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Research Article

Risk as a Sustainability Moderator in Islamic Banking Profitability

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Abstract: Risk is an inherent component of all financing activities and must be managed effectively to optimize Islamic banks' profitability. This study provides insights into how Islamic banks can balance risk and return amid the sector's evolving challenges by employing panel regression analysis using data from Islamic Commercial Banks (BUS) in Indonesia, sourced from the OJK's Islamic Banking Statistics. The dataset integrates a ten-year time-series dimension with a cross-sectional dimension covering multiple banks. The findings show that risk moderates both financing performance and profitability outcomes: it weakens the negative effect of problematic financing (PF) on Return on Assets (ROA), while at the same time reducing the positive effect of channeled financing (CF) on ROA. These results suggest that although effective risk management can cushion losses from problematic financing, it may also limit the full profitability gains from financing expansion, underscoring the importance of balanced and integrated risk-return strategies in Islamic banking.

Keywords: Financing Portfolio; Islamic Bank; Management Efficiency; Profitability; Risk.

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1. Introduction

The performance of Islamic banking can be enhanced through efforts to optimize profit acquisition while effectively managing inherent risks. Islamic banks operate based on principles prohibiting usury (riba) and promoting risk-sharing mechanisms, which fundamentally differentiate their financing structures and risk exposures compared to conventional banking. Notably, the profit-and-loss-sharing (PLS) principle in Islamic financing instruments such as mudarabah and musyarakah creates distinct risk profiles, as these equity-based contracts directly link the bank's profitability to the performance of funded projects (Othman et al., 2023). This structural characteristic necessitates a more profound relationship between the bank and its customers, requiring rigorous monitoring and governance to ensure alignment of interests and mitigate potential moral hazards. The unique risk-return dynamics of PLS financing underscore the importance of sophisticated risk management frameworks in Islamic banking to balance profitability objectives with Sharia compliance requirements (.Sutrisno et al., 2022).

The green-shaded area in Figure 1 illustrates the growth of total financing disbursed by Islamic banks from 2015 to September 2024. In January 2015, total Islamic banking financing stood at IDR 180.232 trillion, growing threefold to reach IDR 592.650 trillion by September 2024. The blue line represents the growth of consumptive financing composed of murabaha, istishna', and ijarah contracts, with an average monthly disbursement of IDR 184.596 trillion to customers from 2015 through September 2024. However, a notable trend shift occurred in May 2023 when productive financing began dominating the financing composition at 50.25%, up from 49.58% in April 2023. This is reflected in the total productive financing disbursed amounting to IDR 251.785 trillion, consisting of IDR 242.175 trillion in musharakah financing and IDR 9.610 trillion in mudharabah financing.

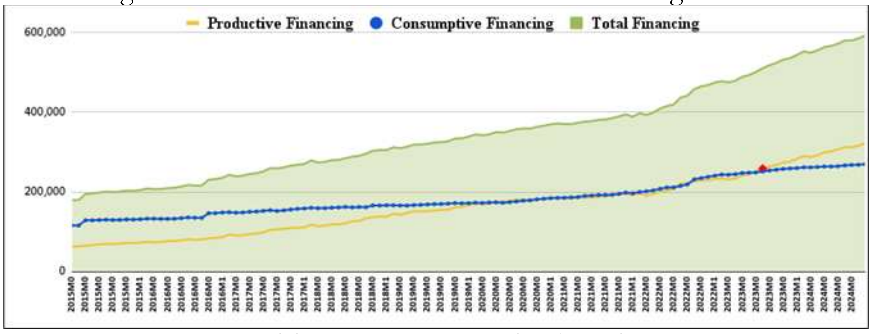

Figure 1. Growth of financing in islamic banking from 2015 to 2024.

Research indicates that high risk levels can negatively impact Islamic banks' profitability. Empirical studies demonstrate that increasing non-performing financing (NPF) correlates with declining return on assets (ROA) and return on equity (ROE) (Hidayah et al., 2023; Hussein et al., 2017). This effect becomes particularly pronounced during economic crises, as financial downturns exacerbate risk levels and consequently impair profitability (Wu et al., 2018 ; Mohammed et al., 2014). Although Islamic banks generally exhibit greater resilience during financial crises compared to conventional banks, they remain vulnerable to the adverse effects of heightened risk exposure (Hussein et al., 2017 ; Yuksel, 2017). The unique risk-sharing nature of Islamic financing may sometimes result in elevated risk levels, particularly when underlying projects underperform relative to expectations.

Based on the aforementioned background, it can be concluded that risk is an inevitable aspect of all financing activities and must be effectively managed to optimize the financing portfolio's contribution to Islamic banks' profitability. By examining the moderating effect of risk on the relationship between financing portfolios and profitability, this study aims to provide deeper insights into how Islamic banks can manage risk while maximizing returns amidst the evolving challenges in the Islamic banking sector, both regionally and internationally.

2. Preliminaries or Related Work or Literature Review

Islamic banks function on a profit-and-loss sharing framework, which underpins their entire range of financial activities, from deposit products to lending services. Although Islamic financial products may appear similar to conventional banking offerings at first glance, they are distinguished by their strict compliance with Shariah principles that prohibit interest (riba), speculative uncertainty (gharar), and gambling-like transactions (maysir). Consequently, all Islamic banking products must be structured to exclude these forbidden elements. Islamic banking performance is commonly evaluated through the Return on Assets (ROA) metric, a crucial measure of a bank's ability to effectively convert its assets into earnings.

Portfolio Financing refers to productive financing formed by equity-based financing with a profit-and-loss sharing mechanism such a mudharaba and musharaka, while consumptive financing consists of two main contract types; sale-based (Murabaha, Salam, and Istishna) and lease-based arrangements (Ijarah). Risk is defined by a financial performance index in Islamic banking that reflects losses resulting from financing risks or NPF (Non-Performing Financing).

Research by (Mirandha, 2021 ; Nadya & Riani, 2020) shows that Musharakah financing has a significantly positive coefficient on the profitability of Islamic banks in Indonesia. This is further supported by studies(Rizky & Azib), which highlight the positive impact of Mudharabah contracts. Additionally, research on equity financing portfolios by (Riyadi et al. ; Widarjono, 2021) indicates that it influences Islamic banking profitability. These findings demonstrate that such financing significantly impacts profitability

Consumptive financing, structured through Murabahah, Istishna', and Ijarah contracts, operates on a deferred sale concept with an added profit margin for customers seeking financing for homes, vehicles, and other needs. Conceptually, this financing model carries lower risk due to fixed monthly payment schemes, aligning with studies (Rizky & Azib, 2021 ; Lestari & Anwar, 2021). [2] research notes that Islamic banks currently prefer non-equity financing like Murabahah due to its lower risk.

Non-performing financing (NPF) risk is inherent in Islamic banking financing. A high NPF indicates significant financing that fails to add value to Islamic banks [15], and financing risk significantly affects the financial performance of Islamic banks in Indonesia [16]. Furthermore, [14] found that NPF moderates the effect of Mudharabah financing and PSR (Profit-Sharing Ratio) on profitability but does not moderate the effect of Musharakah financing. Like productive financing, consumptive financing also carries risks, such as payment delays by customers. Research by Wahid et al. (2023) illustrates the negative impact of consumptive financing during economic crises. This can increase NPF due to economic challenges like inflation and economic growth fluctuations (Priyadi et al., 2021).

Based on established concepts and prior research, Figure 2 provides an overview of this research.

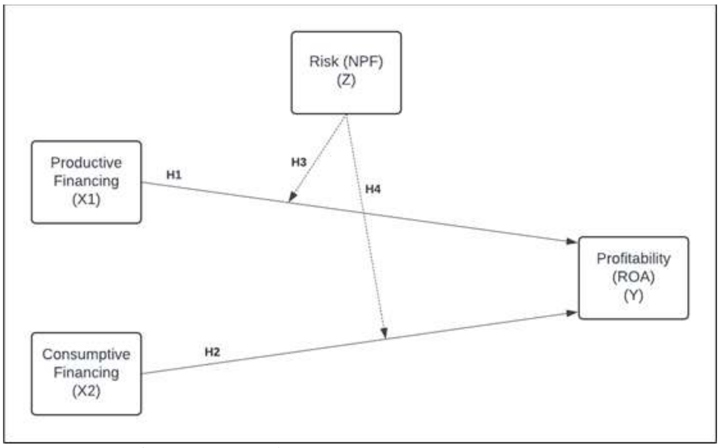

Figure 2. Risk as a moderator variable on the influence of portfolio financing towards profitability.

3. Proposed Method

This research employs a quantitative methodology to examine the proposed hypotheses by analyzing relationships among variables. The sampling in this study uses a purposive sampling technique, with the criteria being all Islamic Commercial Banks (BUS) that have their financial data presented in the Islamic Banking Statistics published by the Financial Services Authority (OJK) from 2015-2024, The study employs a balanced panel dataset consisting of 10 Islamic commercial banks with complete 10-year observations, resulting in n = 100 bank-year observations. The operational variables in this study are presented in Table 1 below.

Table 1. Table of Variable Operationalization.

Symbol	Variable	Indicator
(Y) ROA	Profitability	Post-tax net income divided by income-generating assets
(X1) PF	Productive Financing	Total Mudharabah + Musyarakah Financing This calculation method modifies the approach used by [17], which adopted methodologies from earlier studies by [2], [19], [20], [21].
(X2) CF	Consumptive Financing	Total Murabahah + Istishna' + Ijarah Financing This calculation represents a modified version of the Non-PLS Financing variable (consumptive financing) used by [17], [19], [20].
(Z) NPF	Risk	Ratio of net non-performing financing to total financing.

This study employs panel regression analysis to investigate data concerning Islamic Commercial Banks (BUS) in Indonesia, sourced from the OJK's Islamic Banking Statistics. The dataset combines a ten-year time-series dimension with a cross-sectional dimension, encompassing multiple banks observed simultaneously. The analysis utilizes the Ordinary

Least Squares (OLS) framework. To ensure the validity of the OLS estimates and adherence to BLUE (Best Linear Unbiased Estimator) assumptions, diagnostic testing focused specifically on multicollinearity (where applicable with multiple independent variables) and heteroskedasticity. As argued by Basuki & Prawoto these two tests are paramount for panel data regression using OLS Regression analysis serves as a statistical methodology for quantifying and forecasting the relationships between a dependent variable and its predictors (Gujarati, 2003). Based on this explanation, the panel data regression equation is formulated as follows

$$\boldsymbol{Y} = \boldsymbol{\alpha} + \boldsymbol{\beta 1 X1} + \boldsymbol{\beta 2 X2} + \boldsymbol{\beta 3} Z + \boldsymbol{\beta} 4 \boldsymbol{X1} Z + \boldsymbol{\beta} 5 \boldsymbol{X} 2Z + \boldsymbol{\varepsilon} \quad (1)$$

The model specification includes: Y as the dependent variable (ROA); α as the intercept (Y's value when X and Z equal zero); X_1 and X_2 as independent variables representing (PF) and (CF) respectively; Z as moderating variables for risk (NPF). The interaction terms consist of X_1Z (PF×NPF), X_2Z (CF×NPF). The regression coefficients are denoted as: β_1 for productive financing, β_2 for consumptive financing, and β_3 for financing risk (NPF). The interaction term coefficients are β4 (X_1Z), β5 (X2Z). Finally, ε represents the error term.

4. Results and Discussion

4.1. Descriptive Statistic

Table 2. Descriptive Statistic.

Variable	Min	Max	Mean	Std. Deviation
ROA (Y)	-0,0809	0,1358	0,0154	0,0330
Productive Financing (X1)	0,0000	117,1243	7,9047	17,6871
Consumptive Financing (X2)	0,1481	144,4609	9,8291	25,9659
Non-Performing Financing (Z)	0,0000	0,0497	0,0185	0,0166

Source: Processing result

Table 3 presents the descriptive statistics of key variables from a 10-year panel dataset (2015–2024) of 10 Islamic commercial banks, revealing critical insights into their financial performance and operational characteristics. The dependent variable, Return on Assets (ROA), exhibits a mean of 1.54% with a standard deviation of 3.30%, indicating moderate volatility, while its range (-8.09% to 13.58%) underscores significant profitability disparities across banks and time periods. The independent variables—Productive Financing (X1) and Consumptive Financing (X2)—display substantial heterogeneity, with X1 averaging 7.90 (SD=17.69) and X2 averaging 9.83 (SD=25.97), alongside extreme ranges (X1: 0–117.12; X2: 0.15–144.46), suggesting highly divergent financing strategies that may necessitate logarithmic transformation to mitigate skewness in regression analysis. Moderating variable show comparatively stable trends: Non-Performing Financing (Z1) maintains a mean of 1.85% (SD=1.66%), reflecting consistent credit risk management.

4.2. Result of data processing

The model selection suggesting that FEM Based on these diagnostic tests, the Fix Effects Model (FEM) was ultimately selected as the most suitable estimator for the analysis. See Table 4 for details.

Table 3. Result of Data Panel Model Test.

Effect Test	F-stat.	Decision
Chow-Test	0,000	FEM
Hausman Test	0,000	FEM

Source: Processing result

The initial test results indicated the presence of highly significant correlations exceeding 0.9 between key variables. To satisfy classical regression assumptions, the researcher implemented logarithmic transformations on both X1 and X2 variables using EViews. The post-transformation analysis revealed that all independent variables (X1, X2) and moderator variables (Z) subsequently exhibited correlation coefficients below the critical 0.9 threshold, thereby confirming the successful resolution of multicollinearity issues and validating the model's suitability.

Table 4. Result of multicoliearity test after log.

	LOG(X1)	LOG(X2)	Z1	X1Z	X2Z
LOG(X1)	1.000000	0.352503	0.126284	0.591151	0.525976
LOG(X2)	0.352503	1.000000	-0.108878	0.600962	0.750093
Z	0.126284	-0.108878	1.000000	0.331296	0.208159
X1Z	0.591151	0.600962	0.331296	1.000000	0.897611
X2Z	0.525976	0.750093	0.208159	0.897611	1.000000

Source: Processing result

Based on the Glejser test results conducted using the REABS (Residual Absolute) method in EViews, it can be concluded that the regression model being tested does not exhibit heteroskedasticity problems. This is evident from the probability values (p-values) of all variables being greater than the 0.05 significance level.

Table 5. Result of Glejser Test.

Variable	Prob.
LOGX1	0.5192
LOGX2	0.7379
Z	0.1371
X1Z	0.1108
X2Z	0.1391

Source: Processing result

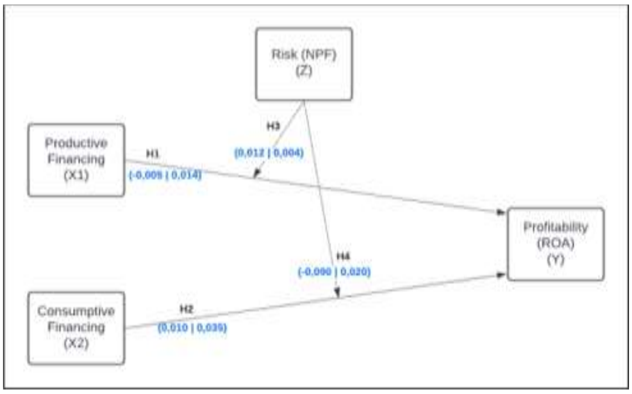

Figure 3. Result of Regression Data Panel.

The analysis reveals that productive financing (LogPF) negatively impacts ROA (β = -0.0049; p = 0.014), suggesting PLS-based financing (mudharabah/musharakah) may decrease Islamic banks' profitability. This aligns with [2] findings, attributable to Banks' inadequate risk assessment during due diligence and Clients' financial transparency issues (Wahid et al., 2023). These risk miscalculations increase monitoring costs for problematic clients, elevating operational expenses that erode profits (Kuraeni 7 Isnaeni, 2022). [16] notes external factors like economic growth improve repayment capacity, reducing NPF, while inflation undermines business profitability by raising material costs (Zarruok et al., 2014).

The analysis reveals that consumptive financing (LogCF) significantly enhances ROA (β = 0.0105; p = 0.0355), demonstrating that asset-based financing positively contributes to Islamic banks' profitability. This finding aligns with (Wahid et al., 2023; Warninda et al., 2019), confirming that non-PLS financing with fixed returns generates more stable profits, explaining its global preference among Islamic banks. Descriptive statistics further support this, showing banks like BTPN Syariah with consumptive-dominated portfolios achieve higher ROA, consistent with studies proving Murabaha's positive impact (Hidayah & Karimah, 2023 ; Kuswara et al., 2019). However, this presents a Sharia-compliance dilemma, as (Miah & Suzuki, 2020 ; Chowdhury et al., 2018) argue PLS financing better embodies Islamic economic principles. Nevertheless, the risk-mitigation clarity through fixed-margin contracts (Chowdury et al., 2018) makes consumptive financing pragmatically attractive despite ideological tensions.

The study reveals that risk positively moderates the PF-ROA relationship (β=0.1191; p=0.0045), suggesting managed risk in productive financing (mudarabah/musharakah) can enhance profitability. While (Warninda et al., 2019) argue higher-risk PLS financing generates superior returns through rigorous due diligence and adaptive profit-sharing ratios, these findings contradict (Priyadi et al., 2021), (Masmuna et al., 2024) who associate increased risk with reduced PF effectiveness. High NPF reflects PLS project failures, often due to moral hazard or weak monitoring (Wahid et al., 2023). Comparative studies highlight systemic vulnerabilities – (Jedidia, 2018) shows Islamic banks in GCC experience sharper profitability declines during high-NPF periods, while (Damanhur et al., 2018) identifies weak feasibility analysis as key contributor in Indonesia. Strategic solutions include hybrid financing models blending risk-sharing with mitigation mechanisms (Chowdhury et al., 2016) and regtech-enhanced real-time monitoring (Al-Hunnayan, 2020), emphasizing strengthened Sharia oversight and transparent reporting to balance risk-return objectives.

The analysis reveals that risk significantly moderates (with a dampening effect) the positive relationship between consumptive financing and ROA (β = -0.0908; p = 0.0197). This indicates that fixed-return Murabahah financing's profitability decreases when moderated by higher default risk, consistent with (Faizah et al., 2023) findings on NPF's negative moderation. Notably, Ijarah financing within consumptive portfolios shows high standard deviation, reflecting risk volatility. Based on our data collection show banks with higher consumptive financing (FC) maintain lower NPF, supported by (Akbar & Siti-Nabiha, 2022) findings on better recovery rates from physical collateral. However, (Wahid et al., 2023) caution about heightened consumptive financing risks during economic downturns like COVID-19.

4.3. Risk as a moderator

To examine the moderating effects of the moderator variables, a simple slope test was conducted, yielding the following Figure 4 and Figure 5. The following table 7 presents the effect size of NPF's moderating role in the relationship between financing portfolios and profitability. The analysis reveals a small moderating effect, as indicated by an f² value of 0.0769. Therefore, Islamic banks should consider implementing robust risk management strategies across their financing portfolios, particularly for productive financing which carries higher risk but also offers greater return potential. By effectively managing the inherent business risks in productive financing, Islamic banks can enhance their overall profitability.

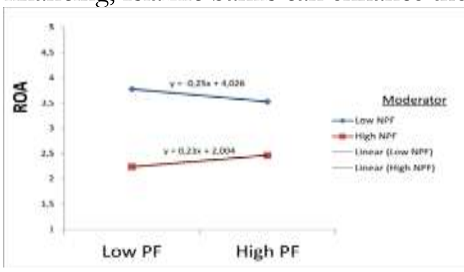

Figure 4. The results indicate that the Risk effect weakens the negative impact of PF on ROA.

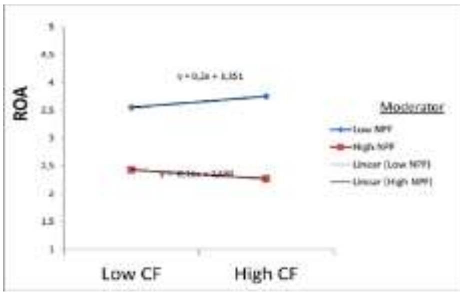

Figure 5. The results demonstrate that the Risk effect weakens the positive impact of CF on ROA.

Table 4. The effect size of moderation.

	Included	*Excluded*	*f-squared*	*Effect size*
R^2	0,74	0,72	0,0769	*Small*

5. Conclusion

This study reveals that profit-sharing financing (Mudharabah/Musyarakah) negatively impacts Islamic banks' profitability due to information asymmetry during due diligence and high monitoring costs, reinforcing the Sharia-compliant risk-return tradeoff principle. The findings emphasize the need for stringent risk governance in productive financing. Conversely, consumptive financing (Murabahah/Ijarah) positively affects profitability, demonstrating that fixed-margin income enhances ROA, particularly during economic uncertainty.

Through risk moderation analysis, this study reveals a novel finding where Non-Performing Financing (NPF) positively moderates the productive financing-profitability relationship - contradicting prior research from many scholars. This phenomenon underscores the inherent vulnerability of Profit-Loss Sharing (PLS) contracts to moral hazard and project failures. Conversely, the opposite effect occurs with consumptive financing, where risk moderation weakens its positive impact on profitability. These findings necessitate a differentiated risk management framework that incorporates: (1) sector-specific business risk profiling for potential clients, (2) financial statement analysis, and (3) adaptive profit-sharing ratios (nisbah) calibrated to the assessed risk levels and financial conditions of borrowers. Such an approach would balance risk exposure while maintaining Sharia-compliant financing principles.

This study yields actionable recommendations for Islamic banking stakeholders alongside important research limitations. For Islamic banks, optimizing productive financing (Mudharabah/Musyarakah) below 50% through technological enhancements like blockchain transparency and AI-driven ESG scoring is advised, coupled with differentiated risk depends on productive or consumptive scheme and dynamic nisbah for equality. Regulators should implement differentiated NPF policies, foster Sharia fintech innovation for IoT monitoring, and develop targeted financial literacy programs. Future research should expand to examine macroeconomic variables, conduct cross-country comparisons, and develop Sharia-specific efficiency metrics. However, the study's Indonesia-focused geographic scope and 2015-2024 timeframe may limit generalizability, while unmeasured variables like Sharia board effectiveness and methodological constraints of fixed-effect models suggest dynamic panel approaches might better address endogeneity in future studies. These findings collectively advance Islamic banking practice while thoughtfully acknowledging boundaries for scholarly interpretation and application.

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