

## Effects of Diversification, Bank Size and Bank Competition on Profitability of Islamic Banks

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### Abstract

*Purpose:* This study aims to analyse the effects of diversification, bank size and bank competition on the profitability of Islamic banks for the period 2019-2023.

*Methodology:* The data was taken from the financial statements published on each bank's website, the Financial Services Authority (OJK), the Central Bureau of Statistics (BPS), and Bank Indonesia. This study uses quantitative research methods with a panel data regression approach. This study covers 10 Islamic banks with the largest assets from 2019-2023. Based on the criteria obtained through purposive sampling method, six samples or 30 data were obtained and data analysis was carried out using eviews 10.

*Results:* Diversification increases the profitability of Islamic banks, with proper diversification banks will minimise the risk of dependence on one product. Bank Size and Bank Competition are negative indicating that in terms of assets and competition these six banks have not controlled the banking market share so that it does not affect the profitability of Islamic banks.

*Applications/Originality/Value:* This study contributes not only to the existing literature, but also paves the way for further research exploring the interplay between diversification, bank size and bank competition in the Islamic banking sector.

### Introduction

In recent years, Islamic banking has grown significantly and emerged as an important part of the financial system. The success of the global economy is thus demonstrated by the provision of sharia compliant financial services and by the provision of alternatives for those who desire sharia based services (Nada & Mugiyanti, 2024). This can be seen from the growth of the Islamic banking sector in Indonesia, which continues to progress rapidly in terms of institutional features and supporting infrastructure, regulatory tools and supervisory framework, as well as public knowledge and literacy about Islamic financial services (Literasi Syariah, 2023). The Financial Services Authority (OJK) notes that there are currently 14 Sharia Commercial Banks (BUS), 18 Sharia Business Units (UUS) and 173 Sharia Rural Banks (BPRS) (Otoritas Jasa Keuangan, 2024).

**Table 1.** Islamic Banking Growth 2019-2023

	Total Aset (Triliun)	ROA (%)	Market Share (%)
2019	538,32	1,83	6,18
2020	608,90	1,54	6,51
2021	693,80	1,72	6,74
2022	802,26	1,90	7,09
2023	892,17	1,86	7,44

Source: Financial Services Authority (data processed, 2024)

The development of Islamic banking shows interesting dynamics in the context of modern banking in Indonesia. Seeing the existence of Islamic banking which is increasingly recognised among the public is accompanied by a variety of goods and services that contribute to its supporting infrastructure. This is apparent from the presence of Islamic banking which is actually valued positively by the community, because it provides a variety of services and products along with various financial schemes, as well as reflecting the transformation of the banking industry which is increasingly adopting digital innovation to meet the demands of an increasingly digital and dynamic market (Rosanti & Hutami, 2024).

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Islamic banking has more options for various product enhancements compared to conventional banking. Islamic banking was initially focussed on limited contractual financial services, including financing and fundraising activities. More recently, Islamic banks have introduced innovative concepts, including the issuance of sukuk and credit cards using hybrid contracts (a mix of qardh, ijarah, and kafalah), as well as additional contracts such as Murabahah, Salam, Istisna, Mudharabah, Musyarakah, and Ijarah. In addition, Islamic banks can now use wakalah contracts to manage foreign trade transactions. The development of these products aims to empower Islamic banks to fulfil all customer transaction needs that are often only achievable at conventional banks (Putra et al., 2022).

**Table 2.** Development of Top 10 Islamic Banks with Largest Assets

Bank Name	Total Aset (triliun)
Bank Syariah Indonesia	353,62
Bank Muamalat Indonesia	66,9
CIMB Niaga Syariah	62,74
BTN Syariah	54,3
Maybank Syariah	41,04
Bank Permata Syariah	38,33
Bank Aceh Syariah	30,47
Bank Riau Kepri Syariah	29,34
BTPN Syariah	21,43
Bank Panin Dubai Syariah	17,34

Source: Financial Services Authority (data processed, 2024)

Of the many Islamic banks present in Indonesia, there are 10 Islamic banks with the largest assets as shown in the table above. In carrying out its activities, the bank is determined by the assets owned or known as bank size, a large bank is more capable of carrying out its activities than a small bank due to the adequacy of its capital and assets. By looking at the total assets of several Islamic banks, the potential for Islamic banks to develop is still very broad because the potential possessed by Islamic banking is still too small to use compared to the potential that might be equal to or rival conventional banking. So it means that various efforts are needed from Islamic banks to be able to further enlarge the bank size in the midst of increasing competition between banks (Paramitha & Prasetyia, 2023).

Over time, the competition in the Islamic banking industry has intensified, despite the relatively small number of institutions, level of competition and total assets compared to conventional banks. As a result, the competitive landscape in Islamic banking is still optimal for future development, as seen from the recent establishment and operation of many Islamic banks. Nonetheless, when indeed many Islamic banks are involved in healthy competition, there will certainly be quite interesting competition from these several Islamic banks, each of which has different characteristics and innovations (Okto Viandrra Arnes, 2022).

Based on the background information provided, the purpose of this research is to ascertain how the profitability of Islamic banks in Indonesia is affected by diversification, bank size and bank competition. In addition, the findings of this study can be considered when choosing an Islamic bank's product diversification plan. It is expected that by considering the potential returns, Islamic banks will be able to improve their performance by weighing the possible risks that will be faced.

## Literatur Review

### Profitability

According to Erry Setiawan (2022) The ability of a company to generate profit over a period of time or the profit a bank makes in the course of its business is known as profitability. The assumption of profitability is that a company that generates a lot of profit is likely to have a stronger chance of competing with similar companies. The higher the profitability of the company, the better the performance of the company. (Sofianingsih & Fitanto, 2022). If a large value is produced on ROA, it indicates that the company can generate optimal profits. Vice versa, if a small ROA is produced, this implies that the firm cannot achieve maximum earnings (Alfiana et al., 2023).

One of the profitability measurement matrices is Return on Assets (ROA). Return on assets gauges how well a business greater can use all of its resources to produce a profit after taxes (Siswanto, 2021). Increased return on assets (ROA) that can be achieved by banks, of course, will further increase the level of profit achievement and the better its position in terms of asset utilisation, making it easier to assess and estimate its profitability (Lestari, Tanuatmodjo, & Cakhyaneu, 2020). ROA can be calculated with the following formula:

$$ROA = \frac{\text{Profit after tax}}{\text{Average total assets}} \times 100\% \quad (1)$$

### *Diversification*

Diversification is one of the ways that the banking industry can do to increase its profitability amid increasingly fierce competition. Efforts that can be made are product diversification, product diversification is one way to improve company performance by involving the search for opportunities to introduce new products that better meet public demand and allow them to compete successfully in the financial sector (Iskandar & Fasihah, 2024). Basically, diversification activities need to be carried out in every business activity this is because to avoid risk, by diversifying banks can reduce the level of risk because the bank's business activities are not only focused on one thing (Sofianingsih & Fitanto, 2022). The diversification approach will not only minimise the risk or loss but also lower the maximum possible profit (Ridho Sahputra et al., 2024). The proxy to measure diversification is the Herfindahl Hirschman Index (HHI), where the HHI is a measuring tool to see the level of market concentration and assess the level of competitiveness with the following calculation.

$$HHI = S_1^2 + S_2^2 + S_3^2 + \dots + S_n^2 \quad (2)$$

HHI : Indeks Herfindahl Hirschman

$S_n$  : Company Market Share

The range of this HHI number is nearly zero to 10,000. The market is less concentrated and more competitive when the HHI value is lower. A market is deemed competitive if its HHI is less than 1,500. The market is deemed to be somewhat concentrated if the HHI falls between 1,500 and 2,000. On the other hand, a significant level of market concentration is indicated by an HHI of 2,500 (Siti Aeni, 2024).

### *Bank Size*

Bank size is the amount of business owned by the bank in terms of total assets owned by the bank. Banks with high assets have the opportunity to earn a large income because the resources owned by the bank are too large while providing a high return (Utomo & Trisnawati, 2021). Large banks have competent human resources, demonstrate strong risk management capabilities, and have easy access to global capital markets. According to this viewpoint, banks with larger total assets enjoy advantages that make them more profitable than smaller banks (Ayusaleha & Laila, 2022). Larger banks also tend to have the capacity to offer a variety of products and services supported by a large number of assets so that they can improve their performance and potentially generate better profits (Darlis & Utary, 2022). Bank size measurement is formulated as follows.

$$\text{Bank Size} = \text{total assets} \quad (3)$$

### *Bank Competition*

Competition is defined as the process of business competition between companies that fight for customers all the time with the aim of increasing market share and obtaining amplified profits (Paramitha & Prasetyia, 2023). In an industry, competition is vying for the same objectives in order to gain a competitive edge. As in other industries, competing in the banking sector requires increasing productivity, promoting creativity, and developing a wide variety of goods (Septiani et al., 2024). Competition in the banking sector encourages banks to implement diversification strategies to improve competitiveness and profitability. In an environment of intense competition banks tend to expand their product and service offerings to attract more customers and reduce the risk of revenue being focused on a single source. Competition in Islamic banking is expected to increase productivity and foster creativity to produce more types of products, cost efficiency, easier access to financing, and better service improvements. Bank competition can be measured using the lerner index with the formula :

$$\text{Index Lerner} = \frac{TR-TC}{TR} \quad (4)$$

Where, TR (Total Revenue) is the total revenue to total bank assets, then TC (Total Cost) is the total operating expenses.

## **Method**

This study is a quantitative analysis covering the 10 publicly listed Islamic banks in the Financial Services Authority (OJK) with the highest assets in Indonesia from 2019 to 2023. The researcher selected six Islamic banks

with the highest assets from this population, which were evaluated based on certain criteria and used them as samples for this study, thus obtaining 30 historical annual time series data for analysis. Courtesy of Fauzy (2019) purposive sampling is a method used to collect data based on certain selection criteria. Thus, the selection of a deliberate sample with regard to certain characteristics, criteria or properties. Therefore, sampling is not done arbitrarily, among them are Islamic banks with the ten largest assets that have published financial statements and complete annual publication reports and are available on the websites of each bank, the Central Statistics Agency (BPS), the Financial Services Authority (OJK), and Bank Indonesia.

**Table 3.** List of Research Samples

No.	Bank Name
1.	Bank Muamalat Indonesia
2.	BTN Syariah
3.	Bank Aceh Syariah
4.	Bank Riau Kepri Syariah
5.	BTPN Syariah
6.	Bank Panin Dubai Syariah

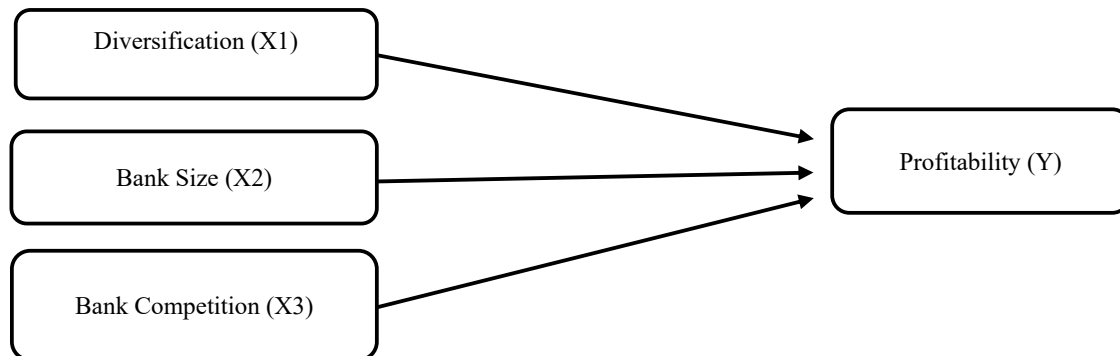
The approach used in this study uses panel data, which integrates cross-sectional and time series information from six Islamic banks over a certain period. The purpose of data analysis in this study is to establish a linear relationship between the dependent and independent variables through the application of multiple linear regression techniques using Eviews 10 software. In this context, profitability serves as the dependent variable, while the independent variables include bank size, competition, and diversification.

### Conceptual Framework

Retrieved from Sugiyono (2020) The conceptual model contains the relationship between theory and several aspects known as the framework. Research is based on theories, premises, and concepts found in the cognition framework. The interactions and mutual relationships between variables are also described by this conceptual framework. Understanding the correlation between factors can help in developing more effective tactics for Islamic banks to deal with obstacles in the banking industry, both domestically and globally. In this case, profitability is one of the key performance metrics in the banking industry.

Diversification refers to banks' efforts to expand their sources of income through various products and services. Furthermore, bank size plays an important role in determining operational capacity and efficiency. Meanwhile, competition in the banking sector can affect business strategy and profitability. In the context of Islamic banking, competition can encourage innovation and service improvement, but it can also suppress profit margins.

The framework can be shown through the following figure:



**Figure 1.** Framework of thinking

## Result and Discussion

### Descriptive Statistics

Descriptive statistics are useful for describe data characteristics, such as mean, median, maximum and minimum values so as to help researchers understand the data.

**Table 4.** Descriptive Statistics Results

	DIV	TA	IL	RROA
Mean	2.875146	77705599	0.536687	2.333000
Median	2.326958	23278215	0.495301	1.675000
Maximum	8.165884	4.39E+08	0.936584	13.58000
Minimum	0.005632	50556.00	0.314044	-6.720000
Std. Dev.	2.303084	1.38E+08	0.143760	3.952233

Source: Author, data processed (2024)

### Selection of Panel Data Regression Model

The determination of statistical modelling is done to maximise the efficiency of the resulting estimates. The Chow Test, Hausman Test, and Lagrange Multiplier Test are three stages of testing used to choose which one to use in panel data processing (Caraka, 2017).

#### Chow Test

**Table 5.** Chow Test Results

Effects Test	Statistic	d.f.	Prob.
Cross-section F	5.658173	(5,21)	0.0019
Cross-section Chi-square	25.596489	5	0.0001

Source: Author, data processed (2024)

Upon looking at the Chow Test result table, the Probability (Prob.) value is seen to be 0.0001, which is below the significance level of 0.05. Therefore, it can be concluded that the Fixed Effect Model (FEM) has been selected for analysis in this study.

#### Hausman Test

**Table 6.** Hausman Test Results

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	4.594016	3	0.2041

Source: Author, data processed (2024)

By reviewing the Hausman Test table, it is found that the Probability (Prob) value is 0.2041, which indicates that this value exceeds the significance level of 0.05. Thus, the Random Effect Model (REM) is considered the most appropriate model selection.

#### Lagrange Multiplier Test

**Table 7.** Lagrange Multiplier Test Results

Null (no rand. effect) Alternative	Cross-section One-sided	Period One-sided	Both
Breusch-Pagan	3.829597 (0.0504)	0.894868 (0.3442)	4.724465 (0.0297)

Source: Author, data processed (2024)

The Lagrange Multiplier Test results show that the Prob. Breusch Pagan value of 0.0504 is more considerable than 0.05. So that the Common Effect Model (CEM) is the best choice.

From the results of the three model selection tests above, the Common Effect Model (CEM) is the best model for panel data regression among all other models.

**Classical Assumption Test**

in accordance with Basuki & Yuliadi (2014) In panel data regression in the Ordinary Least Square (OLS) method, not all classical assumption tests are required, only the Multicollinearity Test and Heteroscedasticity Test are required.

**Multicollinearity Test**

**Table 8.** Multicollinearity Test Results

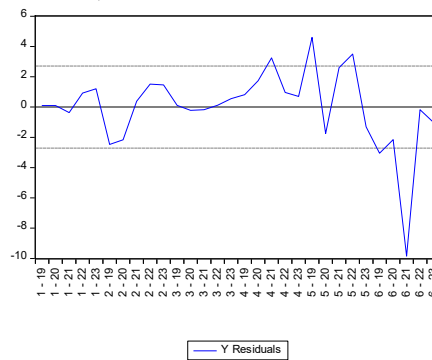
	DIV	TA	IL
DIV	1.000000	0.015659	-0.004862
TA	0.015659	1.000000	-0.008200
IL	-0.004862	-0.008200	1.000000

Source: Author, data processed (2024)

The multicollinearity test was conducted to assess the linear relationship among the independent variables in the regression model. The results of the multicollinearity test presented in the table above show that the independent variables show relatively low correlation coefficients, all of which are below 0.85. In the absence of a linear relationship between the independent variables, the data is considered free and successfully passes the multicollinearity test.

**Heteroscedasticity Test**

It can be seen from the graph presented (blue colour) that the graph is within the range of 500 and -500. This shows that there is no indication of heteroscedasticity symptoms or it passes the heteroscedasticity test because the residual variants are the same (Napitupulu et al., 2021).



**Figure 2.** Heteroscedasticity Test Results

Source: Author, data processed (2024)

**Panel Data Regression Equation**

The panel data regression equation obtained from the research results is as follows:

Substituted Coefficients:

$$RROA = 3.05287733517 + 1.19592913144*DIV - 4.99574399398e-09*TA - 7.02486403616*IL$$

Based on the model above, it is explicable because each independent variable is 0, then the Profitability variable (ROA) follows at 3.0528. Then if there is an increase in the Diversification variable, then ROA as a proxy for profitability also increases by 1.1959. Every increase in the Bank Size variable proxied by total assets, the ROA (profitability) variable decreases by -4.9957, and vice versa. Similarly, the coefficient value of Bank Competition (Lerner Index) if this variable increases, ROA as an instrument of profitability will decrease by -7.0248.

## T-Test

The influence of each independent variable is demonstrated separately using the T test. Below, in table 8, are the T-test results:

**Table 9.** T-test results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	3.052877	2.065021	1.478376	0.1513
DIV	1.195929	0.218535	5.472488	0.0000
TA	-5.00E-09	3.66E-09	-1.366727	0.1834
IL	-7.024864	3.500680	-2.006714	0.0553
R-squared	0.578466	Mean dependent var		2.333000
Adjusted R-squared	0.529827	S.D. dependent var		3.952233
S.E. of regression	2.710013	Akaike info criterion		4.955349
Sum squared resid	190.9484	Schwarz criterion		5.142176
Log likelihood	-70.33024	Hannan-Quinn criter.		5.015117
F-statistic	11.89315	Durbin-Watson stat		1.610814
Prob(F-statistic)	0.000043			

Source: Author, data processed (2024)

After looking at the T-test results, it can be seen that the probability value (Prob) for the Diversification variable is 0.0000, which is below 0.05. This indicates that the Diversification variable has a significant influence on Profitability (ROA). In contrast, the remaining two variables, namely Bank Size with a probability value of 0.1834 and Bank Competition with a probability value of 0.0553, indicate that these variables do not have a significant influence on Profitability (ROA), as both values are more substantial than the 0.05 threshold.

## Simultaneous Test (F -Test)

One of the tools to determine the level of significance of the impact of independent factors on the dependent variable is the F test, often known as the Simultaneous Test.  $0.000043 < 0.05$  is the Prob value (F statistic) obtained from the simultaneous test shown in table 8 above. As a result, the findings of the analysis indicate that the independent factors work together to influence the dependent variable.

## Determination Coefficient Test (R<sup>2</sup>)

A statistical analysis technique called the coefficient of determination test is used to assess how effectively the regression model can account for changes in the independent variable (Basuki, 2021). This is reflected in the Adjusted R-squared (R<sup>2</sup>) value. Based on the test results presented in Table 8, the adjusted R-squared value is 52.9% or 0.529827. This indicates that independent factors such as bank size, competitiveness, and diversification contribute 52.9% to the profitability of Islamic banks in Indonesia, according to the coefficient of determination. The remaining 47.1% is influenced by other elements that are not in this research model.

## Discussion

### The Effect of Diversification on Profitability

The partial test results of the diversification variable resulted in a probability value of  $0.0000 < 0.05$ . Therefore, this study shows that diversification substantially affects the profitability of Islamic banks. The larger the level of diversification, the greater the profitability obtained by the bank. Meanwhile, if diversification has no effect on profitability, it indicates that diversification or business does not guarantee improved financial performance and can cause companies to lose focus, which in turn reduces efficiency and profitability (Sinarti & Darmajati, 2019).

The average HHI result of Islamic banks in Indonesia is 2,875, which means that the market is highly concentrated. Diversification activities are able to see the competitiveness of banks, besides that complete diversification also shows banks in adapting to technological developments and overcoming risks with dependence on one product (Nguyen, 2018). One creative strategy to encourage people to adopt Islamic banking products is to look at the growth of the Islamic banking industry through digitalisation. This increases the opportunities and potential for Islamic banking to become a profitable business. This study supports the research results (Lestari, Tanuatmodjo, & Cahkyaneu, 2020) and (Sofianingsih & Fitanto, 2022) which states that Diversification has an influence on the profitability of the Islamic banking sector.

### The Influence of Bank Size on Profitability

Partial test results show a probability value of  $0.1834 > 0.05$ . This shows that bank size (total assets) has no effect on the profitability of Islamic banks. Based on this, bank size can increase profitability but not a sure thing.

Bank Size is not the only factor that affects the long-term profitability of banks. The features of each bank, the industry in which they operate, and the tactics each bank uses to achieve profitability are actually things that can also determine profitability in addition to bank size. While smaller banks received higher returns during the crisis, larger banks earned higher returns both before and after the crisis (Regehr & Sengupta, 2016). The research findings are in line with (Vernanda & Widyarti, 2016) and (Martins et al., 2019) which states that bank size has no effect on the profitability of Islamic banks.

### **The Effect of Bank Competition on Profitability**

The findings for the bank competition variable indicate a probability value of 0.0553 larger than 0.05 based on the test conditions. Thus, it may be concluded that the profitability of Islamic banks is unaffected by bank rivalry. In other words, the profitability of Islamic banks will not be impacted by changes in the degree of banking competition.

Based on the calculation of the average Lerner Index in Islamic banks around 0.536 which indicates that banks have perfect competition market power, where each bank has a relatively strong market power in its field. The results of banking competition that does not have a significant effect on profitability can be said to be included in medium competition even though the six banks are included in the ten banks with the largest assets. It is said that compared to these six banks, there are reportedly larger banks with wider market shares. Furthermore, it may occur as a result of the banks' close relationship with the financial system (interconnectedness), which is demonstrated by the issuance of securities, notes, and other liabilities. The banking industry may face significant risks as a result of the growth of financial interconnectedness, making it difficult for competition in Islamic banking to increase profitability in terms of both equity and assets (Jin, 2019). The results of this study support the results of research (Paramitha & Prasetyia, 2023) which concluded that bank competition has no effect on bank profitability.

### **Conclusion**

From the outcomes of the data analysis that has been described, it can be concluded that diversification proxied by HHI has an influence on profitability (ROA). Proper diversification can minimise the risks faced by spreading dependence on one product line or market, thus reducing the impact of market fluctuations and being able to create profitable banks. Meanwhile, bank size as seen through total assets shows no influence on profitability (ROA). While competition through the measurement of the lerner index also has no influence on profitability (ROA). With this that actually the six banks in terms of diversification through product innovation they are more progressive compared to other banks, while bank size and bank competition both in terms of assets, market share and access have not really controlled the banking market share despite being included in the 10 largest assets of Islamic banks, it is natural that bank size and bank competition have no influence on the profitability of Islamic banks.

This study still has many limitations, considering that this study only uses several variables and several samples among the large population so that further research is needed with a larger test estimate to generalise the research results. The proposal for future researchers is to expand the scope by including additional variables and research samples to assess the maximum level of profitability.

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