Primary Determinants of PLS Financing in Islamic Banks: Empirical Insights from Indonesia

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ABSTRACT

This study aims to identify the factors influencing Profit-Loss Sharing (PLS) financing in Islamic Banking in Indonesia. This study uses Islamic bank financial performance instrument variables, which consist of Non-Performing Financing (NPF), Capital Adequacy Ratio (CAR), Third Party Funds (DPK), and macroeconomic variables, namely the World Uncertainty Index (WUI), Industrial Production Index (IPI), and BI-Rate monetary variables. This study uses data from January 2015 to May 2024. The research used is a quantitative method with the Auto-Regressive Distributed Lag (ARDL) analysis model. The findings of this study indicate that NPF and BI-Rate variables have a significant effect on PLS financing in the short and long term. Meanwhile, the variables of CAR, DPK, WUI, and IPI do not have a significant impact on the short and long term. The results of this study are expected to serve as recommendations for the government and stakeholders in formulating and establishing appropriate policies and strategies for Islamic banking.

Keywords: *Profit-Loss Sharing Financing; Islamic Banking Performance; World Uncertainty Index; Industrial Production Index; BI-Rate*

INTRODUCTION

The Islamic finance industry has witnessed significant global growth. According to data from 2022, the total assets of the Islamic Financial Services Industry (IFSI) worldwide reached USD 3.25 trillion, with Islamic banks

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contributing 69.3% of these global assets (Islamic Financial Services Board, 2023). Furthermore, the Islamic Financial Service Board (2023) reported that the growth of Islamic banks' assets increased from 0.4% to 6.9% in 2022, while financing growth rose from 4.9% to 13% in the same year. These developments underscore the capacity of Islamic banks to assume a substantial role in promoting global economic development.

As a fundamental component of the Islamic financial industry, Islamic banking has broadened its presence across multiple nations. Indonesia, the world's second most populous Muslim demographic, has considerable potential to leverage the Islamic financial sector as a mediating institution to promote economic growth. The growth of Islamic banks in Indonesia is evident from the consistent increase in their assets over recent years. For instance, the total assets of Indonesia's Islamic banking sector rose from IDR 531.86 trillion in 2022 to IDR 594.71 trillion in 2023 (Otoritas Jasa Keuangan, 2024a).

The transformation of Islamic banking is being undertaken as an initiative to enhance resilience, competitiveness, and socio-economic impact. The consolidation approach aims to facilitate a sufficient increase in the assets of Islamic banks, particularly those with relatively low asset levels. Additionally, to strengthen the identity of Islamic banking, the Financial Services Authority (OJK, *Otoritas Jasa Keuangan*) encourages Islamic banks to develop product differentiation that emphasizes their unique characteristics. Examples of such products include Cash Waqf Linked Deposits (CWLD), gold-based business activities, multi-service financing (covering sectors such as health, education, tourism, umrah, and others), Sharia Restricted Investment Account (SRIA), among others.

Furthermore, to amplify the socio-economic impact, Islamic banking institutions are urged to establish partnerships and collaborate with the Amil Zakat Institution (LAZ, *Lembaga Amil Zakat*) and *Nazir Waqf*, ensuring the optimal utilization of social funds (ZISWAF) for the welfare of society. These strategic actions are encapsulated in the Roadmap for the Development and Strengthening of Indonesian Islamic Banking (RP3SI, *Pengembangan dan Penguatan Perbankan Syariah Indonesia*), which outlines five key objectives: 1) Strengthening structure and resilience, 2) Accelerating digitalization, 3) Reinforcing characteristics, 4) Strengthening the contribution of Islamic banking national economic development, 5) Enhancing the regulation, licensing, and supervision of Islamic banking (Otoritas Jasa Keuangan, 2023). In this regard, the Indonesian government has formulated a series

of regulations and strategies aimed at advancing the Islamic banking sector.

The defining distinction that exists between Islamic and conventional banking resides in the profit-sharing arrangement, commonly referred to as Profit-Loss Sharing (PLS), which is expected to make a meaningful contribution to economic activity in the real sector and promote economic stability. As Abdul-Rahman and Gholami (2020) emphasized, PLS contracts in Islamic finance can be a strategic mechanism to strengthen the financial system. In 2022, the total PLS-based financing in Indonesian Islamic banking amounted to IDR 125.01 trillion, increasing to IDR 159.35 trillion by the end of 2023 (Otoritas Jasa Keuangan, 2024a). This continuous growth in the value of PLS financing in Indonesia illustrates its considerable potential. However, non-PLS financing remains dominant.

Belkhaoui et al. (2020) found that Islamic bank financing in the Gulf Cooperation Council (GCC) primarily uses cost-plus sale (murabaha) contracts, which offer high profits and lower risk. In 2023, PLS financing accounted for 43% of total financing, while non-PLS financing comprised 57% (Otoritas Jasa Keuangan, 2024b). This data demonstrates that the non-PLS financing system continues to outweigh the PLS financing system in Indonesia (Otoritas Jasa Keuangan, 2024b). Chowdhury et al. (2018) and Saleem et al. (2024) argue that while PLS financing possesses the capacity to drive economic development, firms continue to depend on non-PLS financing owing to its lower risk, diminished information asymmetry, and better transparency. Supporting this view, Ibrahim et al. (2022) note that PLS financing entails elevated risk, as seen in the dynamics of PLS financing, where significant changes in financing conditions from the preceding period impact PLS financing in the subsequent year. Rouetbi et al. (2023) observe that financing based on *mudharabah* and *musyarakah* contracts shows promise, as demonstrated by the positive effect of total assets on the profitability of Islamic banks, although these schemes entail significant risk.

Before providing financing services, banks typically conduct a risk assessment process for their customers. This selective risk assessment is essential in banking to mitigate the risk of loss. Research by L. Nugroho et al. (2022) supports this assertion, demonstrating that NPF impacts both Return on Asset (ROA) and the aggregate operational performance of Islamic banks. In addition to NPF, capital and funding are also crucial elements, as they are directly related to the performance, health, and operational efficiency of Islamic banks. A high Capital Adequacy Ratio (CAR) and increased funding

contribute to greater stability within these banks (Widarjono, 2020b).

Amid global economic uncertainty, the Islamic banking industry has displayed significant resilience. Bilgin et al. (2021) have shown that countries with a higher share of PLS-based financing within the banking systems of countries, including Indonesia, Iran, Pakistan, and Sudan, are better equipped to mitigate the risk of defaults by Islamic banks during economic instability. The resilience of the PLS system during economic shocks highlights that this system, grounded in the principle of justice, fosters a positive synergy between banks and their customers. Mubarok (2021) further supports this, finding that Islamic bank financing can quickly stabilize in response to economic shocks. Additionally, the support of stakeholders in the advancement of the Islamic finance industry enhances the performance of Islamic banks, making them more effective than conventional banks (Hasan, 2023).

With its risk-sharing framework, Islamic banking aligns its activities more closely with the real economy (Imam & Kpodar, 2016). Junaeni et al. (2023) also assert that PLS-based financing significantly influences the promotion of real-sector economic growth. Consequently, the activities of Islamic banks are more oriented towards productive endeavors, whereas conventional banks tend to prioritize interest-based transactions. Regarding interest rates, Ibrahim et al. (2022) state that Islamic banks exhibit greater stability within the financial system because they are not subject to fluctuations in interest rates.

Several previous studies have identified key determinants influencing financing with PLS schemes in Islamic banking. Salman (2023b) found that the volume of funds from external parties significantly impacts the allocation of funds to PLS financing. Meanwhile, Nugraheni and Alimin (2022) suggested that risk, financing screening, and financial statement analysis affect PLS financing. Specifically, high risk tends to reduce PLS financing, while robust screening and financial analysis help reduce information asymmetry and increase PLS financing. Setyowati (2019) argued that industrial production rises with increased bank deposits, which is directly relevant to financing, as higher deposits expand the availability of funds for distribution. Building on these findings, this study aims to explore further the factors influencing PLS financing using the latest data for the period 2024, addressing gaps in previous research that rarely incorporated macroeconomic variables, such as the World Uncertainty Index (WUI), Industrial Production Index (IPI), and BI-Rate.

This research aims to investigate the determinants influencing

PLS financing in Islamic banks in Indonesia and analyze the temporal dynamics¾both short-term and long-term) of each variable from January 2015 to May 2024. The study will consider both Islamic bank performance variables, Non-Performing Financing (NPF), Capital Adequacy Ratio (CAR), Third Party Funds (DPK), as well as macroeconomic factors such as the World Uncertainty Index (WUI), Industrial Production Index (IPI), and BI-Rate, which are key monetary instruments. The outcomes of this study are anticipated to provide a significant addition to extant literature, offer new insights, and support policymakers and practitioners in developing relevant policies. Additionally, the study aims to assist Islamic banks in enhancing their financing products, services, strategies, and management in order to improve the quality, operational efficiency, and sustainability of Islamic banks.

LITERATURE REVIEW

Research Hypothesis

The Relationship between Non-Performing Financing (NPF) and PLS Financing

NPF is a critical ratio that reflects the financial health of banks, particularly within the context of financing activities (Hendrik et al., 2018). While some studies, such as those by Winarsih and Asokawati (2019) and Salman (2023b), suggest that NPF exerts no substantial influence on profit-sharing financing, other research highlights its negative effect on bank profitability and stability. For instance, Ajizah and Widarjono (2023) emphasize that Islamic banks must exercise prudent management of financial disbursements to mitigate the adverse effects of high NPF. Thus, the hypothesis for this study is:

H1: NPF has a negative effect on PLS financing

Relationship between Capital Adequacy Ratio (CAR) and PLS Financing

M. Saeed et al. (2020) found that Islamic banks tend to increase capital reserves and enhance cost efficiency when facing the risk of bankruptcy. However, this approach to risk mitigation does not substantially reduce

the risk of bankruptcy. This suggests the importance of optimizing capital management, effectiveness, and risk management within Islamic banks. Sutrisno (2023) further observes that a high NPF level leads to reduced profitability for Islamic banks, as it compels them to increase reserves or capital reserves. Arintoko (2021) states that an elevated CAR enhances a banking institution's ability to manage risk and influences its lending capabilities. Meanwhile, Salman (2023b) found no significant relationship between CAR and PLS financing disbursed. Therefore, the hypothesis for this study is:

H2: CAR has a positive effect on PLS Financing

Relationship between Third-Party Funds (DPK) and Profit-Sharing Financing

Deposits held by banks serve as an essential determinant in promoting economic development by increasing the availability of financing (Kismawadi, 2024). This is supported by Salman (2023b) and Wirman (2017), who found that increasing third-party funds encourages a greater allocation of PLS financing. Pradana et al. (2022) also noted that profitability is positively affected by DPK, indicating that when DPK are effectively managed and allocated, they can enhance profitability. Thus, the hypothesis formed in this study is:

H3: DPK has a positive effect on PLS Financing

Relationship between World Uncertainty Index (WUI) and Revenue Sharing Financing

Macroeconomic shocks can impact both the financial industry and the real economy (Santosa et al., 2020). Al-Banna (2017) suggests that Islamic banks are relatively insulated from global economic crises for two reasons: first, the impact is more limited to the micro sector of Islamic banks, and second, Indonesian Islamic banks were not yet listed on the financial market. Fatoni (2022) found a significant effect of the WUI on Islamic banking stability in both the short and long terms. However, Ashraf (2021) argues that economic uncertainty may limit financing distribution, as banks tend to become more risk-averse. Lin et al. (2021) also state that economic uncertainty exerts an adverse impact on investment. Building upon these previous studies, it may

be inferred that economic uncertainty can reduce the proportion of PLS financing. Therefore, the hypothesis formulated in this study is:

H4: WUI has a negative effect on PLS financing

Relationship between Industrial Production Index (IPI) and Revenue Sharing Financing

Islamic banking responds positively to shocks in the IPI, which indicates that the financial strength of banks increases when economic conditions stabilize (Pambuko et al., 2018). Economic activity in the real sector, including industrial production, significantly impacts Islamic bank deposits (Setyowati, 2019). Moreover, Bougatef et al. (2020) identified a positive impact of Islamic bank financing on industrial development, although the significant impact was primarily from non-PLS financing. Therefore, the relationship between IPI and PLS financing warrants further investigation, as a robust industrial sector attracts investments, and PLS financing, which is closely tied to the real economy, can stimulate industrial growth. Consequently, the hypothesis for this study is:

H5: IPI has a positive effect on PLS financing

Relationship between BI-Rate and Profit-Sharing Financing

Santosa et al. (2020) revealed that an increase in interest rates could negatively impact the health of Islamic banks. This suggests that interest rates might affect PLS financing. This view contrasts with Abasimel (2023), who argues that the Islamic financial system is more stable than conventional systems, which use interest rates as a basis. Hidayat and Purbayati (2023) found no effect of the BI-Rate on profit-sharing income. On the other hand, Supriani and Sudarsono (2018) argued that an increased BI-Rate could lead to a higher proportion of Islamic bank financing, accompanied by increased financing risk. Supporting the view, Kismawadi et al. (2023) suggest that, although Islamic banks operate a non-interest-based principle, fluctuations in interest rates may still affect individual decisions to engage in transactions. Thus, the hypothesis for this study is:

H6: BI-Rate has a negative effect on PLS financing

Research Hypothesis Model

In order to fulfill the research aims of identifying factors that can affect PLS financing in Islamic banking, the research hypothesis model is developed, as illustrated in Figure 1 below:

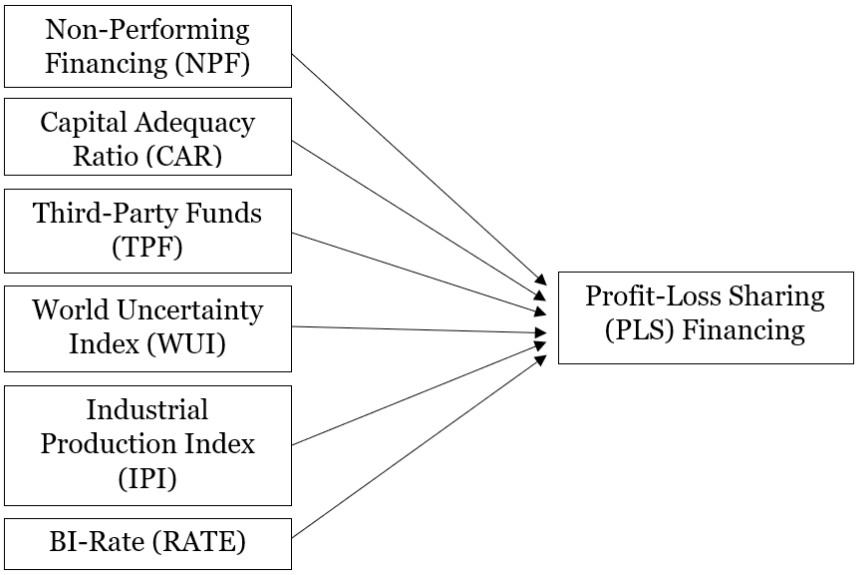


Figure 1 *Research Hypothesis Model*

RESEARCH METHOD

This study is classified as quantitative time series research. The primary objective of quantitative research is to provide statistical analysis and identify the relationships between the variables, including NPF, CAR, DPK, WUI, IPI, and BI-Rate. The research sample consists of Indonesian Islamic commercial banks, utilizing monthly data from January 2015 to May 2024, resulting in 113 observations. The dependent variable of this study is PLS financing, while the independent variables are NPF, CAR, DPK, WUI, IPI, and BI-Rate. The operational definitions of each variable are provided in Table 1 below:

Table 1 *The Variables Definition*

Dependent Variable	**Definition**	**Measurement**	**Unit**	**Data Source**
Profit-Loss Sharing Financing (PLS)	Financing provided by Islamic banks, consisting of Mudharabah and Musyarakah	Total Mudharabah and Musyarakah financing	Billion in IDR	Financial Services Authority
Independent Variables	**Definition**	**Measurement**	**Unit**	**Data Source**
Non-Performing Financing (NPF)	The ratio of non-performing financing	NPF = (Total NPF/(Total Financing) ×100% (Otoritas Jasa Keuangan, 2024b)	Percentage (%)	Financial Services Authority
Capital Adequacy Ratio (CAR)	The ratio of the bank's capital to risk-weighted assets	CAR = Capital/ Risk-Weighted Assets ×100% (Otoritas Jasa Keuangan, 2024b)	Percentage (%)	Financial Services Authority
Third-Party Funds (DPK)	Funds raised by Islamic banks from customers in the form of current accounts, savings, and deposits	Total TPK funds collected	Billion in IDR	Financial Services Authority
World Uncertainty Index (WUI)	An index that measures global uncertainty	Counting the frequency of the term "uncertainty" (or its variants) in country reports by the Economic Intelligence Unit (EIU)	Percentage (%)	World Uncertainty Index

Industrial Production Index (IPI)	An index that measures the performance of large and medium-sized industries	Calculated using the formula: IPI =∑(W1 x P1/ P0)/W1 W1= *Base year weights* P1 = *Production in the current year* P0 = *Production in base year*	Percentage (%)	Central Bureau of Statistics (BPS, *Badan Pusat Statistik*)
BI-Rate (Rate)	The Indonesian interest rate	The rate set by Bank Indonesia (Bank Indonesia, 2016)	Percentage (%)	Bank Indonesia

Source: Processed data by the authors (2024)

The Autoregressive Distributed Lag (ARDL) analysis method is employed to examine the relationships between variables both in the short and long-term (Saeed et al., 2020; Widarjono & Rudatin, 2021). The ARDL analysis consists of several steps. According to Angraini et al. (2020), these steps include conducting a unit root test to assess data stationarity, performing cointegration analysis, determining the optimal lag length, and estimating the ARDL model. The equation formed to use the ARDL model is as follows:

$$\Delta PLS_t = a_0 + a_{1i}\Sigma_{i=1}^{n}\Delta PLS_{t-1} + a_{2i}\Sigma_{i=1}^{n}\Delta NPF_{t-1} + a_{3i}\Sigma_{i=1}^{n}\Delta CAR_{t-1} + a_{4i}\Sigma_{i=1}^{n}\Delta DPK_{t-1} + a_{5i}\Sigma_{i=1}^{n}\Delta WUI_{t-1} + a_{6i}\Sigma_{i=1}^{n}\Delta IPI_{t-1} + a_{7i}\Sigma_{i=1}^{n}\Delta Rate_{t-1} + \beta_1 PLS_{t-1} + \beta_2 NPF_{t-1} + \beta_3 CAR_{t-1} + \beta_4 DPK_{t-1} + \beta_5 WUI_{t-1} + \beta_6 IPI_{t-1} + \beta_7 Rate_{t-1} + e_t$$

The equation represents the ARDL framework, where PLS denotes Profit-Loss Sharing Financing, NPF stands for Non-Performing Financing, CAR refers to Capital Adequacy Ratio, DPK represents Third-Party Funds, WUI is the World Uncertainty Index, IPI refers to Industrial Production Index, and BI-Rate signifies the interest rate set by Bank Indonesia. The term e_t represents the error term. The symbol Δ indicates that the data is stationary at the first difference level. While β1- β7 represent the long-term relationships, and α1-α7 denote the short-term relationships.

RESULTS

Table 2 illustrates the summary statistics, demonstrating that the average value of PLS financing in Islamic banks is IDR 11.33796 trillion. The minimum value occurred in January 2015, whereas the maximum value was recorded in May 2024. During the study period, the average NPF ratio was 3.71%, which suggests that Islamic banks effectively managed NPF within the maximum limit of 5%. The minimum recorded NPF level was in December 2023, whereas the highest level, exceeding the standard limit, was 6.17% in 2016. The average CAR stood at 20.30%, with a minimum value of 14.09% in June 2015 and a maximum value of 26.28% in December 2022. The average value of TPF was IDR 12.52886 trillion, with the minimum value of IDR 12.00038 trillion recorded in June 2015, and the maximum value of IDR 13.07611 trillion in March 2024. The lowest WUI value was observed during various months throughout the study period, while the highest value of 0.54% occurred in May 2019. The average WUI was 0.13%. IPI had an average value of 0.41%, with a minimum value of -17.18% in April 2020 and a maximum value of 19.86% in May 2023. Finally, the average BI-Rate was 4.89%, with a low of 0.047% observed from January to July 2017, and a high of 7.75% in 2015.

Table 2 *Descriptive Statistics*

Variables	Mean	Min.	Max.	Standard Deviation
PLS	11.33796	10.79106	12.08104	0.345420
NPF	3.716531	2.038954	6.170000	1.150309
CAR	20.30729	14.09000	26.28000	3.874743
DPK	12.52886	12.00038	13.07611	0.324639
WUI	0.135150	0.000000	0.542000	0.113918
IPI	0.410000	-17.18000	19.86000	6.314900
RATE	4.896748	0.047500	7.750000	1.779687

Source: Processed data by the authors (2024)

The Auto-Regressive Distributed Lag (ARDL) model was utilized in this analysis to determine the factors influencing the dependent variable and to assess both short-term and long-term relationships. Several preparatory steps were taken to ensure that the data used were suitable for estimation with the

ARDL model. The initial step involved conducting the Augmented Dickey-Fuller (ADF) unit root test to assess the stationarity of the data. Ensuring data stationarity enhances the reliability of estimates and mitigates the risk of spurious results (Ahmed et al., 2020; Harun et al., 2024). The results of the unit root test are presented in Table 3 below:

Table 3 *ADF Unit Root Test*

Variables	Level I (0)		1st Diff. I (1)		Stationary Status
	ADF t-Statistic	Prob.	ADF t-Statistic	Prob.	
PLS	0.194153	0.9711	-8.969377	0.0000	I (1)
NPF	-0.940744	0.7718	-5.064822	0.0000	I (1)
CAR	-1.159152	0.6901	-10.92917	0.0000	I (1)
DPK	-0.189367	0.9354	-13.14922	0.0000	I (1)
WUI	-8.142726	0.0000	-11.00231	0.0000	I (1)
IPI	-10.86508	0.0000	-8.235099	0.0000	I (1)
RATE	-2.209083	0.2043	-10.26624	0.0000	I (1)

Source: Processed data by the authors (2024)

The ARDL approach can be applied if the data do not exhibit stationarity at the second-difference I(2) level. According to the results in Table 3, WUI and IPI are stationary at the I(0) level, while the PLS, NPF, CAR, DPK, and RATE are non-stationary at the I(0) level. However, after conducting unit root testing, each variable examined became stationary at the first difference I(1) level. This suggests the suitability of the ARDL model for use in this study.

Table 4 *Bound Test Results*

Test statistic	Value	K
F-statistic	16.30015	6
Critical value Bounds		
Signif.	I (0)	I (1)
10%	1.99	2.94
5%	2.27	3.28
2.50%	2.55	3.61
1%	2.88	3.99

Source: Processed data by the authors (2024)

A bound test was carried out to investigate the presence of cointegration

among the studied variables. This test is essential for detecting the sustained association between the independent and the dependent variables (Widarjono, 2020a). The results of the bound test, presented in Table 4, indicate that the F-statistic value (16.30015) surpasses the critical bound threshold (3.28) at the 5% significance level. These findings confirm the presence of long-term cointegration between the independent and dependent variables.

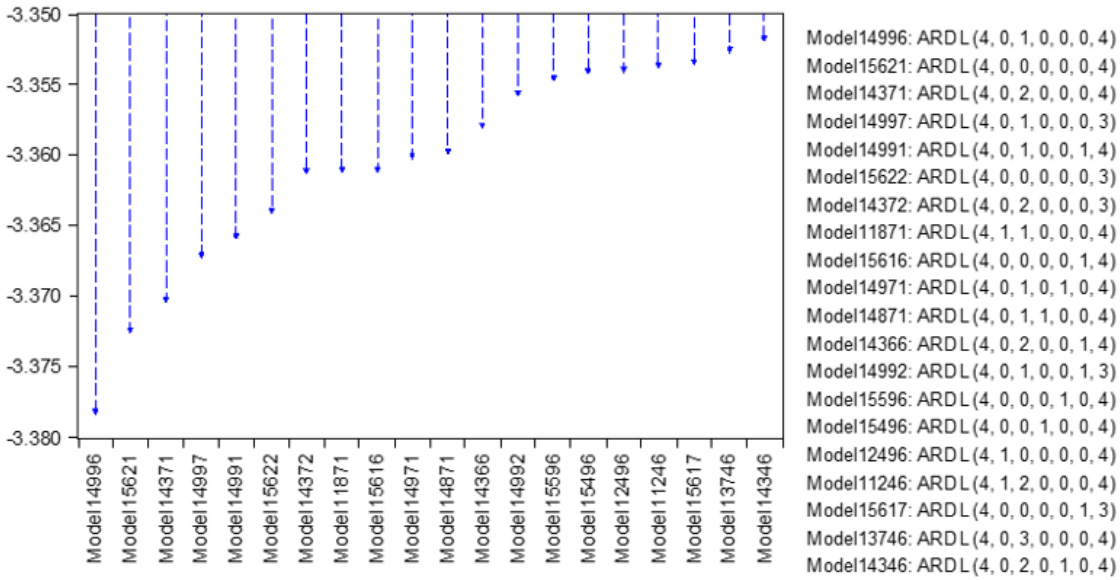


Figure 2 *AIC Optimal Lag*

Following the bound test, the next phase involved ascertaining the optimal lag length for model estimation. Proper lag selection is crucial as the ARDL model incorporates both short-term and long-term analyses. The lag length determines how the variables influence one another over time and has a direct effect on the model's accuracy and the validity of the analysis. Widarjono and Rudatin (2021) emphasized the importance of selecting an optimal lag due to the inclusion of past values in the ARDL model. The Akaike Information Criteria (AIC) approach was employed to determine the suitable lag length. The results of the lag determination, presented in Figure 2, indicate that the selected maximum lag structure is ARDL (4, 0, 1, 0, 0, 0, 4). The AIC value suggests that the PLS variable has four lags, NPF has zero lags, CAR has one lag, DPK has zero lags, WUI has zero lags, IPI has zero lags, and RATE has four lags.

Table 5 *Autocorrelation Test*

Breusch-Godfrey Serial Correlation LM Test			
F-statistic	0.044459	Prob. F(2,90)	0.9565
Obs*R-squared	0.106597	Prob. Chi-Square(2)	0.9481

Source: Processed data by the authors (2024)

Time series research is often susceptible to autocorrelation issues. To address this concern, autocorrelation testing was performed to determine whether the samples are correlated (Winarsih & Asokawati, 2019). The Lagrange Multiplier Breusch-Godfrey test was used to check for autocorrelation. The results, shown in Table 5, indicate that the prob. The chi-Square value exceeds the 5% significance threshold, suggesting no autocorrelation problems.

Table 6 *Heteroskedasticity Test*

Heteroskedasticity Test: Breusch-Pagan-Godfrey			
F-statistic	0.937236	Prob. F(15,92)	0.5268
Obs*R-squared	14.31589	Prob. Chi-Square(15)	0.5017
Scaled explained ss	41.05187	Prob. Chi-Square(15)	0.0003

Source: Processed data by the authors (2024)

In addition to the autocorrelation test, a heteroscedasticity test was conducted to assess the consistency of data variance and to check for disparities in residuals (Winarsih & Asokawati, 2019). Inconsistent variance could lead to biased estimation results. The heteroscedasticity test, utilizing the Breusch-Pagan-Godfrey approach, compares the Prob. Chi-Square value with the 5% significance value. In Table 6, the Prob. The chi-Square value of 0.5017 exceeds the significance threshold (0.5017 > 0.05), indicating no heteroscedasticity issues were detected.

Table 7 *Estimation Results*

Short-Term Estimation Results					
Variables	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**	**Desc.**
D(CAR,2)	-0.000641	0.004241	-0.151095	0.8802	Insignificant
D(RATE,2)	-0.067613	0.006587	-10.265080	0.0000	Significant

D(RATE(-1),2)	-0.031958	0.007925	-4.032545	0.0001	Significant
D(RATE(-2),2)	-0.025093	0.007508	-3.342200	0.0012	Significant
D(RATE(-3),2)	0.012975	0.006385	2.031951	0.0450	Significant
CointEq(-1)*	-1.839301	0.155270	-11.845800	0.0000	Significant
R-Squared			0.808378		

Long-Term Estimation Results

Variables	Coefficient	Std. Error	t-Statistic	Prob.	Desc.
NPF	-0.033803	0.011577	-2.919819	0.0044	Significant
CAR	0.004834	0.005029	0.961189	0.3390	Insignificant
DPK	-0.078238	0.122419	-0.639098	0.5243	Insignificant
WUI	-0.011004	0.015973	-0.688923	0.4926	Insignificant
IPI	0.000170	0.000212	0.805619	0.4225	Insignificant
RATE	-0.019440	0.007574	-2.566479	0.0119	Significant
C	0.010444	0.002502	4.174054	0.0001	Significant

Source: Processed data by the authors (2024)

Table 7 presents the results of the short-term and long-term estimation using the Error Correction Model (ECM) regression. The ECM estimation provides insights into the changes in variables both in the short-term and long-term, along with an Error Correction Term (ECT) that corrects any deviations. The value of the ECT is derived from the CointEq(-1) coefficient in the estimation results. In the short-term estimation results shown in Table 7, the ECT condition is satisfied, with the CointEq(-1) coefficient value of -1.839301 and the probability value of 0.0000, which is below the 5% significance level. This implies that any error or deviation of 1.839% will be corrected monthly. The coefficient of determination (R-squared) is also presented, indicating the proportion of variance in the dependent variable accounted for by the independent variables within the model. The R-squared value in this study suggests that the capacity of independent variables to account for the model is 80.83%. In contrast, the remaining 19.17% is ascribed to external factors outside the model.

DISCUSSION

The Effect of Non-Performing Financing (NPF) on Profit-Loss Sharing Financing

This study found a significant negative long-term relationship between NPF and PLS financing, supporting the hypothesis. However, in the short term, the hypothesis was rejected, indicating no significant impact of NPF on PLS financing. This short-term finding contradicts the notion that higher NPF levels directly reduce PLS financing. Sudarsono (2017) attributed the lack of short-term impacts to banks' effective NPF management strategies and the adjustment of financing policies based on past performance. Furthermore, Islamic banks possess greater flexibility in handling NPF through the restructuring mechanism outlined in Bank Indonesia Regulation No. 13/9/PBI/2011, which encompasses rescheduling, reconditioning, and restructuring options for customers facing financial difficulties.

In the long term, increasing NPF levels negatively impact PLS financing. Adzimatinur et al. (2015) argued that NPF necessitates increased provisions for loan losses, thereby reducing banks' capacity for new financing. Primadhita et al. (2021) further emphasized that rising NPF ratios increase bad debt provisions, playing a significant financial burden on banks and hindering the sustainability of PLS financing. High NPF ratios can also negatively impact bank profitability (Widarjono, Mifrahi, et al., 2020). To mitigate NPF risks, Hidayah and Karimah (2023) recommended that banks strengthen prudential financing principles and potentially reduce high-risk PLS contracts. Riyadi et al. (2021) suggested that prioritizing financial health recovery may lead to a temporary decline in PLS financing activities.

The Effect of Capital Adequacy Ratio (CAR) on Profit-Loss Sharing Financing

Empirical findings from both short-term and long-term estimations revealed no significant relationship between CAR and PLS financing, leading to the rejection of the hypothesis. This finding aligns with Salman (2023b), who also observed no such relationship. Theoretically, a higher CAR should enhance a bank's risk mitigation capabilities. As a crucial indicator of bank health and stability, CAR reflects a bank's resilience. However, the inherent risks associated with PLS financing, such as uncertain profit sharing based on customer performance and the potential for customer default, may diminish

the direct influence of CAR on PLS financing decisions (Sutrisno, 2023; Widarjono et al., 2020). The lack of regulatory support and incentives has led banks to adopt a more cautious approach in allocating capital for PLS financing (Sabrina & Majid, 2020). Consequently, banks have not pursued PLS financing aggressively, despite its significant potential.

Information asymmetry, a primary driver of moral hazard and adverse selection, poses significant risks to Islamic banks. Weak management of PLS financing, often reliant solely on customer-provided information, exacerbates these risks (Nugraheni & Alimin, 2022). To mitigate these risks, Salman (2023a) emphasized the importance of strict screening, marking, and monitoring practices, aligning with the 5C lending principles. Furthermore, enhancing the robustness of the financing process and increasing the transparency of customer financial statements can significantly reduce PLS financing risks (Nugraheni & Alimin, 2022). Widarjono and Mardhiyah (2022) emphasized the crucial role of the CAR in safeguarding bank stability and protecting third-party funds. However, this does not imply that CAR is the sole determinant of PLS financing decisions.

The Effect of Third-Party Funds (DPK) on Profit-Loss Sharing Financing

Empirical analysis revealed no significant relationship between DPK and PLS financing in both short-term and long-term periods, leading to the rejection of the research hypothesis. These findings of Primadhita et al. (2021) and Salman (2023b), who observed a positive relationship between DPK and PLS financing, suggest that increased DPK would facilitate greater allocation towards PLS financing. While TPF constitutes a primary funding source for Islamic banks, the observed lack of significant impact can be attributed to several factors. Firstly, a significant portion of DPKF is typically allocated towards deposits (Primadhita et al., 2021). Secondly, Islamic banks may prioritize risk mitigation by not fully allocating DPK to PLS financing, given the inherent risks associated with PLS contracts (Priyanto et al., 2016). Moreover, managing larger volumes of deposits increases overall bank risk (Mairani & Patrisia, 2021).

The risk-averse behavior exhibited by banks also leads to a reduction in the volume of high-risk financing (Misanam & Widarjono, 2024). The operational framework of Islamic banks is characterized by a conservative risk management posture, a direct consequence of their inherent moral

responsibility (Purnamasari et al., 2018). This ethical obligation compels Islamic banks to manage risks prudently, safeguard depositor funds, and ensure the sustainability of their operations in accordance with sharia principles. PLS financing is characterized by inherent risks, primarily stemming from the uncertainty of returns. The potential for profit and loss depends on the customer's business performance (Puspita et al., 2022).

Consequently, DPK may preferentially allocate towards lower-risk financing options such as Murabaha. This observation is supported by Belkhaoui et al. (2020), who found that Islamic bank financing in Gulf Cooperation Council (GCC) countries predominantly comprises Murabaha contracts due to their higher profitability and lower risk profiles.

The Effect of World Uncertainty Index (WUI) on Profit-Loss Sharing Financing

This study rejects the hypothesis, as the WUI variable exhibited no significant impact on PLS financing in both short-term and long-term analyses. The WUI measures the influence of global economic uncertainty on economic policies, market conditions, and decision-making. This finding contradicts the research of Santosa et al. (2020) and Fatoni (2022), who suggested that macroeconomic factors, including the WUI, significantly impact both the financial and real sectors. However, it aligns with the findings of Bilgin et al. (2021) and Mubarok (2021), who demonstrated that the PLS scheme can effectively mitigate the default risk during periods of economic shocks and global uncertainty, enabling Islamic banks to maintain stability. This resilience was further evidenced by Ajizah and Widarjono (2023), who observed sustained performance and stability among Islamic banks during the COVID-19 pandemic.

These findings suggest that WUI, as a measure of global economic conditions, does not directly influence PLS financing decisions within Islamic banks. Instead, PLS financing is susceptible to factors that directly impact customer decisions. Fluctuations in the WUI may indirectly affect Islamic banks by influencing consumer and investment decisions (Rodrigues, 2023). Moreover, monetary policy variables, such as inflation and exchange rate depreciation, can significantly destabilize Islamic banks (Widarjono, 2020b). Fahamsyah et al. (2023) further emphasized that the factors influencing PLS financing are predominantly associated with policy and regulatory

frameworks, risk management, and governance structures. Therefore, the WUI does not represent the sole macroeconomic variable with a direct influence on PLS financing.

The Effect of Industrial Production Index (IPI) on Profit-Loss Sharing Financing

Analysis of both short-term and long-term data revealed no significant relationship between IPI and PLS financing, leading to the rejection of the hypothesis. The IPI serves as an indicator of economic growth, particularly within the industrial sector. The observed lack of relationship can be attributed to several factors. Firstly, PLS financing is inherently characterized by high risks and information asymmetry. These inherent challenges have contributed to a greater utilization of non-PLS options, hindering the broader role of PLS financing in fostering economic development. (Chowdhury et al., 2018; Saleem et al., 2024). Bougatef et al. (2020) found a positive correlation between IPI and non-PLS financing, further emphasizing the limited impact of IPI on PLS financing. Secondly, the customer base for PLS financing primarily comprises Micro, Small, and Medium Enterprises (MSMEs), while IPI primarily reflects the performance of larger industries. This disparity in target sectors diminishes the direct impact of IPI fluctuations on PLS financing activities. This observation is supported by Saleem et al. (2024), who attributed the dominance of non-PLS financing to corporate efforts to mitigate agency problems. Additionally, the guaranteed profit margins offered by non-PLS schemes make them more attractive to businesses (Hidayah & Karimah, 2023). Masrizal and Trianto (2022) found that PLS financing holds significant potential in contributing to economic development, particularly in countries like Indonesia. However, the expansion of PLS financing on a broader scale requires the implementation of concrete and targeted policy measures to effectively support its growth.

The Effect of BI-Rate on Profit-Loss Sharing Financing

Despite the fundamental principle of Islamic banking prohibiting the use of interest, this study found a significant relationship between interest rates and PLS financing in both short-term and long-term horizons, supporting the hypothesis. A significant negative correlation was observed in the long term. In the short term, a significant negative impact was observed

in the first two months, while a significant positive impact emerged in the subsequent month. These findings align with Akhatova et al. (2016), who demonstrated that Islamic banks are still influenced by monetary policy while not directly involved in interest-based transactions. Specifically, the study highlighted that economic shocks and tightening monetary policy through interest rate hikes can negatively impact PLS financing. Nugroho et al. (2020) further emphasized that rising interest rates can disrupt bank operations. Additionally, tightening monetary policy can diminish purchasing power and hinder businesses' ability to observe the negative impact of interest rates on PLS financing.

Several factors may have contributed to the observer's positive impact of interest rates on Islamic banks. Rising interest rates may incentivize individuals to deposit their funds in safer banks, such as Islamic banks, to mitigate potential losses in conventional banking. Fluctuations in interest rates significantly influence individual financial decision-making (Kismawadi et al., 2023; Caporale et al., 2020). Furthermore, when interest rates rise, customers of conventional banks may shift their funds to Islamic banks, as the latter may offer more attractive investment opportunities than fulfilling credit obligations in a high-interest-rate environment (Supriani & Sudarsono, 2018). These findings contradict the findings of Zulkhibri and Sukmana (2017), Ibrahim et al. (2022), and Wirman (2017), who concluded that interest rates have no significant impact on PLS financing, suggesting greater stability within the Islamic banking sector.

CONCLUSION

This study utilizes the Auto-Regressive Distributed Lag (ARDL) approach as the methodological framework to identify the determinants of PLS financing within the Indonesian Islamic banking sector from January 2015 to May 2024. The findings indicate that the impact of these determinants on PLS financing exhibits a medium- to long-term horizon, suggesting that assessing the success of financing requires a considerable time frame. While the NPF ratio did not significantly impact PLS financing in the short term, reflecting banks' ability to manage NPF through restructuring policies for distressed customers, its long-term impact proved significant. A persistently high NPF ratio imposes a substantial burden on banks, as increased provisions for loan losses inevitably reduce the allocation of funds towards PLS financing.

Information asymmetry, moral hazard, and adverse selection pose

significant risks to PLS financing. The dependence of PLS financing returns on the customer's business performance exposes banks to heightened uncertainty. To mitigate these risks, banks tend to prioritize lower-risk financing options. This observation aligns with the insignificant impact of CAR and DPK on PLS financing, both in the short and long term. Furthermore, the study found no significant relationship between the WUI and PLS financing, suggesting that global economic uncertainty and shocks do not directly influence PLS financing decisions. However, these factors indirectly impact Islamic banks by influencing customer behavior. The IPI also exhibited no significant impact on PLS financing, attributable to the fact that PLS financing primarily targets MSMEs, while IPI primarily reflects the performance of larger industries.

The BI-Rate demonstrated a significant negative impact on PLS financing in both the short and long-term. In the short term, a significant negative impact was observed in the first two months, followed by a significant positive impact in the third month. This pattern can be attributed to the tightening of monetary policy through interest rate hikes, which negatively impacts consumer behavior and, consequently, PLS financing. Conversely, the short-term positive impact may be attributed to a shift of funds from conventional banks to Islamic banks as investors seek safer banks during periods of rising interest rates.

The Indonesian Islamic banking sector holds significant potential for economic growth. Islamic banks must prioritize quality and implement robust risk management frameworks to enhance their performance and public trust. Stringent financing screening procedures are crucial, given the significant influence of NPF on PLS financing. Diversifying financing portfolios towards more stable and promising sectors can effectively mitigate NPF risks. Recognizing the close link between PLS financing and the real industry, banks should strive to lower NPF ratios to facilitate increased allocation of funds towards PLS financing.

Indonesia's financial system operates as a dual-banking system, with conventional and Islamic banks competing. While Islamic banks do not directly engage in interest-based transactions, they are nonetheless influenced by changes in the BI-Rate. This is because conventional banks adjust their interest rates according to BI-Rate fluctuations, indirectly impacting Islamic banks' competitive landscape. Islamic banks often benchmark their profit-sharing ratios against prevailing market conditions, including interest rate movements. Consequently, customers actively compare the returns offered by both conventional and Islamic banks, particularly during periods of

interest rate volatility. In an inflationary environment with rising interest rates, investment activities tend to decline, and consumer purchasing power diminishes. Therefore, Islamic banks must prioritize efficiency, risk mitigation, and long-term financing strategies, recognizing that short-term interest rate fluctuations have a limited impact on long-term financing products, as these instruments directly contribute to economic growth and real-sector investment. However, Islamic banks must implement comprehensive security measures to effectively mitigate the inherent risks associated with these financing products.

LIMITATION

This study is subject to certain limitations. The analysis was primarily based on a limited set of variables, including financial ratios of Islamic banks, macroeconomic variables, and monetary factors. A more comprehensive understanding could be achieved by incorporating additional variables into the analysis. This research advances the existing body of literature by providing valuable insights into the determinants of PLS financing in the Indonesian Islamic banking sector. The findings serve as a valuable reference for policymakers, regulators, and practitioners in formulating effective policies and strategies for the sustainable growth of the Islamic banking industry.

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