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# The Determinants of Non-Performing Financing (NPF) in Islamic Commercial Banks in Indonesia

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## ABSTRACT

This research aims to analyze the effect of total financing, Financing to Deposit Ratio (FDR), Good Corporate Governance (GCG) on Non-Performing Financing (NPF) with inflation as a moderating variable. This research population is Islamic commercial banks for the period 2012-2018, which are registered with the Financial Services Authority. Research samples are obtained through a purposive sampling technique. According to the purposive sampling technique, some 11 Islamic Commercial Banks obtained 77 units of analysis. This research's analytical method is multiple regression analysis and the absolute difference value. This research proves that GCG has a negative and significant effect on NPF, while Total Financing and FDR have no significant effect on NPF. Meanwhile, inflation did not moderate total financing, FDR, and NPF. Referring to the research results that have been described, the conclusion that the writer can compile is that the quality of GCG in a company is getting better, proven to reduce the level of NPF. Thus, Islamic Commercial Banks are expected to optimize the role of GCG to reduce the NPF level.



## INTRODUCTION

Referring to the Law (UU) No. 21 year 2008 Regarding Islamic Banking, Islamic banking is everything related to Islamic banks and sharia business units, including institutions, business activities, as well as methods and processes in carrying out their activities. Islamic banking is one of the fastest-growing sectors in Indonesia. In accordance with FSA data in Islamic banking statistics, in 2018, Islamic banks in Indonesia have reached 14 units of Islamic Commercial Banks.

Business activities in Islamic banking are collecting and distributing funds to the public. The distribution of funds by Islamic banking aims to support development, equalize justice and people's welfare. The process of distributing funds to Islamic banks is to use a sharia system that is guided by Islamic law. This system is based on a prohibition for Muslims to borrow money or goods by providing interest on loans (usury).

Islamic banks in carrying out their business activities will not be separated from a risk. The cause of Islamic banks experiencing various risks is due to the lack of internal control within the company. One of the risks that occur is financing risk.

Financing risk is a risk of loss caused by the debtor being unable to pay a loan that has been given by the creditor (bank). High financing risk will affect the sustainability of the bank in carrying out its business activities, which has an impact on decreasing bank performance. Financing risk in Islamic banks is measured through the Non-Performing Financing (NPF) ratio, while in conventional banks; it is measured through the Non-Performing Loan (NPL) ratio.

According to CNBC Indonesia (2019), Based on Islamic Banking Statistics data from the Financial Services Authority, the high NPF of Islamic banks compared to conventional banks makes it difficult for Islamic banking to compete with conventional banks. This condition is indicated by the NPF of Islamic commercial banks at the end of March 2019 of 3.44%, while the Non-Performing Loans (NPL) of conventional banks was at the level of 2.5%. In the previous period, the non-performing financing of Islamic commercial banks was even worse. For example, at the end of 2017, the NPF of Islamic commercial banks reached 4.76%, and it reached 4.42% in 2016 (CNBC Indonesia, 2019). However, the NPL value of conventional banks at the end of 2017 reached 2.35%, and it reached 2.93% in 2016. This means that the NPF of Islamic Commercial Banks is worse than the NPL of conventional banks.

The high level of non-performing financing can be caused by 2 factors, namely internal and external. According to Mahmoedin (2002), factors that affect financing from the internal side are due to the weakness of banks in credit analysis and financial aspects. Factors

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causing NPF from Internal perspectives can be analyzed by looking at financial statements and reports on Good Corporate Governance (GCG). Meanwhile, the factors that affect the NPF from the external side occur due to the negative economic situation, which can be seen from the macro monetary policy made by Bank Indonesia.

Based on the previous research on NPF, several research gaps are still found. Based on the research conducted by Rafsanjani (2019) and Akinlo & Emmanuel (2014), financing affects the NPF significantly and positively. The result of this research shows that when financing increases, the NPF will also increase. This means that still many Islamic banks that cannot manage risk management properly, resulting in problem financing. This condition is contrary to the research of Santoso et al. (2018) and Imaduddin (2011) which prove that the total financing affects the NPF negatively significantly.

The research results according to Pradana (2018) and Nihayah & Walyoto (2018) state that FDR has a positive effect on NPF. The research findings show that when the FDR increases, the NPF will increase. This means that the high distribution of funds in the form of financing rather than public fund deposits to the bank will result in increased financing risk if it is not balanced with good risk management. This is contrary to the research of Mukhibad & Khafid (2018) and Damanhur et al. (2018) which reveal that FDR does not affect NPF.

Based on the research conducted by Furqon & Asrori (2016) and Santoso et al. (2018) state that GCG affects NPF significantly and negatively. This condition indicates that increasing the quality of GCG will reduce the level of NPF. This is contrary to the research of Mukhibad & Khafid (2018) and Nyor & Mejabi (2013) which state that GCG does not affect NPF.

Based on the previous research, there are still inconsistencies in the results of the total financing, FDR, and GCG variables on the NPF. In addition, the problem that occurs in Islamic banks is that the NPF has not been able to compete with the NPL of conventional banks. This is evidenced by NPF data from 2012 to 2018, which are still above the NPL of conventional banks.

Based on the problems that occur in Islamic banks, the researchers are interested in examining the effect of total financing, FDR, and GCG on NPF and finding empirical evidence whether inflation can moderate the effect of total financing, and FDR on NPF. The difference between this research and previous research is that the researchers add the inflation variable as a moderating variable. Inflation is presented as a moderator because inflation is assumed to be able to cause a decrease in the company's financing and FDR ability, which will result in a weakening of the effect of financing and FDR on the NPF level (Effendi et al., 2017; Mazreku et al., 2018).

The theories used to explain the variables in the research are Sharia Enterprise Theory, stewardship theory, keyness theory, and risk management theory. Sharia Enterprise Theory positions God as the center of all things. God is the center of the return of humans and the universe, while humans are only His representatives (khalitullah fil ardh) who must obey all of God's laws (Triyuwono, 2006). Sharia Enterprise Theory is used to explain the GCG variable. Stewardship theory is a theory that describes a situation where management in conducting its obligations is not motivated by individual interests but is more concerned with organizational results and achievements (Donaldson & Davis, 1991). Stewardship theory explains the effect of GCG on NPF.

Fahmi (2010) explained that risk management theory is a field of science in which it examines how organizations implement measures in mapping various problems by positioning some management approaches comprehensively and systematically. Risk management theory is used to explain FDR and NPF. Then, Keyness Economic Theory explains that inflation is caused by people's desire to live beyond their economic capacity, so that people's effective demand for goods exceeds the number of existing goods, resulting in an inflationary gap (S.Admadja, 1999). Keyness economic theory is used to explain the inflation variable.

High financing must be balanced with sufficient funding sources. This is because if the sources of funds are limited, Islamic banks will find it difficult to manage to finance for customers. Thus, it will pose a risk. In addition, high financing at Islamic banks will produce high returns. However, high returns if not balanced with good risk management will result in increased financing risk for Islamic banks. This condition occurs because Islamic banks that set a high financing return target will make the distribution of financing to customers uncontrollable. Thus, it will reduce their prudence in managing the risks contained in their customers. Thus, it has a bad impact on financing installments from customers.

This condition is in line with risk management theory which explains that Islamic banks in managing their business activities must be able to manage risk effectively in order to improve banks' financial performance and health. This research is supported by Rafsanjani (2019) and Akinlo & Emmanuelm (2014) which explain that financing affects the NPF in a significantly positive way.

**$H_1$: Total Financing has a Positive Effect on Non-Performing Financing**

A high FDR indicates that Islamic banks have a good intermediation function so that the returns obtained will also increase. However, a high return will also experience several problems, one of which is financing risk. Financing risk can arise due to poor risk management.

Referring to risk management theory, which explains that an activity that carries out risk management procedures effectively, will result in improved bank's financial performance and health. The greater the financing distributed compared to customer deposits at a bank, the greater the risk that must be faced by the bank, thereby increasing the possibility of NPF. This research is supported by Pradana (2018) and Nihayah & Walyoto (2018) who proved that FDR affects NPF significantly and positively.

**$H_2$: Financing to Deposit Ratio has a Positive Effect**

**on Non-Performing Financing**

One of the risks that often occur in Islamic banks is the risk of non-performing loans/financing. To overcome the risk, Islamic banks implement Good Corporate Governance (GCG). The implementation of GCG is expected to minimize financing risk.

This is in line with the stewardship theory, which states that management will tend to be more concerned with the company than his interests. Thus, if management can carry out a governance control system of sharia bank properly, it indicates that the company can manage risk management effectively and efficiently. Thus, when the quality of GCG is in good condition it will increase the growth of Islamic banks and minimize non-performing financing.

In addition, financing is also related to the Sharia Enterprise Theory that Islamic banks in carrying out their duties are not only responsible to fellow humans but are also responsible to Allah SWT. This research is in line with the research conducted by Furqon & Asrori (2016) and Santoso et al. (2018) which state that GCG has a significant positive effect on NPF.

**$H_3$: Good Corporate Governance has a Negative Effect on Non-Performing Financing**

The high financing will result in the return on Islamic banking to increase. However, high returns if not balanced with good risk management will create risks in Islamic banking. One of the risks faced by Islamic banks is financing risk. Financing risk is assumed to be affected by inflation.

The assumption is that inflation can moderate the effect of total financing on the NPF. Increased inflation will make the company's sales and profits decrease. If this happens significantly, it will cause customers to find it difficult to make installments to Islamic banks. Customers who have difficulty paying installments to the bank will result in a risk, which is non-performing financing.

**$H_4$: Inflation Moderates the Effect of Total Financing on Non-Performing Financing.**

FDR is used as a standard to measure a bank's expertise in repaying the withdrawal of funds done by depositors by controlling the credit provided. In this case, the bank is at risk of not having deposit funds if, at the time the bank distributes all funds for financing, the customers (the owner of the funds) withdraw the funds at any time (Rofiah & A'yun, 2019).

Inflation is expected to be able to moderate FDR on NPF. This happens because when inflation rises, sales and profits for the company (customers) decrease. This will result in a decrease in customer interest in saving in Islamic banking. The decline in customer deposits to Islamic banking will result in reduced funds that will later be distributed for providing financing to the public/companies. Low financing at Islamic banks will result in low returns. This can be interpreted that management in managing business activities at Islamic banks is less than optimal.

Poor management in managing business activities at Islamic banks will result in decreased company performance. Thus, it will make Islamic banks experience risks in their business. One of them is the occurrence of non-performing financing.

**$H_5$: Inflation Moderates the Effect of Financing to Deposit Ratio on Non-Performing Financing**

Referring to the explanation, the framework of thinking in this research is illustrated in Figure 1.

## RESEARCH METHODS

This study was quantitative research using secondary data derived from financial statements at Islamic Commercial Banks in Indonesia in 2012-2018. There were 11 Islamic Commercial Banks as samples, which were selected through the purposive sampling technique. The sampling criteria are shown in table 1.

This research used the independent variables of total financing, FDR, and GCG, inflation as the moderating variable, and NPF as the dependent variable. The operational definition of each research variable is shown in table 2.

The secondary data in this research were obtained from the annual financial reports and GCG implementa-

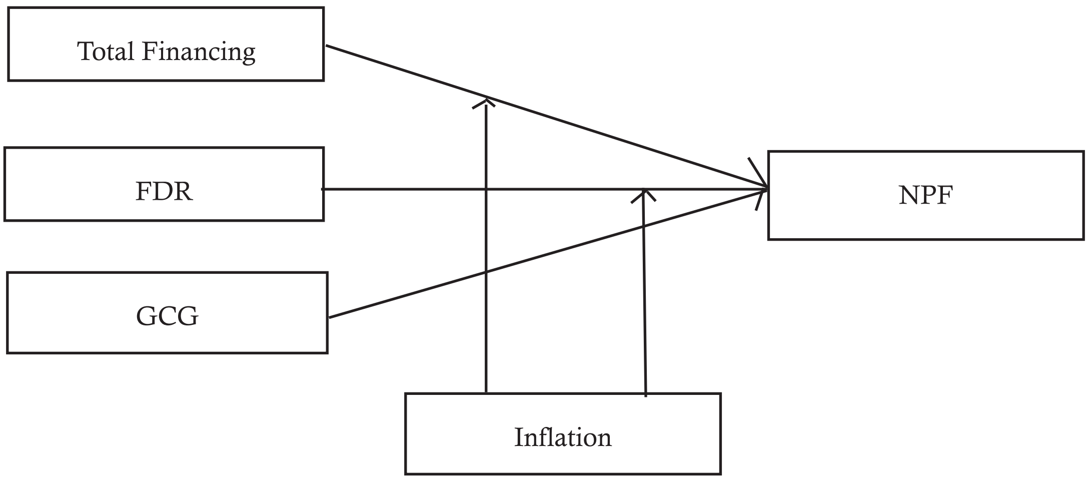


**Figure 1.** Framework of Thingking

**Table 1.** Sampling Criteria.

| No | Sampling Criteria | Beyond Criteria | Included Criteria |
|---|---|---|---|
| 1. | Islamic Commercial Banks registered with FSA | | 14 |
| 2. | Islamic Commercial Banks registered with FSA from 2012 to 2018. | (3) | 11 |
| 3. | Islamic Commercial Banks provided financial reports and GCG implementation reports for the period 2012 – 2018. | (0) | 11 |
| 4. | Islamic Commercial Banks have complete data based on the variables used in the research. | (0) | 11 |
| Total sample used | | | 11 |
| Year of Observation | | | 7 |
| Total analysis units | | | 77 |

Source: Processed secondary data, 2020

tion reports, which are available on the FSA website and the official websites of each Islamic bank. Surat Edaran No. 12/13/DPbs Tahun 2010 used as a guide for measuring GCG in this research. The analytical techniques applied were multiple regression and absolute difference values using IBM SPSS 22, with analytical techniques consisting of descriptive statistical analysis, Moderated Regression Analysis (MRA), and inferential statistical analysis, using the classical assumption tests (normality test, multicollinearity test, heteroscedasticity test, and autocorrelation test). After the tests, it was continued with multiple linear regression analysis and hypothesis testing. The significance level of this study was 5%. The multiple linear regression equation used in this study is shown in equation 1.

$$NPF = \alpha + \beta_1 \text{ Financing} + \beta_2 \text{ FDR} + \beta_3 \text{ GCG} + \beta_4 \left| \text{ZFDR- ZInflation} \right| + \beta_5 \left| \text{ZFDR - Z ZInflation} \right| + e \quad \text{.......(1)}$$

## RESULTS AND DISCUSSION

The descriptive statistical analysis provides an overview of each research variable consisting of maximum, minimum, average (mean), and standard deviation values. The result of the descriptive statistical test proves that the NPF variable has a minimum value of 0.00 and a maximum value of 9.76. The mean of the NPF variable is 3.68 with a standard deviation of 2.26. The financing variable has a minimum value of 477 and a maximum value of 60.472. The mean of the financing variable is 14.092 with a standard deviation of 16.680.

The FDR variable has the lowest value of 68.65 and the highest value of 102.7. The mean of the FDR variable is 89.16 with a standard deviation of 7.51. The inflation variable has the lowest value of 3.02 and the highest value of 8.38. The mean of the inflation variable is 5.04 with a standard deviation of 2.29. The inflation target set by Bank Indonesia was an average of 4.2% from 2012 to 2018. The GCG variable for Islamic banks in the last 7 years for a score of 5 (very good) shows a frequency of 20 or 31.25% of the 64 samples, while for a score of 4 (good) and a score of 3 (good enough) respectively indicating a frequency of 37 (57.81%) and a frequency of 7 (10.94%). As well as for GCG in less good and not good conditions show a frequency of 0.

Before conducting the hypothesis test and the moderating regression equation test, the classical assumption tests are first conducted which consist of normality test, multicollinearity test, autocorrelation test, and heteroscedasticity test. The normality test using the Kolmogorov-Smirnov test explains that the data are normally distributed because of the Asymp value. Sig (2-tailed) 0.085 is greater than 0.05. The multicollinearity test proves that the tolerance value for each independent variable is > 0.10 and the VIF value is < 10. Thus, it can be interpreted that the research data do not occur multicollinearity.

The autocorrelation test seen by the Run Test proves that there is no autocorrelation between the residual values. This is due to the result of the Runt Test is 1.764 with the Asymp Sig value. (2-tailed) of 0.078 > 0.05. The heteroscedasticity test using the white test explains that the regression model passes the heteroscedasticity test. This can be seen in c2 with the formula for the number of samples multiplied by R2 0.104 which results in 6.656. This means that the c2 count of 6.656 is smaller than the c2 table of 9.488. After the classical assumption tests, then proceed with the hypothesis test. The results of hypothesis testing are presented in Table 3.

### The Effect of Financing on Non-Performing Financing

Based on the research result, financing does not affect the NPF of Islamic Commercial Banks in Indonesia. This condition shows that if there is an increase or decrease in total financing, it will not have an impact on Non-Performing Financing. The previous assumption is that high total financing will result in high returns. However, high returns can result in non-performing financing which will also increase if it is not balanced with good risk management.

In fact, the level of financing in this study could not affect non-performing financing. The reason the total financing does not affect the NPF is due to the policy of Islamic banks is very expansive in distributing financing aimed at pursuing growth targets, which have been balanced with effective and efficient risk management by the management of Islamic banks. This is evidenced by the mean value of NPF in descriptive data of Islamic commercial banks, which is still below 5%, namely 3.36%. Based on the FSA data, NPF which is still below 5%, indicates that Islamic banks can manage risk very

**Table 2.** Operational Definition of Research Variables

| Variable | Definition | Measurement |
|---|---|---|
| Non-Performing Financing (NPF) | The indicators to measure the health of asset quality in Islamic banks (Purbaningsih & Fatimah, 2018). | NPF = (Total Non-Performing Financing / Total Financing) x 100%<br><br>(Iriani & Yuliandi, 2015) |
| Total Financing | Provision of money or bills which can be equated, based on an agreement between the bank and other parties (Arifin, 2009). | Total Financing = Total of all financing (Rafsanjani, 2019) |
| Financing to Deposit Ratio (FDR) | Ratio to measure the number of third party funds collected by Islamic banks that have been distributed in the form of financing (Mukhibad & Khafid, 2018) | FDR = (Financing Provided / Total third party funds ) x 100%<br><br>(Permataningayu & Mahdaria, 2019) |
| Good Corporate Governance (GCG) | The principle to direct and control the company to achieve a balance between power and authority in providing accountability to shareholders and stakeholders | Rating 1 = very suitable<br>Rating 2 = suitable<br>Rating 3 = less suitable<br>Rating 4 = less suitable<br>Rating 5 = not suitable<br>(Surat Edaran No. 12/13/DPbs/2010) |
| Inflation | An increase in goods and services in general, the impact of which will reduce the purchasing power of money (Lee & Isa, 2019) | Inflation : Dummy 1 for inflation above Bank Indonesia's target and 0 for inflation below Bank Indonesia's target. |

Source: Processed secondary data, 2020

well and bank performance is maintained. This research is not in line with Rafsan Jani (2019) which states that Total Financing has a significant positive effect on NPF.

### The Effect of FDR on Non-Performing Financing

Based on the research result, FDR does not affect NPF in Islamic Commercial Banks in Indonesia. A high FDR indicates that the intermediation function of Islamic banks is in good condition. High FDR also makes Islamic banks experience several problems, one of which is non-performing financing. In fact, the high and low FDR in this study could not affect problematic financing.

This hypothesis is rejected because the banks in distributing financing to their customers have followed the procedures set by the regulator. Islamic banks have also made good corporate governance. This can be seen in the descriptive data, which explains that the average implementation of GCG in Islamic banks is very good. Thus, non-performing financing can be minimized and can increase bank profits. In addition, not all non-performing financing comes from third-party funds collected by the banks, but there are other sources of funds that are used to explain financing (Furqon & Asrori, 2016). This research is in line with the research of Mukhibad & Khafid (2018) and not in line with the research of Pradana (2018) which states that FDR positively affects NPF.

### The Effect of GCG on Non-Performing Financing

Based on the research result, GCG significantly affects the NPF of Islamic Commercial Banks in Indonesia. The finding of this research shows that an increase or decrease in GCG will affect the NPF. This is in line with the stewardship theory, which states that company

**Table 3.** Summary of Hypothesis Test Results

| | Hypothesis | β | Sig. | α | Results |
|---|---|---|---|---|---|
| $H_1$ | Financing has a positive and significant effect on Non-Performing Financing | 1.197 | 0.236 | 0.05 | Rejected |
| $H_2$ | Financing to Deposit ratio has a positive and significant effect on Non-Performing Financing | -0.640 | 0.949 | 0.05 | Rejected |
| $H_3$ | Good Corporate Governance has a positive and significant effect on Non-Performing Financing | -2,122 | 0.038 | 0.05 | Accepted |
| $H_4$ | Inflation moderates the effect of Total Financing on Non-Performing Financing | 0.580 | 0.564 | 0.05 | Rejected |
| $H_5$ | Inflation moderates the effect of Financing to Deposit ratio on Non-Performing Financing | -0.598 | 0.552 | 0.05 | Rejected |

managers will not be motivated by individual interests, but will prioritize the interests of their organization. One of the interests in a bank organization or company is to create good governance so that it can minimize risk and encourage company growth. This means that good governance can reduce the level of non-performing financing because the quality of financing has increased.

GCG is in line with Sharia Enterprise Theory, which requires Islamic Commercial Banks in carrying out their duties to implement a scheme that does not violate sharia principles. The result of this research is in line with the research of Ahmad & Asrori (2016) which states that GCG affects NPF significantly negatively. The result of the study proves that the quality of GCG implementation is proven to be able to affect the level of risk of non-performing financing. Good corporate governance will help Islamic bank business activities to prevent conflicts between management and owners in order to maintain risk. Thus, it is expected to reduce non-performing financing.

### The Effect of Total Financing on Non-Performing Financing with Inflation as the Moderating Variable

The result of the moderated regression analysis indicates that inflation does not moderate the effect of total financing on the NPF of Islamic Commercial Banks in Indonesia. The result of this research can be interpreted that high or low inflation, which is measured using the dummy variable, cannot affect the relationship between total financing on the NPF of Islamic commercial banks in Indonesia.

This condition occurred due to inflation in 2013 of 8.38% and 2014 of 8.36%, meaning that inflation was still above the target set by Bank Indonesia. This indicates that inflation in that year would be a serious problem for society. Meanwhile, it was 4.30% in 2012, 3.35% in 2015, 3.02% in 2016, 3.61% in 2017, and 3.31% in 2018, meaning that inflation was still below Bank Indonesia's target, which indicated that inflation could still be tolerated and was not a serious problem for the public. Based on these data, it shows that the sample is dominated by inflation conditions below the target, so the test result tends to be insignificant.

This research is not in line with the Keyness theory, which explains that inflation will make installment payments to banks not smooth, causing non-performing financing for Islamic Commercial Banks. However, in fact, this study finds that inflation cannot moderate the effect of total financing on NPF.

This research shows that inflation is not able to moderate the effect of total financing on Non-Performing Financing because the inflation growth that has occurred during the last seven years is insignificant. Inflation from 2012 to 2018 was relatively low because the annual inflation rate was still below 10%. This can be interpreted that inflation cannot affect customer behavior to make financing installment payments to Islamic banks. Thus, if inflation increases, customers will continue to make installment payments to Islamic banks. This happens because the customer (community) is still able to meet the necessities of life so that it does not affect income and can still set aside funds to make financing installments.

### The Effect of Financing to Deposit Ratio on Non-Performing Financing with Inflation as the Moderating Variable

Based on the research result, inflation does not moderate the effect of FDR on NPF at Islamic Commercial Banks in Indonesia. The result of this research can be interpreted that high low inflation cannot affect the relationship between FDR and NPF at Islamic Commercial Banks in Indonesia. This research is not in line with the Keyness theory, which explains that an increase in the price of goods will affect the purchasing power of the people to decrease which results in reduced company profits (customers). This causes the installment of financing payments to be not smooth.

In fact, in this study, inflation cannot moderate the effect of the Financing to Deposit Ratio on NPF. This condition occurs because Islamic Commercial Banks have a stronger resilience than conventional banks. Islamic banks implement a number of contracts that are more varied in their financing with the aim of diversifying financing risk (Purnamasari & Musdholifah, 2018). Based on the data from Bank Indonesia, inflation for the last seven years is still relatively reasonable because inflation in Indonesia is still below the target. Thus, it can be concluded that inflation is still in a reasonable condition and can be accepted by the economy in Indonesia. The occurrence of inflation will not have a major effect on the real income of customers so that it does not change people to save their funds in Islamic Commercial Banks.

## CONCLUSIONS

The findings of this study prove that GCG affects NPF significantly negatively. Referring to these results, the increasing quality of GCG is proven to be able to reduce the rate of NPF in the company. Thus, companies need to optimize the role and function of GCG, for a more controlled NPF. The authors recommend that Islamic bank managers pay attention to GCG through increased monitoring in carrying out their duties and responsibilities, especially in risk control by paying attention to the principle of prudence. Islamic banks must also pay attention to Islamic values, which in carrying out their business activities prohibit usury and gharar.

Based on the FSA data, the average NPF of Islamic commercial banks is actually still below 5%. However, there are still some Islamic commercial banks, which are still above 5%. This indicates that the NPF of some Islamic banks is in bad condition. Thus, it is expected that FSA should be able to direct Islamic banks that have NPF above 5% by increasing the role and function of GCG in order to reduce non-performing financing. This refers to hypothesis 3 that quality GCG has an important role to minimize the occurrence of risks.

This study still uses a dummy variable to measure inflation. Further research is recommended to use another measurement for inflation variable, such as the growth of the consumer price index (CPI) from one month to another. CPI growth is considered more factual in measuring the rate of inflation so that it shows in more detail the occurrence of inflation each year.

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