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MAQASID SHARIA INDEX, BANKING RISK AND PERFORMANCE CASES IN INDONESIAN ISLAMIC BANKS

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ABSTRACT

In the operation, Islamic banking is assessed not only based on the banking risk management but also based on the maqasid sharia. The purpose of the study is to examine the influence of Maqasid Sharia and banking risk on Islamic bank performance. The performance of Islamic banks is measured by the return on assets (ROA), Maqasid Sharia proxied by Maqasid Sharia Index (MI), musharaka financing (MUS) and mudharaba financing (MUD), while banking risk is measured by Capital Adequacy Ratio (CAR), financing to deposit ratio (FDR), non-performing financing (NPF), and operating expense to operating income ratio (OEI). The population in this study is all of the Islamic commercial banks that operate in Indonesia, and there are as many as 13 of them. As the population is a little realistic, all of the population is taken as samples. The results show that the MI did not significantly affect the performance of Islamic banks, while MUS had a significant and positive impact on ROA and MUD had a significant but negative impact on ROA. NPF and OEI had a significant and negative effect on performance, but CAR and FDR had no significant effect on the performance of Islamic banks.

Contribution/ Originality: This study contributes to the measurement of sharia bank health using the maqasid sharia approach, which is to determine the effect of sharia maqasid implementation and risk on the performance of Islamic banks. The research is based on a lack of studies on the implementation of maqasid sharia related to bank performance

1. INTRODUCTION

It has been almost three decades since Islamic banks in Indonesia started to operate and it is still an interesting area to conduct research into. 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 (Antonio *et al.*, 2012). Mohammed and Razak (2008) have measured Islamic bank performance in the framework of Maqasid Sharia, which includes aspects of education and research, as well as aspects of justice and maslahah. Hartono and Sobari (2017) have also measured the performance of Islamic banks by using the Maqasid Sharia Index (MSI). The implementation of Islamic bank performance measurement in Indonesia, based on Maqasid Sharia, is still low. It even has an inverse relationship with the banks' performance based on CAMELS and the performance of Maqasid Sharia (Sutrisno and Widarjono, 2017). While Kuppusamy *et al.* (2010) measures the performance of sharia banks using sharia conformity.

Even though the performance evaluation based on Maqasid Sharia has not been officially implemented by the Financial Services Authority, it is obligatory for an Islamic bank manager to implement it in order to keep the operation of Islamic banks in line with the Shariah goal. Islamic banks must not only be profit-oriented, but also have a social mission, which is to increase people's living standards. Maqasid Sharia performance is the point that differentiates Islamic banks from conventional banks (Ahmad and Ismail, 2017).

Qasim *et al.* (2017) suggested that we can use the Financial Ratio Analysis (FRA), Data Envelopment Analysis (DEA) and Maasid Index (MI) to measure the performance of Islamic banks. Maqasid Sharia is used to assess whether the operation of Islamic banks is based on the Shariah goal or not. The implementation of Maqasid Sharia is expected to increase the banks' performance because customers will have more trust in Islamic banks that can implement Maqasid Sharia well. Hartono and Sobari (2017); Ahmad and Ismail (2017) and Soleh (2016) have all found that the implementation of Maqasid Sharia in Islamic banks is still low.

Based on Maqasid Sharia, it is suggested that profit-sharing financing is the type of financing that should be applied to Islamic banks. This consists of two types of financing, which are mudaraba and musharaka financing. Mudaraba financing is the kind where funds are provided from the bank while the customers only provide the project and management. Therefore, the bank is not included in the management. Musharaka financing is a type of financing in which the bank provides funds to the customers' company and the bank can be included in the management. This type of finance has a higher risk. Rahman and Rochmanika (2012) found that profit-sharing financing has a positive effect on the performance of Islamic banks. Sutrisno (2015) found that musharaka financing had an effect on Islamic bank performance, while mudaraba financing did not have any effect on performance.

A bank is an institution with a high risk, either from capital risk, financing risk, liquidity risk, or operational risk. Therefore, a bank has to be able to manage and control all of the risks.

Banking capital has a strategic position because capital becomes the bank's main support in a bankruptcy case. Because of the capital's importance, the government determines the CAR, which is a minimum of 8%. The higher a bank's capital, the more people will put their trust in the bank, which will increase its profitability. Akhtar *et al.* (2011); Srairi (2009) and Abduh and Alias (2014) found that CAR has a positive and significant effect on bank performance. In contrast, Harjanti *et al.* (2016) and Idris *et al.* (2011) found that CAR does not have an effect on bank performance.

Liquidity risk, which is measured by the financing to deposit ratio (FDR), shows the amount of financing given by the bank. The higher the FRD, the higher the financing given by the bank, and this can increase its profitability. This is because the profits of an Islamic bank depends on the amount of financing given. Milhem and Istaiteyeh (2015) and Sanwari and Zakaria (2013) found that LDR hada significant effect on bank performance. In addition, Mahmud *et al.* (2016) and Harjanti *et al.* (2016) found that LDR had an insignificant effect on bank performance.

The financing risk occurs if the process of giving finance is not accompanied by prudential principle. The financing risk, which is measured by non-performing financing (NPF), is the cost, which will reduce the bank's profit. Therefore, the higher the NPF, the more the performance of the bank will be reduced. The results of research by Abdillah *et al.* (2016) and Abduh and Alias (2014) show that NPL has a negative significant effect on bank performance. Meanwhile, the findings of Milhem and Istaiteyeh (2015) and Mahmud *et al.* (2016) show an insignificant effect.

Banking also faces operational risk, which is shown by the ratio between the operating costs to operating income (OEI). The more efficient the bank is, the lower the operational risk will be. Therefore, the more efficient the bank is, the greater the profitability will be. This is because the profit is gained by reducing the income with the bank operating cost. The results of research by Mahmud *et al.* (2016) and Abduh and Alias (2014); Harjanti *et al.* (2016) and Abduh and Alias (2014) showed that OEI has a significant effect on bank profitability. On the other hand, Milhem and Istaiteyeh (2015) and Idris *et al.* (2011) found an insignificant effect.

2. THEORETICAL REVIEW AND HYPOTHESIS

2.1. Maqasid Sharia Index and Islamic Bank Performance

Antonio *et al.* (2012) state that Islamic banks, besides being expected to make a profit, must also consider the Shariah goal or Maqasid Sharia because their operations are based on Shariah principles. According to Ahmad and Ismail (2017) the implementation of Maqasid Sharia can reduce inequity and the practice of usury. Mohammed and Razak (2008) classify Maqasid Sharia as: (1) Tahdhib al-Fard (individual education); (2) Iqamah Al-adl (upholding justice), and (3) Jaib al-Maslahah (increasing welfare). Therefore, Islamic banking is required to uphold those three pillars of Maqasid Sharia. A Sharia bank must consider the education and training of its employees so that they are more professional, can uphold justice for the customers and themselves, and are able to consider the welfare of the bank owner (profit orientation). If Maqasid Sharia is well implemented, it leads to quality human resources that are fair and have the potential to produce high profitability.

H_1: Maqasid Sharia index has positive effect on Islamic bank performance

2.2. Profit-Sharing Financing and Performance

The main difference between an Islamic bank and a conventional bank is the concept of how they operate. Conventional banks use interest rates in their operation, which apply to both the financing of products and also to credit. An Islamic bank is not allowed to use interest rates and replaces them with the profit-sharing concept and profit margin. Profit-sharing financing consists of two types of financing, which are mudhabarah financing and musharaka financing. According to Shanmugam and Zahari (2009) mudaraba financing is financing where the funds are from the bank, while the customers only provide the project and the management. The bank is not included in the management. Musharaka financing is financing in which the bank provides funds to the customers' company and the bank can be included in the management. This type of finance is a higher risk because the bank's income depends on the customers' income. However, the expected profit is also higher.

The higher the mudaraba or musharaka financing, the more the bank's income will increase if it is well managed. This, in turn, will increase the performance of the Islamic bank. Sutrisno (2015) stated that mudaraba financing hada significant effect on bank performance, which is measured by ROE. Musharaka financing also has a significant effect on bank performance, and Rahman and Rochmanika (2012) also found that profit-sharing financing has a positive effect on Islamic bank performance.

H_2: Mudaraba financing has positive effect on Islamic bank performance

H_3: Musharaka financing has positive effect on Islamic bank performance

2.3. Capital Risk and Performance

Capital is an important element of a company, especially a bank, because it serves as a backup that can cover a loss experienced by a bank. In banking, the main source of funds is from the people, so the security of the funds is the main priority, as the bank must provide sufficient capital to anticipate a loss. The function of capital is to protect the deposit that does not get insurance, in case there is an unsolvable problem and liquidation, and to absorb a loss in order to keep the people's trust so that the bank can continue to operate. Bank capital is measured by using CAR and determined by the government at a minimum rate of 8%. The higher the CAR value is, the better the bank is. Abduh and Alias (2014) found that CAR had a positive effect on Islamic bank performance. Milhem and Istaiteyeh (2015) and Sanwari and Zakaria (2013) also found that a positive effect exists between capital and bank performance.

H_4: Capital risk (CAR) financing has positive effect on Islamic bank performance

2.4. Liquidity Risk and Performance

Liquidity is the capability of a bank to fulfil its commitment and obligation to customers. Banks have an obligation to provide sufficient funds when customers take their funds, which can happen at anytime. The commitment is to provide funds to the financing that has been promised. An Islamic bank liquidity risk is measured by using the financing to deposit ratio (FDR), which is the amount of financing that is given compared to third-party funds. The higher the FDR is, the higher the financing given to the customer. This will increase an Islamic bank's income and result in an increase in profitability at the end. Youssef and Samir (2015) and Sanwari and Zakaria (2013) found that the risk of liquidity (FDR) hada positive and significant effect on bank performance. Abduh and Alias (2014); Gul *et al.* (2011) and Almazari (2014) also found that LDR hada positive effect on bank performance.

H_4: Liquidity risk (FDR) has positive effect on Islamic bank performance

2.5. Financing Risk and Performance

The financing given to the customers is a double-edged sword as, on the one hand, it can increase profits, but on the other, it can create a problem as the financing is not returned if it is not well managed. A financing risk may occur when some of the customers do not pay their debt, either of the financing credit or the profit share. The financing risk is measured by using non-performing financing (NPF). A bank's management has to ensure the NPF is no more than 5%, as it is determined by the Bank of Indonesia. This is because the higher the NPF is, the lower the profitability level will be. Youssef and Samir (2015) and Abdillah *et al.* (2016) found that NPL has a negative and significant effect on bank performance. Sanwari and Zakaria (2013) and Akhtar *et al.* (2011) also found that NPL has a negative and significant effect on bank performance.

H_5: Financing risk (NPF) has positive effect on Islamic bank performance

2.6. Operating Risk and Performance

The bank's management is expected to operate efficiently. This means that the operational cost should be reduced so that the spread between the income and finance is bigger. Operational risk occurs when the management cannot increase the bank's efficiency. The operational cost is higher as a result. The operational risk is measured by using the operational cost to operation income ratio (OEI). The higher the OEI is, the smaller the spread is. This reduces the bank's profits. In contrast, the smaller the ratio of OEI, the more efficient the operational cost spent by the bank is, which will increase its profitability. Srairi (2009) and Abdillah *et al.* (2016) found that OEI has a negative effect bank performance. Youssef and Samir (2015); Harjanti *et al.* (2016) and Mahmud *et al.* (2016) also found there was a negative correlation between OEI and bank performance.

H_6: Operating risk (OEI) has positive effect on Islamic bank performance

3. RESEARCH METHOD

3.1. Population and Sample

The population of the research is 13 Islamic banks that operate in Indonesia. The sample is 10 Islamic commercial banks that were chosen by using purposive sampling. The data was gathered from the Islamic banks' annual financial reports within an observation period of 5 years (2012-2016).

3.2. Variables and Measurement

There are two variables in this research. These are Islamic bank performance (ROA), which is the dependent variable, and 7 independent variables that consist of the Maqasid Sharia Index, mudaraba financing, musharaka financing, CAR, liquidity risk or financing to deposit ratio (FDR), financing risk or non-performing financing (NPF

and operational risk or operating expense to operating income (OEI). Then, there is alsothe variable measurement, except for Maqasid Sharia.

Table-1. Variables and Measurement

No	Variable	Code	Measurement
1	Return on assets	ROA	EBIT/Total assets
2	Mudharaba Financing	MUD	Mudharaba financing/Total financing
3	Musharaka Financing	MUSY	Musharaka financing/Total financing
4	Capital Adequacy Ratio	CAR	Equity/Weighted asset by risk
5	Financing to deposit ratio	FDR	Total financing/third-party fund
6	Non-performing financing	NPF	Bad debt financing/Total financing
7	Operating expense to income ratio	OEI	Operating expenses/Operating income

Source: The Annual Financial Statement of Islamic Bank

Next, the value of the Maqasid Sharia Index (MI) was calculated. This is based on the Maqasid Sharia framework by Mohammed and Razak (2008) in which MI has three dimensions: individual education, justice/equality, and maslahah. Here is the calculation of the MI variable:

Table-2. Measurement of MI Variable

MI Dimension	weight	Element	Measurement	Weight
Educating individual	30	Education grant	Education grant/total income	24
		Research cost	Research expense/total expense	27
		Training	Training expense/total expense	26
		Publicity	Publicity expense/total expense	23
Justice	41	Fair return	Profit/total income	30
		Affordable price	Bad debt/Total financing	32
		Interest-free product	Interest-free income/total income	38
Welfare	29	Profit ratios	Net profit/total asset	33
		Individual income	Zakah/net income	30
		Investment ratio in rial sector	Investment deposit/total deposit	37

Source: Mohammed and Razak (2008)

3.3. Data Analysis Instrument

The data analysis instrument used to test the hypothesis is multiple regression, with the regression equation below:

$$ROA = \alpha + \beta_1 MI + \beta_2 MUD + \beta_3 MUR + \beta_4 CAR + \beta_5 FDR + \beta_6 NPF + \beta_7 OEI$$

Where:

ROA: return on assets

MI: Maqasid Sharia index

MUD: mudaraba financing

MUS: musharaka financing

CAR: Capital Adequacy Ratio

FDR: financing to deposit ratio

NPF: non-performing financing

OEI: operating expense to operating income ratio

4. RESULT AND DISCUSSION

4.1. Descriptive Statistic

Based on the result of the data tabulation processed on SPSS, the description of each variable was obtained:

Table-3. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	65	-.20	.04	.0060	.03214
MI	65	.27	39.94	18.5387	5.23948
MUD	65	.00	29.58	23.1516	9.13157
MUS	65	.00	30.64	25.7083	7.38318
CAR	65	10.60	124.43	25.3091	19.91994
FDR	65	68.93	289.20	99.4880	32.66421
NPF	65	.00	43.99	4.4511	6.93438
OEI	65	34.73	192.60	91.3627	22.99308
Valid N (listwise)	65				

Source: processed from research data

Based on the data above, Islamic bank performance (ROA) has a minimum value of -20% and a maximum value of 4% with the average being 0.6%. This means that the level of Islamic bank profit is still very low. There are even some banks that experience a loss. The minimum value of the Maqasid Sharia Index (MI) is 0.27, the maximum 39.94 and the average 18.34from the financing side. The minimum value of mudaraba and musharaka financing is 0, which means there is an Islamic bank that does not give this financing because this type of financing is high risk. The maximum value of mudaraba financing is 29.58% and the average value is 23.25%. The maximum value of musharaka financing is 30.64% and the average value is 25.71%.

CAR has not been managed efficiently because the average value of 25.30% is still too high, while the minimum requirement is only 8%. Moreover, there is an Islamic bank which has a CAR value of 124.43%. The liquidity risk (FDR) is already good because the average value is 99.49%. However, there is an Islamic bank which has too high a FRD value of 289.20%, so it needs to be controlled. The financing risk (NPF) is in a good condition because the average value is 4.45%, which is still below the maximum requirement value. However, there is an Islamic bank that has a very high NPF value, which is 43.99% at the maximum. Next, the efficiency risk (OEI) is still too high because the average is above 90% and the maximum value is 192.60%

4.2. Hypothesis Testing Result

The hypothesis is tested by using both multiple linear regression and SPSS program. The result is shown below:

Table-4. Hypothesis test result

Model		Standardised Coefficients Beta	t	Sig.
1	(Constant)		4.847	.000
	MI	.026	.516	.608
	MUD	-.200	-2.581	.012
	MUS	.188	1.957	.055
	CAR	-.030	-.418	.677
	FDR	-.032	-.422	.674
	NPF	-.442	-6.549	.000
	OEI	-.577	-7.994	.000

Source: Processed from research data

4.3. Maqasid Sharia Index and Islamic Bank Performance

The hypothesis testing shows the significance level of the Maqasid Sharia value of 0.608, which is higher than the required significance level (0.05), so MI does not have an effect on company performance. This result confirms that Maqasid Sharia's implementation in Indonesian banking is still low. Hartono and Sobari (2017) also found that the Maqasid Sharia Index of Islamic commercial banks and business units was not high yet. This finding is supported by Sutrisno and Widarjono (2017) who also found that the implementation of Maqasid Sharia in Islamic banking in Indonesia was still low. This also happens in some other countries, such as Bangladesh (Mohammad, 2015) and Jordan (Antonio *et al.*, 2012). Antonio *et al.* (2012) compared Indonesia and Jordan. The implementation of Maqasid in Islamic banking is very important because it can avoid the practice of usury and inequality (Ahmad and Ismail, 2017). Mohammad (2015) also stated the importance of equality, transparency, and Maqasid Shariah in Shariah finance. It is also important to consider the practice of some banks that do not uphold the value of MI in their products and operations.

4.4. Financing and Islamic Bank Performance

The hypothesis testing that was used against the mudaraba financing results in a lower significance levelcompared to the required value, and the result was also negative. Therefore, MUD hada negative and significant effect on bank performance. This result was in contrast to the hypothesis that it should be positive. This is probably because mudaraba financing is a risky type of financing in which the income that is earned is based on the profit gained by the customers. If it is not well analysed and managed, this type of financing reduces the profitability of Islamic banks. Basically, this financing should be dominant in Islamic banking. In fact, there are some banks that do not provide mudaraba financing. Sutrisno (2015) found that mudaraba financing has a significant effect on Islamic bank performance. However, his finding was different from the findings of Rahman and Rochmanika (2012) which showed that profit-sharing financing hada positive effect on the performance of Shariah banks.

In contrast, musharaka financing hada positive and significant effect on Shariah banking performance. This result showed that this type of financing provides a positive contribution, which increases the amount of musharaka financing and the profitability of Islamic banks. This is probably because profit-sharing financing allows the bank to participate in the customer's company management,which makesthe profit more controllable. This type of financing is of more interest to Islamic banks, whichis evident from the higher proportion that use it compared to mudaraba financing. This finding is in accordance with the findings of Rahman and Rochmanika (2012) but is contrary tothe findings of Sutrisno (2015) who found that musharaka financing did not have an effect on Islamic bank performance.

4.5. Capital Risk and Islamic Bank Performance

CAR results in a significance level of 0.677, which is higher than the required value.Therefore, it does not have an effect on Islamic bank performance. This result showed that the value of CAR does not have an effect on Islamic bank performance. Bank capital is also the most important aspect of banking because the function of bank capital is to backup a bank's loss. It means that when a bank experiences a loss, this loss has to be covered by the bank. The bank capital is so important that the government sets the minimum limit of capital, which is measured by a CAR of 8%. We can see that the average CAR of Islamic banks is far from the minimum requirement of 25.3%. Thus, Islamic bank capital is very safe but it does tend to be less productive because the excess can be used to provide financing. This is why the CAR of Islamic banks does not have an effect on bank performance. This result is supported by Harjanti *et al.* (2016) and Idris *et al.* (2011) who found that CAR does not have an effect on Islamic bank performance.

4.6. Liquidity Risk and Islamic Bank Performance

Liquidity risk (FDR) has a significance value of 0.674, which is higher than the required value, so it does not have an effect on bank performance. FDR shows the financing that is provided by Islamic banks. The higher the financing is, the higher the profitability. However, FDR does not have an effect on bank performance, probably because of the movement of ROA data. When LDR increases, the ROA of some banks decreases. The average FDR is 99.45%, which isactually good andshould be able to support the ROA increase. However, there are some banks that have a very high FDR, which is 289%, while the lowest is 69%. This may be why FDR does not have an effect on Islamic bank performance. Harjanti *et al.* (2016) also found thatFDR has an insignificant on ROA in Islamic banking. Milhem and Istaiteyeh (2015) in Jordan also found thatFDR had an insignificant effect on ROA. This result was in accordance with Mahmud *et al.* (2016) and Sutrisno (2015) who conducted research into conventional banks. They found that LDR does not have an effect on bank performance.

4.7. Financing Risk and Islamic Bank Performance

Financing risk (NPF) has a negative value and a lower significance than the requirement. It can be concluded that NPF has a negative and significant effect on the performance of Islamic banking. Non-performing financing (NPF) shows there are some problems with the financing and this will be treated as the cost. Therefore, the higher NPF will reduce the bank's profitability. Islamic banks have a higher risk compared to conventional banks, so they need to be managed carefully. Based on the statistical data, there is a bank that has a very high NPF value (44.99%).The average is 4.45%, which is still below the maximum requirement. The management of Islamic banks should be able to control the financing risk (NPF) because NPF significantly affects bank performance. To make NPF controllable in its provision of financing, the bank should implement the banking prudential principles. This result is in accordance with the findings of Akhtar *et al.* (2011) in Pakistan and Srairi (2009) in Arabian countries. Idris *et al.* (2011); Abdillah *et al.* (2016) and Youssef and Samir (2015) also found the same result.

4.8. Operational Risk and Islamic Bank Performance

Operational risk (OEI) has a negative value and a lower significance level than the requirement. It means OEI has a negative significant effect on Islamic bank performance. The higher operating expense to operating income ratio (OEI) shows a higher operational cost, so the efficiency of the bank is therefore low. The higher value of OEI will result in a lower profit, which will lead to a decrease in profitability. The control or management of the operational risk is very important because it is connected directly to profit. The management of Islamic banks should be able to control this ratio. The bank can analyse the unnecessary costs in order to increase its efficiency. This result is in accordance with Mahmud *et al.* (2016) who found there was a negative and significant effect of operational risk on bank performance in Islamic banking in Bangladesh. Harjanti *et al.* (2016) and Abdillah *et al.* (2016) also found the same result in Indonesia.

5. CONCLUSION

Based on the hypothesis testing, which used the multiple regression that was explained previously, we found that the Maqasid Sharia Index has an insignificant effect on bank performance. The capital risk (CAR) and liquidity risk (FDR) did not have an effect on bank performance. Musharaka financing has a positive and significant effect, while mudaraba financing has a negative and significant effect on bank performance, which is in line with the proposed hypothesis. Financing risk (NPL) and operational risk (OEI) has a negative and significant effect on bank performance.

The result of this research is expected to help Islamic bank managers to manage their banks. The result is especially related to the variables that have an effect on bank performance. Islamic bank managers should control the liquidity and operational risks so that bank performance can be increased.

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