing Decisions

Bank is a business of trust, as it manages the majority of fund derived from the society storing in the bank. The expectation given by society upon the fund stored is to make it safe and developed, if it is needed at any time it can be taken in addition to providing profits for the customers. Therefore, the bank must maintain the trust even the bank operation is regulated and monitored carefully by *Bank Indonesia*. In managing the bank, the management should use the precautionary principle (prudential banking), so that the bank operation should be managed well to maximize profits and keep it safe.

Bank management policies are closely related to the regulation issued by *Bank Indonesia*, for example bank liquidity level may not be less than 5%, capital adequacy ratio should be 8% at minimum, financing ratio with society fund of 110% at maximum, and problematic financing level or non performing financing may not be more than 5%.

Satrio dan Subegti (2010) who used capital ratio and non performing load as management policy proxy found a positive and significant influence on credit distribution. Meanwhile, Arianti and Muharam (2012) figured out a non-significant influence between management policies and Islamic bank financing. Moreover, Pratin and Akhyar (2005) employed management policy variables in form of non performing financing, but they did not find any significant influence on financing. Based on the theoretical review and authors' finding, it can be hypothesized as follows:

H_1 : Management policies positively influence financing decisions.

2. Management Policies and Islamic Banks Performance

Management policies are expected to be able to improve the performance of bank finance. The braver the risk taken, the bigger the possibility obtains profits. As explained above, there is a one-way relationship between the risk and profit, the bigger the risk taken the higher the profit expected. In the banking, the management is demanded to manage carefully for the majority of banking fund is society's. Therefore, there is trade-off between safety and profit. Careful management policies usually will result in non-profitable banking, whereas aggressive policies are expected to be able to produce high profit. One of indicators of management policies is *Financing to Deposit Ratio* (FDR). If the lowering FDR will decline the profit, the high liquidity will reduce the profit. Likewise a high capital ratio also causes a lot of funds absorbed into capital so that it reduces the opportunity to distribute, so that it makes the profit decline.

Haron (1995) found that the efficiency level and capital ratio have positive and significant influences on profitability. Likewise, Akhtar and Sadaqat (2011) also found that capital ratio of non-performing loan and efficiency level have positive and significant influences on profitability. Zeitun (2012) and Srairi (2009) also found capital ratio influences Islamic bank performance. Bukhari and Qudus (2012), Moin (2008) and Idris et. al., (2011) employed liquidity as a variable influencing bank performance.

H_2 : Management policies positively influence Islamic banks performance.

3. Islamic Bank Financing and Performance

The primary income of banking including Islamic banking is derived from financing. The higher the financing given, the higher the profit rate of the company received. The increase of financing will increase the profitability if it is not followed by the higher problematic financing. Therefore, financing decisions are not only in the quantitative form merely pursuing the number distributed but it is also in the form of qualitative that is financing in a project or good customers. Thus, the possibility of payment failure is small.

Haron (1995) found that the financing given in the form of profit sharing financing, profit margin-based financing and investment-based financing are positively and significantly influencing the Islamic bank performance. Bukhari and Qudus (2012) and Zeitun (2012) also employed credit (loan) distribution as the variable influencing bank performance. Bukhari and Qudus (2012) found significant influences between loan and profitability. Al-Qomar and A-Mutairi (2008) also used loan as a variable influencing bank performance, but the findings in Kuwait bank were not significant. The similar results were also discovered by Gul e.t al., (2011) who investigated banking in Pakistan, whereas Acaravci et.al (2013) found the opposite results, loan was not significantly influencing profitability.

H_3 : Financing decisions positively influence Islamic bank performance

RESEARCH METHOD

1. Population and Sample

Population of this study is all general Islamic banks operating in Indonesia. Up to now, Islamic banks operating in Indonesia are 11 general Islamic banks. The samples were taken from 8 Islamic banks with the criteria of initial establishment. Regarding to the data sufficiency, the data were taken quarterly, since 2008 up to the middle of 2013 for banks established in 2008, whereas the data of Islamic banks established after 2008 were taken since the bank was established and submitted the quarter financial statement to *Bank Indonesia*. The data obtained were as follows:

Samples and Amount of Data

No	Bank Names	Period	Amount of Data
1	Bank Muamalat Indonesia	Qt 1 2008-Qt 2 2013	22
2	Bank Syariah Mandiri	Qt 1 2008-Qt 2 2013	22
3	Bank Mega Syariah	Qt 1 2008-Qt 2 2013	22
4	Bank BRI Syariah	Qt 1 2009-Qt 2 2013	18
5	Bank Syariah Bukopin	Qt 3 2009-Qt 2 2013	16
6	Bank Panin Syariah	Qt 4 2009-Qt 2 2013	15
7	Bank BCA Syariah	Qt 3 2010-Qt 2 2013	12
8	Bank BNI Syariah	Qt 2 2010-Qt 2 2013	13
Jumlah Data (Qtartalan)			140

2. Research Variables

Based on the research variables stated above, it is necessary to define it clearly in order to conduct the research implementation in the field without any doubt. Operational definitions of each variable in the study are as follows:

a. Islamic Bank Performance

Profitability is a company ability to obtain profit equity deposited both by the owner from total assets used to operate and from the income received by bank. There are three indicators forming profitability which are Return on Equity (ROE), Return on Assets (ROA), and net profit margin.

b. Size

The size of the bank significantly influences the profitability (Syafri, 2012). Acaravci (2013), Ani et al., (2012), and Gul et al (2011) also found that company size influenced profitability. In this study, the variable of size used as a control variable for the big size of Islamic banks in Indonesia is highly heterogeneous, so the control variable is very necessary for the company size. The company sizes were with the magnitude of total assets, and for the very big number of asset data whereas other variables are small, then the company size is proxied with logarithm of total assets.

c. Management Policies

Banking industry is a very regulated company. It is the company in which the operation is highly regulated by the government through *Bank Indonesia*. This is caused by the biggest asset of banking is derived from the society savings. Thus, if the banking is bankrupt, it will give a big impact to the society welfare. Therefore, the management's role in controlling banking is necessary. Management's role in taking policies is in order to control banking risks in the forms of financing risk, capital risk, liquidity risk, and operating risk. Financing risk is proxied with Non Performing Financing (NPF), capital risk is proxied with Capital Adequacy Ratio (CAR), liquidity risk is proxied with Minimum Statutory Reserves (RR), while operating risk is proxied with Operating Cost Ratio to Operating Income (OEOI).

d. Financing decisions

Financing decisions are decisions taken by financing officers to determine the number and composition of financing given to customers. Karim (2010) and Muhammad (2005) divided fund into several principles: profit-sharing principles, trade principles, lease principles, and social principles. Profit-sharing principles mostly used are *mudharaba* and *musharaka* financing, trade principle-based financing is in the form of *murabah* financing, financing with lease principle is such as *ijara*, whereas social principle is *qordul hasan*. In the study conducted by Haron (1996), it is divided into profit sharing-based financing (fund in profit sharing principles) and mark up-based financing (fund in mark-up principles). Meanwhile, Pratin and Akhyar (2005) and Arianti and Muharam (2012) used financing as a dependent variable influenced by the fund of third party, capital, Non Performance Financing (NPF). Izhar and Asutay (2007), Bukhari and Qudus (2012) and Zeitun (2012) employed total financing as a factor influencing profitability. Meanwhile, Gul et al., (2011), Satrio and Bagus (2010), Acaravci et.al(2013) and Ani et al., (2012) who conducted a study on conventional banking used total loan as a variable influencing profitability. In conventional banking, credit given is not separated from all credits which use interest instrument. The indicators of financing decisions in this study were *murabaha* financing, *mudharaba* financing, and *musharaka* financing.

Below is the measurement of the variables and indicators of the research.

Table 2: Variable Measurement

No	Variabel dan Indikator	Notation	Measurement
A	Financial Performance		
1	Return on Equity	ROE	Earning After Tax/Equity
2	Return on Assets	ROA	Earning Before Tax/Total Asset
3	Net Profit Margin	NPM	Net Profit/Total Financing
B	Management Policy		
4	Financing to Deposit Ratio	FDR	Total Financing/The Thid Party Fund
5	Capital Adequacy Ratio	CAR	Equity/Weighted risk Assets

6	Reserve Requirement	RR	Saving Total/Compulsory payment
7	Operating risk	OEOI	Operating expenses/Operating income
C	Financing policy		
8	*Murabaha* Financing	MUR	*Murabaha* Financing Total/Activa Total
9	*Mudharaba* Financing	MUD	*Mudharaba* Financing Total /Activa Total
10	*Musharaka* Financing	MUS	*Musharaka* Financing Total /Activa Total
D	Firm Size	SIZE	Log Natural Total Asset

3. Instrument of Analysis

To answer the hypotheses proposed in this study, it is necessary to use an accurate analysis instrument. This study employed structural equation model or SEM by using a program package of AMOS 19.0 and SPSS 17.0 program to support. Structural Equation Model (SEM) is statistical techniques allowing the test of a set of relatively complicated relationship simultaneously (Ferdinand, 2002).

RESEARCH RESULTS

1. Model Testing

Based on data processing by using AMOS 19.0 program supported by SPSS 17.0 program, a path diagram was obtained as follows:

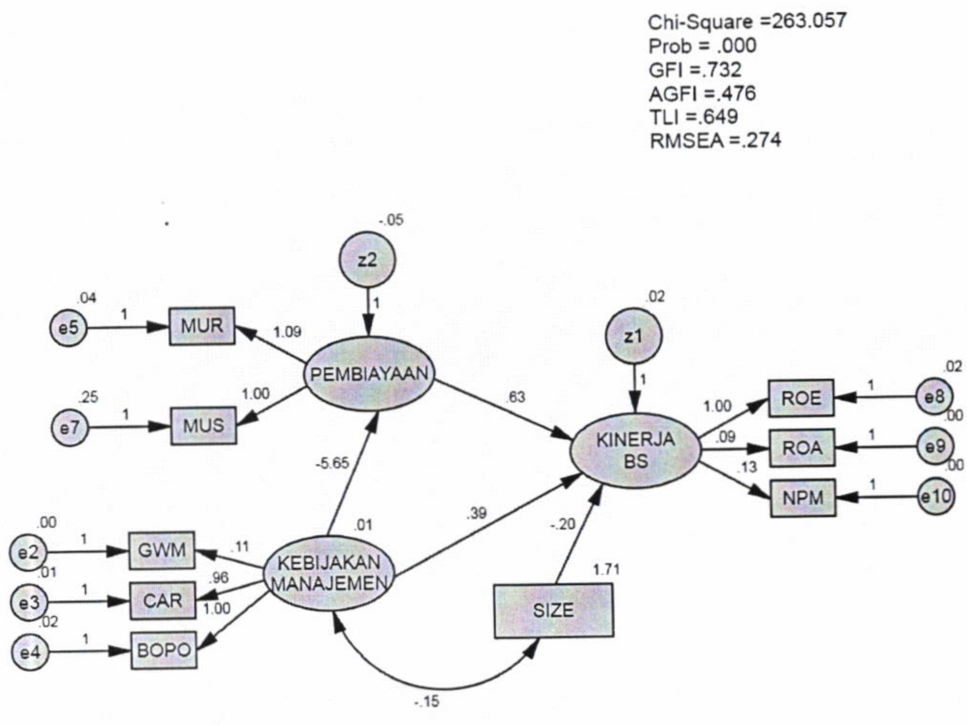

Figure 1: Model testing

Based on the feasibility of the model, it shows Chi-Square of 263,057 is quite big, whereas according to the rule of thumb, it is supposed to be small. Meanwhile, the size of model feasibility with probability expected to be bigger than 0, in fact it is smaller, likewise the other feasibility size such as RMSEA, Goodness Fit Index (GFI) and AGFI and TLI also do not show a good model (See Table 4). However, since the research objective is finding out the influence among variables. Then, in this study, the model feasibility is not prioritized.

Table 4: Result of Goodness of fit

Goodness of Fit Index	Cut-off Value	Result	Description
Chi-Square	Expected to be small	263.057	Not fit
Probablility	≥ 0.05	0.000	Not fit
RMSEA	≤ 0.08	0.732	Not fit
GFI	≥ 0.90	0.476	Not fit
AGFI	≥ 0.90	0.649	Not fit
TLI	≥ 0.95	0.274	Not fit

2. **Indicator Testing**

Latent variable is formed by several indicators; therefore, it needs indicator testing to determine whether those indicators are valid as the developer of latent variable. Here are the results of indicator testing.

Table 5: Result of Indicator Test

			Estimate	S.E.	C.R.	P	Label
MUS	←	ManPol	1.000				
MUR	←	ManPol	1.087	.076	14.227	***	par_1
ROE	←	FinPerf	1.000				
ROA	←	FinPerf	.090	.012	7.515	***	par_2
NPM	←	FinPerf	.131	.025	5.285	***	par_3
OEOI	←	ManPol	1.000				
CAR	←	ManPol	.955	.123	7.769	***	par_4
RR	←	ManPol	.111	.021	5.283	***	par_5

The table above is the indicator testing results measuring whether those indicators are valid as the developer of latent variable. ROE, ROA and NPM as the developer of financial performance variable are valid as the variable developer for the *p*-value of 0.01 is smaller than the significance level required of 0.05. Meanwhile, related to the indicators forming financing policy variable, there are only two (MUR and MUS) which are valid as variable developers; regarding to the management policy indicators, there are only three of them (CAR, RR, and OEOI) which are significant as the variable developers; and while FDR is not significant as the developer of financing policy variable.

3. **Hypothesis Testing**

Tabel 6: Results of Hypothesis Test

			Estimate	S.E.	C.R.	P	Label
FinDec	←	ManPol	-5.647	.684	-8.258	***	par_6
FinPerf	←	ManPol	.393	.538	.730	.465	par_7
FinPerf	←	FinDec	.632	.175	3.616	***	par_8
FinPerf	←	SIZE	-.203	.070	-2.910	.004	par_9

Based on the table above, it shows that the management policy significantly and negatively influences to the financing decisions at significance level of 0.01 which is smaller than significance level required of 0.05. Meanwhile, management policies do not influence

Islamic bank performance for the *p*-value of 0.465 which is bigger than significance level required of 0.05.

Financing decisions turn out to have a significant influence on Islamic bank financial performance shown by *p*-value of 0.01 that is smaller than significance level of 0.05.

DISCUSSION

a. The influence of management policies on financing decisions

The findings showed a negative and significant influence between management policies and financing decisions. This shows that the higher the management policies taken, the lower the financing given. This is normal for the valid indicators forming management policy variable which are Capital Adequacy Ratio (CAR), Minimum Statutory Reserves (RR), and Operating Expense Ratio to Operating Income (OEOI). The higher the CAR was, the bigger the equity owned by bank. It shows that equity utilization is not really efficient. Likewise, RR shows the fund provided for customers if they need at any time. The higher the RR is, the better the bank liquidity is. However, if unused fund is increasing, it implies that it reduces opportunity to distribute the fund in financing. This result is supported by Siregar (2005) who also found negative and significant influences between management policies and financing. Pratin and Akhyar (2005) found an influence which is not significant between management policies and financing. Likewise, Rachmadita (2013) also found non-significant influence between management policies and financing. Sri et al., (2013) also figured out non-significant influence between management policies measured by CAR and financing. In contrast, Satrio and Subegti (2010) who conducted a study in conventional banks found positive and significant influences between management policies measured with CAR and credit given.

b. The influence of management policies on financial performance

Based on the result of data processing, it was found that the management does not influence Islamic bank financial performance. This result is possibly caused by indicators of management policy developer which pass the indicator testing which are CAR, RR, and OEOI. From the descriptive-statistic data, it is identified that the variation of RR is not really big which is the average of 6.93% of *Bank Indonesia* provision of 5% at minimum, so that Islamic banks always maintain RR at the nearest of minimum. This result also shows that Islamic banks in Indonesia do not really like taking risks. It is proven by the management policies measured with capital risk, liquidity risk and efficiency risk which do not influence Islamic bank financial performance. The data shows that Islamic banks provide more financing rest on *murabaha* financing. *Murabaha* financing is a financing with lower level of risk, for it is included in an agreement giving fixed income or natural certainty contract (NCC).

The results of this study support the findings of Bukhari and Qudus (2012) who conducted a study in Islamic banking in Pakistan, Izhar and Asutay (2007) and Idris et.al. (2012). Likewise with the findings of Al-Qomar and Al-Mutairi (2008), Acaravci et.al. (2012) and Syafri (2012) also found non-significant influence between management policies and Islamic bank performance. These findings opposed Haron (1996) who discovered that management policies influence banking performance. Also, Gul et.al. (2011) conducted a study on Islamic banks in Pakistan and Ani et.al. (2012) who investigated Islamic banks in Nigeria also revealed positive influence between management policies and Islamic bank performance.

c. The influence of financing decisions on financial performance

The result of hypothesis testing showed that financing decisions influence positively and significantly on financial performance. This result matches the hypothesis that financing decisions positively influence Islamic bank performance. It means that the higher financing given by Islamic bank, the more improved the Islamic bank performance will be. These research results are consistent with Haron (1996), who found an evidence that profit margin-based and profit sharing-based financing have significant influences on Islamic bank performance. Bukhari and Qudus (2012), Vong and Chan (2009), Rahman and Rochmanika (2012) and Gul et al (2011) also found positive and significant influences between financing and Islamic bank performance.

In this study, it is initially proposed three types of financing that are profit margin-based *murabaha* funding, profit sharing-based *muyarakah* and *mudharaba* financing. From those three types of financing, the most significant types which influence Islamic bank performance are only *murabaha* and *musharaka* financing. *Murabaha* financing has a quite big portion for the average of this financing which is over 69%. This financing includes the financing with a contract giving certain benefits. It means that the Islamic bank management still relies on safe financing, in other words, it is not really brave to take risks.

CLOSING

Based on the research results, it can be concluded that the management policies significantly influenced to the financing decisions. It means that financing decisions conducted by Islamic bank comply with the plan made by the management. In contrast, it was found that the management policies do not influence to the Islamic bank financial performance. This shows that the policies taken by the management have not been able to improve profits. There are financing decisions having positive and significant influences on the financial performance. It means that the higher financing given by Islamic banks, the more profits they will receive.

Financing decisions indeed have positive influence on financial performance, but the dominant type of financing is profit margin-based financing. Profit margin-based financing is the financing with a very low risk, and the financing product is actually urgent (Sudarsono, 2003). Therefore, Islamic bank management should not rely on profit margin-based financing, and immediately improves to make profit sharing-based financing portion bigger and has more value of justice.

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