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The Influence of Financing Contract Types on Credit Risk, Financing Return Levels, Efficiency, and Profitability of Islamic Banks in Indonesia

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Abstract

This study aims to examine the impact of different types of financing contracts on the credit risk, financing return rates, financing cost efficiency, and profitability of Islamic banks in Indonesia. Additionally, it investigates the effects of credit risk, financing return rates, and financing cost efficiency on the profitability of Islamic banks. This research employs a quantitative approach using statistical analysis to explore both direct and indirect relationships among the variables. The results indicate no strong evidence that the type of financing contract directly affects credit risk, financing return rates, financing cost efficiency, or profitability. Furthermore, the type of contract does not significantly influence profitability through the mediating effects of credit risk, financing return rates, or cost efficiency. The only significant finding is a negative relationship between financing return rates and profitability, suggesting that the level of financing return plays a more critical role in determining the profitability of Islamic banks than the type of financing contract used. Although certain pathways, such as the indirect effect of credit risk on profitability, show potential influence with large coefficients, they are not statistically significant and therefore lack robust causal support.

1. Introduction

Islamic banks as a company certainly want to maximize the value of the company. The maximum company value can be seen from several perspectives, including the company's perspective, the shareholder's perspective, the customer's perspective, the employee's perspective, and the community's perspective. From the company's perspective, the company wants to get maximum profit. Shareholders want to get an increase in the value of their shares and dividends from the shares they own. Fund customers want to get high profit sharing/bonuses. Financing customers want to get competitive ratios/margins. Employees want to get good welfare. The community wants to get benefits from the presence of Islamic banks.

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One way to optimize the company's value is to generate optimal income with efficient costs. Islamic banks as financial intermediary institutions generate income by managing financial assets in the form of distributing funds received. Islamic banks can distribute funds in the form of placements in Bank Indonesia, placements in other banks, securities owned, and financing. Management of financial assets to obtain optimal income with efficient costs cannot be separated from the management of risks inherent in these financial assets. Risk is defined as "the potential for loss due to the occurrence of a certain event"(Financial Services Authority, 2016). Management of these risks will affect the amount of income earned and the costs that must be charged by Islamic banks.

One of the risks inherent in the financial assets of a sharia bank is credit risk.Financial Services Authority (2016)defines credit risk as “the risk that occurs due to the failure of customers or other parties to fulfill their obligations to the bank in accordance with the agreed agreement”. Credit risk is one of the main risks of banking in Indonesia. The largest source of credit risk for Islamic banks is the activity of distributing funds in the form of financing.

In formulating a fund distribution strategy, Islamic bank management, among other things, needs to understand the risks of the financing to be distributed, both risks from the targeted market segment, the customers financed, the type of financing, the financing structure and the agreement to be used, adjusted to the infrastructure owned, both human resources and technology owned. The fund distribution strategy also needs to pay attention to the concentration of fund distribution on customers, geographic areas, products, types of financing, and the agreements used.

Islamic banks have various financing contracts that conventional banks do not have. Broadly speaking, these financing contracts can be grouped into 3 (three) based on the nature of the underlying contract, namely financing contracts based on receivable transactions consisting of buying and selling transactions and lending transactions, financing contracts based on lease transactions, and financing contracts based on profit sharing transactions. Financing with receivable transaction-based contracts includes murabahah, istishna', and qardh financing. Financing with lease transaction-based contracts includes ijarah financing. Financing that uses profit sharing transaction-based contracts includes mudarabah and musyarakah financing. Calculation of profit sharing for mudarabah and musyarakah financing can be done using two methods, namely profit sharing or net revenue sharing or gross profit sharing. Currently, the profit sharing calculation method used by Islamic banks in Indonesia is net revenue sharing (gross profit sharing).

Each type of financing agreement has different characteristics that affect the dominant risk contained in each agreement. Financing with an agreement based on receivables transactions and lease transactions requires the customer to fulfill their obligations to the bank in the form of installment payments and/or settlement of the purchase price (murabahah and istishna financing), loan repayment (qardh), and rent (ijarah). By considering the definition of credit risk, credit risk basically arises from agreements based on receivables transactions such as buying and selling transactions and lending, as well as lease transactions.

Financing with a profit-sharing transaction-based contract has characteristics that are quite different from contracts based on receivables and lease transactions. Financing with a profit-sharing transaction-based contract emphasizes more on cooperation and sharing of income or profits based on the agreed ratio and/or sharing of losses based on the portion of funds of each party. In the concept of a profit-sharing contract, there is risk sharing between the customer and the bank for the success of the financed business. The bank shares the risk of losses faced by the customer when experiencing business difficulties or going bankrupt due to business losses and

not due to any element of intent or negligence of the customer. When such losses occur, the bank has the potential to not be able to recover the funds that have been distributed to the customer.

This potential is a form of investment risk faced by the bank. Credit risk can arise in financing with a profit-sharing transaction-based contract if the financed customer fails to pay the income or profit that is the bank's right and/or the principal of the financing to the bank because the customer breaks his promise/defaults. Thus, the dominant risk in financing with a profit-sharing transaction-based contract is investment risk. With the profit sharing method generally applied by Islamic banks in Indonesia currently in the form of the net revenue sharing method (gross profit sharing), the credit risk in financing with profit sharing transaction-based contracts should be smaller compared to financing with receivables and lease transaction-based contracts.

The type of financing agreement will also have an impact on the overall profitability of the bank. The influence of the type of financing agreement can occur directly or indirectly through 3 transmission channels, namely through its influence on credit risk, through the level of financing income (reward), and through the loss reserve costs that must be formed. Research on the relationship between the type of financing agreement with credit risk and profitability has been conducted by previous researchers, such as "the influence of the type of financing and credit risk on the profitability of Islamic banks in Indonesia"(Abusharbeh, 2014)and “the effect of financing schemes on credit risk and financing performance of Islamic banks in Indonesia”(Roziq & Sukarno, 2021).Abusharbeh (2014)AndRoziq & Sukarno (2021)both use the ratio of non-performing financing (NPF) as a risk variable and ROA as a profitability variable. In addition to the time period of the data used in the study, the difference between the two studies lies in the grouping of the types of financing studied.

Abusharbeh (2014)grouping the types of financing into 2, namely profit and loss sharing financing (mudarabah and musyarakah) and non-profit and loss sharing financing (murabahah), whileRoziq & Sukarno (2021)grouping the types/financing schemes into 3, namely buying and selling-based financing, profit and loss sharing-based financing, and lease-based financing. Other more specific research was conducted byWarninda et al. (2019)AndFarihana & Rahman (2021).Warninda et al., (2019)conducted a special study to see the impact of mudarabah and musyarakah contracts on the credit risk of Islamic banks, using Islamic bank data in 3 regions, namely the Middle East, South East, and Southeast Asia.

WhileFarihana & Rahman (2021)conducted a study of 40 banks in 12 countries to see the implications of the profit and loss sharing theory and to test whether profit and loss sharing financing will empirically reduce the credit risk of Islamic banks. This study is based on the profit and loss sharing theory which states that profit and loss sharing-based financing will reduce credit risk because this financing requires banks to be involved in projects that are financed directly and to be more selective in choosing projects to be financed because of the uncertainty in the results to be obtained and the prohibition of collateral. In addition, in profit and loss sharing financing, banks have a position as partners who can monitor and supervise projects so that they run transparently. Banks also have the right to participate in the operation and management of projects so that they can eliminate the issue of moral hazard and asymmetric information.Warninda et al. (2019)AndFarihana & Rahman (2021)both use the NPF ratio as a credit risk parameter. Other research conducted byBelkhaoui et al. (2020)trying to see more broadly about the impact of financing types on risk, capitalization, efficiency and profitability of Islamic banks, using data from 30 Islamic banks in the Gulf Cooperation Council (GCC) countries. The parameters of risk, capitalization, efficiency and profitability are each indicated by the NPF ratio, equity to assets, cost to net income, and ROA. Furthermore, the researcher gave the title of this study "The Effect of Financing Contract Types on Credit Risk, Financing Return Levels, Efficiency and Profitability of Islamic Banks in Indonesia".

2. Research Methods

This research is a quantitative research using secondary data in the form of monthly time series data from January 2015 to December 2022. The data source comes from the Financial Services Authority. This study uses the population of Islamic banking in Indonesia with data sampling of the Islamic general banking industry.

3. Research Results and Discussion

Hypothesis Testing

Hypothesis testing is conducted to test the causal relationship between latent variables (theoretical constructs) and observed variables (indicators). Hypothesis testing aims to determine whether the relationship path between variables in the model is significant or not and whether the relationship proposed in the research hypothesis is supported by the data. This hypothesis test is also conducted to determine the direct or indirect influence between variables.

Hypothesis testing uses three parameters, namely the path coefficient value, t-statistics, and p-value. The path coefficient shows the causal relationship between two variables, namely how much change in the dependent variable occurs due to changes in the independent variable. T-statistics are used to test whether the path coefficient is significant or not. A t-statistic value greater than 1.96 indicates that a variable is stated to have a significant effect on another variable. The greater the t-statistic, the stronger the causal relationship between variables. The p-value indicates the statistical significance of the relationship between two variables. A p-value less than 0.05 usually indicates that the relationship is significant at the 95% confidence level. The following are the results of data processing based on these three parameters:

Table 1.
Results of Hypothesis Testing – Direct Effect

Direct Effect	Original Sample (O)	t stat	P values
X1 -> Y1	32,731	1,853	0.064
X1 -> Y2	12,151	0.720	0.472
X1 -> Y3	5,758	0.186	0.853
X1 -> Z1	1,410	0.082	0.934
X2 -> Y1	32,577	1,896	0.059
X2 -> Y2	12,656	0.772	0.440
X2 -> Y3	5,497	0.182	0.856
X2 -> Z1	1,431	0.086	0.932
X3 -> Y1	4,644	1,875	0.061
X3 -> Y2	1,839	0.790	0.430
X3 -> Y3	0.244	0.058	0.954
X3 -> Z1	0.295	0.126	0.900
Y1 -> Z1	0.074	0.629	0.530

Y2 -> Z1	-1,075	6,194	0,000
Y3 -> Z1	-0.044	0.501	0.617

Source: Smart PLS 3.2.8 Output Results (2025)

The Influence of Financing Contract Types on Credit Risk in Islamic Banks in Indonesia

The study reveals that there is no statistically significant relationship between the type of financing contract used by Islamic banks and the level of credit risk they experience. This suggests that whether Islamic banks employ *murabahah*, *mudharabah*, *musharakah*, or *ijarah* contracts, the choice of contract itself does not substantially influence the probability of borrower default or non-performing financing. These findings contradict Antonio's (2001) assertion that the choice of financing agreement directly affects financing risk. Antonio emphasized that appropriate contract selection based on risk-sharing and business characteristics could help Islamic banks minimize potential losses. However, the present findings imply that the practical implementation of these contracts may be more standardized and regulated than theoretically presumed, which could dilute their differential impact on risk.

Furthermore, the results diverge from empirical studies such as Farihana and Rahman (2021), which found that profit-sharing-based contracts generally reduce credit risk due to better alignment of bank and customer interests. Similarly, Khan and Ahmad (2001), as cited in Abusharbeh (2014), concluded that a higher proportion of *murabahah* contracts leads to greater exposure to credit risk due to fixed payments and lesser risk-sharing. The contrasting findings in this study may stem from the unique context of the Indonesian banking environment, where institutional risk management practices, regulatory oversight, and borrower behavior may play a more decisive role in shaping credit outcomes than the financing contract structure itself. These findings encourage a re-examination of risk determinants in Islamic banking and suggest that broader operational and macroeconomic variables may outweigh the effects of contract typology.

The Influence of Financing Contract Types on Financing Return Levels in Islamic Banks

This study finds no significant evidence to suggest that the type of financing contract influences the financing return levels of Islamic banks. Despite the conceptual distinctions between profit-sharing and fixed-return contracts, the empirical data indicates that the return levels are relatively uniform across contract types. This finding challenges the notion advocated by Antonio (2001), who argued that selecting an appropriate financing contract could strategically optimize both risk and return. It appears that, in practice, financing returns may be determined more by market forces, benchmark rates (such as the Bank Indonesia Sharia Rate), and internal pricing policies rather than the intrinsic features of the contract itself.

Additionally, the lack of a significant relationship may also be due to the homogenization of pricing strategies in Indonesia's Islamic banking sector. In competitive markets, banks may align their pricing to remain attractive to customers, irrespective of contract type. Consequently, *although* profit-sharing contracts theoretically allow for variable returns based on project success, in practice, Islamic banks may set indicative return rates that mimic conventional fixed-return models, thus limiting variance. Therefore, while the contract type may hold legal and ethical distinctions, its influence on actual return rates appears limited in the Indonesian context.

The Influence of Credit Risk on the Profitability of Islamic Banks in Indonesia

The analysis demonstrates that credit risk does not have a statistically significant effect on the profitability of Islamic banks in Indonesia. This finding contradicts numerous previous studies, including Belkhaoui et al. (2020), which found a direct negative relationship between increasing credit risk and decreasing profitability. In theory, higher credit risk should result in

greater provisioning for loan losses and write-offs, which in turn reduce net income and return on assets. However, this study's results suggest that Islamic banks may have developed sufficient risk mitigation strategies—such as requiring collateral, pre-screening borrowers, and diversifying financing portfolios—to shield profitability from the adverse effects of credit risk.

Another possible explanation for this result lies in the nature of the data and time period studied. Between 2015 and 2022, regulatory frameworks and risk governance structures in Indonesia's Islamic banking sector may have improved significantly, reducing the sensitivity of profits to fluctuations in credit risk. Moreover, the presence of profit-and-loss sharing mechanisms may distribute risk more equitably, allowing banks to absorb shocks without significant damage to their bottom line. The study also confirms that credit risk does not serve as a mediating variable in the relationship between financing contract type and profitability. This further underscores the limited role of credit risk in explaining profitability dynamics within the observed timeframe.

The Influence of Financing Return Rate on the Profitability of Islamic Banks in Indonesia

A key and statistically significant finding of this research is the negative impact of financing return rates on the profitability of Islamic banks. Contrary to the common assumption that higher returns on financing lead to greater profitability, the results show that increasing the margin or profit rate may have adverse effects. One explanation is that excessively high return rates may reduce customer demand, as clients may perceive the financing terms to be too expensive or exploitative. In turn, this leads to lower financing volumes and revenue generation, which ultimately suppresses profitability. Additionally, high return rates may increase customer delinquency or default rates, particularly among price-sensitive segments.

Furthermore, elevated return rates might signal aggressive risk-pricing strategies, potentially indicating that the bank is dealing with high-risk borrowers. If these borrowers fail to meet their obligations, the bank may incur higher non-performing financing levels, provisioning costs, and operational inefficiencies. Another possibility is reputational damage; customers may view high return rates as inconsistent with the ethical and equitable principles of Islamic finance, which could erode trust and long-term customer loyalty. Therefore, Islamic banks need to find a balance between achieving sustainable returns and maintaining market competitiveness, affordability, and Sharia compliance. This finding emphasizes that pricing strategy is a critical determinant of profitability, more so than contract selection alone.

The Impact of Cost Efficiency on the Profitability of Islamic Banks in Indonesia

The study indicates that cost efficiency does not have a statistically significant impact on the profitability of Islamic banks in Indonesia. While it is widely accepted in banking literature that cost control enhances margins and boosts profits, this finding suggests that improvements in operational efficiency may not be sufficient to affect profitability outcomes in a meaningful way. This may be attributed to the relatively uniform cost structures across banks due to regulatory standardization, fixed labor costs, and technology expenditures that do not vary significantly by contract type or institution. Additionally, the limited scale and asset base of some Islamic banks may hinder the realization of economies of scale, thereby constraining the potential benefits of cost efficiency.

Moreover, the study finds that cost efficiency does not mediate the relationship between financing contract types and profitability. This suggests that variations in contract usage do not lead to significant differences in cost savings or operational leverage. Islamic banks, regardless of

the contracts they employ, may be subject to similar administrative, legal, and compliance procedures that neutralize any potential cost advantages. As a result, improving profitability may require more than simply reducing operating expenses—it may demand innovation in product development, strategic investment in digital infrastructure, and enhanced service delivery to create value beyond cost considerations.

The Influence of Financing Contract Types on the Profitability of Islamic Banks in Indonesia

Finally, the study concludes that the type of financing contract has no significant direct effect on the profitability of Islamic banks. This finding suggests that whether a bank predominantly uses *murabahah*, *ijarah*, *mudharabah*, or *musharakah* contracts, the impact on its overall profitability is minimal. While previous literature often highlights the strategic importance of selecting appropriate financing contracts to enhance performance, the results of this study point to the diminishing relevance of contract type in determining financial outcomes. One possible reason is that Islamic banks tend to standardize contract implementation and pricing mechanisms, resulting in similar revenue patterns regardless of contract variation.

Additionally, profitability appears to be shaped more by external market factors and internal risk management capabilities than by contract design. Customer preferences, regulatory influences, macroeconomic conditions, and institutional efficiency may all play a more central role in influencing bank profitability. Moreover, as Islamic banking continues to evolve in Indonesia, banks may need to look beyond legal-contractual structures and focus instead on holistic performance strategies. These may include customer relationship management, technological adoption, and product diversification. The findings underscore the importance of a multidimensional approach to profitability that incorporates operational, strategic, and market-driven factors rather than relying solely on contract typology

4. Conclusion

This study analyzed the influence of different types of financing contracts on credit risk, financing return rates, financing cost efficiency, and profitability of Islamic banks in Indonesia, using data from Islamic commercial banks covering the period from January 2015 to December 2022. The findings reveal that there is no strong statistical evidence to suggest that the type of financing contract directly affects key performance indicators such as credit risk, return rates, cost efficiency, or overall profitability. Whether a bank employs profit-sharing contracts like *mudharabah* and *musharakah*, or markup-based contracts like *murabahah* and *ijarah*, the choice of contract alone does not appear to have a decisive impact on financial outcomes.

In addition to the absence of direct effects, the study also found no significant indirect relationship between financing contract type and profitability when mediated by variables such as credit risk, financing return rates, or cost efficiency. This suggests that the structure of financing contracts, although important in defining the principles of Islamic finance, does not significantly contribute to enhancing bank profitability, either directly or through intermediary financial indicators.

The only statistically significant finding from the analysis is the negative relationship between financing return rates and profitability. This counterintuitive result implies that higher expected returns from financing activities do not necessarily lead to increased profitability. On the contrary, higher return rates may reflect elevated credit risk or inefficiencies in credit allocation, which can ultimately reduce the financial performance of Islamic banks. This highlights the critical role of prudent pricing strategies and risk management practices in determining profitability, rather than relying on the type of contract being used.

Although some paths showed the potential for a substantial effect—such as the indirect influence of credit risk on profitability—these relationships were not statistically significant. The relatively high coefficient values in these paths suggest a possible underlying influence; however,

due to the weak statistical support, no definitive conclusions can be drawn. This opens the door for future research to explore these potential connections further, perhaps using more detailed data, alternative models, or a broader institutional context.

In summary, this research underscores the limited role of financing contract types in determining the financial success of Islamic banks. Instead, it points to the importance of focusing on operational factors such as effective risk management, efficient cost control, and rational pricing of financing products. For policymakers, regulators, and bank management, the findings imply that strategies aimed at improving profitability should prioritize these internal and market-driven factors rather than assuming that the contractual form of financing alone can drive financial performance.

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