



Factors Influencing Financial Quality between Conventional and Islamic Banks in Indonesia

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Abstrack : This study examines the factors influencing financial quality between conventional and Islamic banks in Indonesia. Islamic banks operate without interest, focusing on economic justice, while conventional banks rely on interest rates. This research aims to identify and analyze the key factors affecting the financial quality of both types of banks. Panel data from annual financial reports (2008-2016) were analyzed using multivariate regression. The main findings indicate that Islamic banks are influenced by operational efficiency and net operating margin, whereas conventional banks are more affected by credit risk and operational management. These findings suggest that Islamic banks must enhance operational efficiency for profitability, while conventional banks should focus on risk management and cost efficiency. In conclusion, there are significant differences in the factors affecting the financial quality between the two types of banks, which is essential for policymakers and bank management.

Keywords: Finance, Banking, Risk, Sharia, Conventional

INTRODUCTION

Banking plays a crucial role in the development of the global economy, functioning to regulate the flow of capital and thus supporting economic growth within a country (Neanidis, 2019). The banking system is generally dominated by the interest principle, which has long been the economy's foundation. Parallel to this, Islamic banks have emerged based on Sharia principles that prohibit interest (*riba*) and prioritize economic justice. These two systems have important roles but operate on different fundamentals: conventional banks use interest as the main instrument for income and expenditure, whereas Islamic banks rely on profit-sharing and 'halal' investment activities. Over time, both systems have undergone significant developments in operational scale and historical progression of each type of bank.

Conventional banks have evolved since the 14th century, reflecting the need for safe storage facilities and as a payment system. On the other hand, Islamic banking is rooted in Islamic economic principles that have existed since the classical Islamic era but have only been formally institutionalized in recent decades. Islamic banking experienced significant growth after the 2007-2008 financial crisis, becoming an alternative to the existing economic system (Rafay, 2020). A significant milestone in the evolution of Islamic banking occurred with the establishment of the first Islamic bank in 1975 in Dubai and the implementation of global standards by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions). This transformation marks a significant evolution in recognizing and accepting Sharia principles in the global banking arena.

The concept of Sharia compliance requires that bank operations must align

with Islamic law (Faruq, 2021), including the prohibition of interest and investment in industries deemed haram, such as alcohol and gambling. Profit-sharing is the primary income method, replacing interest, where the bank and its customers share the risks and profits from the investments made. Conversely, conventional banks operate on an interest and interest-based loan system, with risk management primarily aimed at minimizing credit and market risks. A comparison between these two systems reveals fundamental differences in approaches to ethics, sustainability, and risk structure. Understanding these differences helps explain how different financial systems respond to various economic pressures.

Previous studies indicate that during economic crises, Islamic banks exhibit higher financial stability (Luqmanulhakim et al., 2021), due to their non-interest-based financial structure. The interest system causes unpredictable fluctuations, negatively impacting conventional banking. Islamic banks can maintain system stability, thus mitigating vulnerability to financial crises (Abidi et al., 2020). On the other hand, conventional banks are more flexible in meeting market needs (Hanif, 2014), allowing them to improve their financial conditions quickly. The differences in operational management between the two types of banks result in differences in financial management, making Islamic banks more efficient while conventional banks can achieve higher profitability (Alharbi, 2016). When banks achieve high profitability, they also experience higher risk levels. This affects conventional banks, resulting in higher credit risk than Islamic banks (Kabir et al., 2015). The effects of high credit risk lead to increased risks, which certainly impact financial stability and the economy. Therefore, it is

necessary to understand the financial quality of both Islamic and conventional banks to ensure a more stable financial system.

Various studies on banking financial quality have yet to address internal aspects fully. (Islam, 2023) extensively discusses macroeconomic aspects, while (Handayani et al., 2022) touch on external conditions, such as their relationship with stocks. Financial ratio aspects have also not been comprehensively discussed, as seen in (Al Rasyid & Sosrowidigdo, 2022) which connects CAR with ROE or loan ratios explained by (Füzes, 2019). The studies mentioned have not thoroughly examined financial ratios, which are very important to consider. This indicates a significant research gap in the existing literature, where more profound research into internal financial ratios can provide a more comprehensive understanding of bank financial performance and potential implications for future risk management policies and strategies

Understanding the factors that influence financial quality is crucial for long-term sustainability. This research contributes to the literature by exploring how these differences can broadly impact banking policies and industry practices. Implications for policymakers include developing a fairer and more inclusive regulatory framework while banking professionals can better assess which practices are most effective for implementation in specific contexts. This analysis not only helps in devising more effective adaptation strategies but also enhances interactions between banks and their customers, leading to more informed and responsible decision-making.

LITERATURE REVIEW

Agency Theory

Agency Theory explores the relationship between owners (principals) and managers (agents), where information asymmetry occurs. Agency Theory provides a crucial framework for understanding the internal dynamics within the banking sector, especially in managing the relationship between owners (principals) and managers (agents) (Haugen & Senbet, 1979). In the banking industry, information asymmetry between shareholders (as principals) and bank management (as agents) can lead to conflicts of interest, where management may not always act in the best interest of the shareholders (Smith, 2010).

Managerial malfeasance represents a significant challenge for corporations, mainly when there is a misalignment of interests between owners and managers (Nyberg et al., 2010). To address this agency problem, aligning the interests of owners (principals) and managers (agents) becomes essential and achievable through agent compensation and equity ownership mechanisms. This alignment not only supports the enhancement of corporate performance but also minimizes conflicts of interest.

Managers often endeavor to maximize their utility by managing corporate expenses per their interests (Rose, 1992). In the same context, reductions in non-interest operational costs, increased employee productivity, acceptance of greater portfolio risk, and higher dividend distributions to shareholders indicate the positive potential of such interest alignment.

Conflicts of interest between agents (CEOs or other managers) and principals (shareholders) often result in financial losses for the company and its shareholders (Smith, 2010). This indicates that a CEO's failure to act in the

best interests of the shareholders is a manifestation of agency theory in corporate practice.

Capital Structure Theory

The Capital Structure Theory is a fundamental concept in finance that focuses on the optimal funding composition of a company to maximize corporate value. It highlights the behavior of rational players in the financial market who strive to maximize utility or wealth, even when faced with certain risks (Sara Saeed, 2013). This underscores the importance of capital financing decisions for corporations to achieve this objective. Modigliani and Miller, in 1958, introduced the capital structure irrelevance hypothesis. This hypothesis suggests that the value of a company is unaffected by its capital structure decisions in an efficient market, where taxes, bankruptcy costs, and information asymmetry do not exist. According to the Modigliani-Miller theorem, the theory of capital structure and company value is considered independent of the firm's capital structure choices (Mullick, 2023). This approach offers a new perspective in understanding corporate financing dynamics, where the appropriate capital structure is not considered to impact the company's value directly.

Capital structure can indeed be designed in such a way as to maximize corporate value and returns for investors (Burgess, 2020). This indicates that although Modigliani and Miller emphasize the irrelevance of capital structure to company value, companies still seek an optimal financing composition. This highlights the importance of considering fundamental theories of corporate finance, including the Modigliani and Miller propositions, in designing a capital structure that maximizes company value, minimizes risk, and enhances investor confidence.

The liquidity services provided by bank deposits have made them a cheaper financing source than equity (Gale & Gottardi, 2020). Banks can pass on some financing benefits to borrowing companies in an efficient equilibrium through lower interest rate offerings. This process balances the benefits of debt financing and bankruptcy risks, which can be fatal for companies. This balance highlights how banks play a crucial role in the corporate financing ecosystem, offering a beneficial financing alternative for companies.

Interestingly, the capital structure of banks themselves has a significant influence on their propensity to engage in monitoring (Jayaraman & Thakor, 2014). Banks tend to adjust their capital structure in response to changes in creditor rights, a dynamic that reinforces the role of banks in managing risk and optimizing resource allocation. This reflects a reciprocal relationship between a bank's capital structure and operational performance, where strategic adjustments can effectively respond to changing market conditions and regulations.

Asset Quality

Asset quality plays an inseparable role in determining the operational costs of banks and the economic efficiency that can be achieved in the banking sector (Bernstein, 1996). The cost function for banks with a low proportion of non-performing loans shows a significant difference compared to those with a high proportion of non-performing loans, thus affirming that asset quality directly impacts the cost structure of banks. An increase in non-performing loans burdens the bank and affects the overall operational cost curve.

Poor asset quality increases cost burdens and raises the probability of disagreements in credit ratings,

highlighting the importance of maintaining asset quality to minimize risk perception differences (Kladakis, 2020). Gadhia (2015) underscores that asset quality is one of the most critical aspects in determining the overall financial performance of banks, given its role in influencing profitability and stability.

In a broader context, Sharma and Taneja (2013) emphasize the importance of maintaining depositor trust and preventing bank failures through capital adequacy. In this regard, asset quality becomes a primary parameter in measuring banks' financial strength and ability to protect depositors while promoting stability and efficiency in the financial system.

Furthermore, Ghosh (2023) elucidates the importance of asset quality management in evaluating and managing the credit risk associated with assets such as loans and investment portfolios. Effectiveness in controlling and monitoring credit risk directly contributes to efficient asset quality management, indicating that good credit risk management is critical to maintaining asset quality.

METHODS

The research employed is quantitative, as the objectives, subjects, data sources, samples, and research design are clearly defined, allowing for data analysis after all have been collected (Arikunto, 2019). The population in this study consists of all conventional Commercial Banks (61 banks) and Islamic Commercial Banks (10 banks) registered with the Financial Services Authority. The sample in this study utilizes a purposive sampling technique with specific considerations (Sugiyono, 2022). To ensure equivalent results for a comparative analysis between the two types of banks, the number of banks used

in the study should be the same for both Islamic and conventional banks. Therefore, the number of conventional banks is adjusted to match the number of Islamic banks, resulting in 9 conventional banks selected based on the following criteria:

1. Banks that publish their financial statements on their respective websites.
2. Financial statements published from 2008 to 2016, as the financial reporting for Islamic banks begins within this time frame.
3. Total assets ranging from 2 trillion to 66 trillion.
4. The type of banks studied are National Private Commercial Banks, not State-Owned Commercial Banks because all the Islamic banks are National Private Commercial Banks.

The data analysis technique used is panel data analysis. Panel data analysis offers advantages in handling individual heterogeneity, which cannot be achieved separately by cross-sectional or time-series data (Ghozali & Ratmono, 2017). In the context of this study, such heterogeneity may include intrinsic differences between Islamic and conventional banks.

RESULTS AND DISCUSSION

Model Selection Test

Table 1.
Result of Model Selection Test

	Conventional Banks		Islamic Bank	
	Prob	Decision	Prob	Decision
Chow test	0,0000	FEM	0,0000	FEM
Hausman test	0,0025	FEM	0,0365	FEM
LM test	0,0000	REM	0,0000	REM

Source: Processed Data (2024)

Model selection testing in the context of panel data analysis for conventional and Islamic banks is critical to ensure that the model used can accurately depict data dynamics and produce valid estimates (Ghozali & Ratmono, 2017). This process involves several statistical tests to determine whether the fixed, random, or common-effect models are most suitable for the data. Here's a further explanation regarding the model selection tests for both types of banks.

Conventional Bank

Three main tests are performed: the Chow Test, the Hausman Test, and the Lagrange Multiplier (LM) Test, to determine the most appropriate model between the fixed effects model and the random effects model.

Chow Test

Used to evaluate the existence of fixed cross-sectional effects by comparing the fixed effects model with a model without fixed effects. A test result with a probability value ($0,000 < 0,05$) indicates significant differences between groups (cross-section), supporting the fixed effects model (FEM).

Hausman Test

Aims to choose between the fixed and random effects models by testing the difference in estimators of the two models. With a probability of 0,0025, this result confirms that the difference between the two estimators is significant,

making the fixed effects model (FEM) more suitable for use.

Lagrange Multiplier (LM) Test

Used to detect the presence of random effects in the model. Results indicating a probability value ($0,000 < 0,05$) suggest that the random effects model (REM) is more appropriately used. However, even though this test indicates significant random effects, the preference towards the fixed effects model is reinforced by the results of the Chow Test and Hausman Test.

Islamic Banks

A similar model selection process is carried out, but the results are adjusted to the characteristics of Islamic bank data, which differ from conventional banks.

Chow Test

In Islamic banks, strong evidence for fixed effects is also produced, with a probability value ($0,0000 < 0,05$) indicating significant differences between groups, supporting the use of the fixed effects model (FEM).

Hausman Test

For Islamic banks, with a probability result of 0,0365, the use of the fixed effects model over the random effects model is supported, making this result similar to findings for conventional banks.

Lagrange Multiplier (LM) Test

Reveals significant use of random effects. However, based on the Chow Test and Hausman Test results, the fixed effects model is more appropriate due to

more robust evidence regarding differences between groups and between estimators of the fixed and random effects models.

Both analyses indicate that the fixed effects model (FEM) is more suitable for use both for conventional and Islamic banks, suggesting that observed variables possess unique characteristics related to each group or entity in the data. This choice allows researchers to more accurately capture the influence of specific individuals or groups on the dependent variable, providing more profound and more particular insights regarding the factors affecting the financial performance of both types of banks.

Classical Assumptions Test

The utilization of panel data models mitigates the necessity for several classical assumptions (Andreß et al., 2013; Hsiao, 2007), providing more accurate modeling that leverages the uniqueness of time and individual dimensions, effectively integrating time-series and cross-sectional data (Ghozali & Ratmono, 2017). Consequently, this prevents the mandatory testing of classical assumptions. Nonetheless, a multicollinearity test is conducted to delineate the optimal regression model from the analysis.

Multicollinearity Test

Table 2.
Result of Multicolierity Test

No	Variable	1	2	3	4	5	6
Conventional Bank							
1	KPPM	1					
2	CKPN	0,074	1				
3	NPL	0,037	0,560	1			
4	NIM	0,061	-0,348	-0,439	1		
5	BOPO	-0,302	0,395	0,345	-0,402	1	
6	LDR	0,158	-0,11	-0,121	0,007	-0,132	1
Islamic Bank							
1	KPMM	1					
2	CKPN	0,044	1				
3	NPF	0,015	-0,139	1			
4	NOM	0,081	0,325	0,240	1		
5	BOPO	0,089	0,096	0,099	0,240	1	
6	FDR	0,018	-0,037	0,04	0,099	0,067	1

Source: Processed Data (2024)

The multicollinearity test in econometric analysis within both conventional and Islamic banking sectors is a crucial element that determines the reliability and validity of research findings (Ghozali & Ratmono, 2017). Through this process, researchers can identify and address potential distortions in parameter estimates caused by high

linear relationships among independent variables. This explanation will explore how the multicollinearity test is applied in two banking contexts and its implications for interpreting analysis results.

Conventional Banking Analysis

In the analysis performed on conventional banks, the application of multicollinearity testing through the

calculation of the Variance Inflation Factor (VIF) and Pearson correlation analysis serves as the foundation for assessing the quality of the regression model. Employing a threshold value of VIF that is more than 10 as an indicator of significant multicollinearity aids researchers in identifying variables that might cause information redundancy. Based on this analysis, variables such as KPPM, CKPN, NPL, NIM, BOPO, and LDR are proven to have correlation values and VIFs indicating minimal multicollinearity, meaning that the panel data regression model has been designed considering the unique contributions of each independent variable to the dependent variable. This underlines the model's effectiveness in estimating parameters with precision, without interference from unwanted internal correlations among independent variables.

Islamic Banking Analysis

Meanwhile, the analysis of Islamic banks follows a similar approach in

evaluating potential multicollinearity. Variables such as KPMM, CKPN, NPF, NOM, BOPO, and FDR are analyzed to determine their correlation levels. The results show that correlations among independent variables do not indicate significant multicollinearity, signifying that each variable plays a distinct role in the model without obscuring the effects of other variables. This ensures that the parameter estimates produced by the Islamic bank's panel data regression model are accurate and reliable for further analysis.

This thorough multicollinearity testing strengthens confidence in the analysis results and contributes to more informed data-based decision-making in bank management. The findings provide valuable insights into how independent variables affect the dependent variable, with clarity enhanced by eliminating potential distortions caused by multicollinearity.

Regression Analysis

Table 3.

Result of Regression Analysis

	Var.	β	Sig.	F	F test	Coef. of Determination Test
Conventional Bank				196,344	0,00	0,913
1	KPPM	-0,076	0,000			
2	CKPN	0,389	0,196			
3	NPL	-0,293	0,039			
4	NIM	-0,591	0,035			
5	BOPO	-0,418	0,000			
6	LDR	-0,071	0,000			
Islamic Bank				39,311	0,00	0,676
1	KPMM	0,016	0,259			
2	CKPN	-0,151	0,748			
3	NPF	-0,386	0,206			
4	NOM	0,775	0,000			
5	BOPO	-0,099	0,000			
6	FDR	-0,16E-05	0,509			

Source: Processed Data (2024)

Based on the table provided, panel data regression equations have been formulated for each variable as follows:

$$Y_{it} = \beta_1 + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + \beta_5 X_{5it} + \beta_6 X_{6it} + \beta_7 X_{7it} + \mu_{it}$$

For the conventional bank:

$$ROE = 53,637 - 0,076_{KPPM} + 0,389_{CKPN} - 0,293_{NPL} - 0,591_{NIM} - 0,418_{BOPO} - 0,072_{LDR} + \mu$$

For the Islamic bank:

$$ROE = 15,112 + 0,016_{KPMM} - 0,151_{CKPN} - 0,386_{NPF} + 0,775_{NOM} - 0,099_{BOPO} - 1,16e-05_{FDR} + \mu$$

These regression models represent the relationship between the Return on Equity (ROE) and various independent variables for conventional and Islamic banks. Each coefficient β in the equation corresponds to the expected change in ROE for a one-unit change in the corresponding independent variable, holding all other variables constant. The term μ represents the error term for each observation, capturing the unobserved effects that influence ROE.

Conventional Bank Analysis

t-Test

The t-test evaluates the statistical significance of individual coefficients of independent variables against the dependent variable. Variables such as KPPM, NPL, NIM, and BOPO show significant t-statistic values with very low probabilities ($p < 0,05$), indicating these variables significantly influence the dependent variable. For instance, KPPM and BOPO, with β values of $-0,076$ and $-0,418$, respectively, assert strong and negative influences on the dependent variable. CKPN and LDR are also significant, yet CKPN presents a higher significance value (0.196) than others, suggesting a less solid or considerable influence.

F-Test

The F-test is utilized to test the hypothesis that all coefficients in the

model collectively do not affect the dependent variable. With an F-statistic of 196,344 and a significant probability value ($0,000 < 0,05$), the regression model demonstrates very high adequacy in explaining the variability of the dependent variable, rejecting the null hypothesis that all coefficients collectively are not significant.

Coefficient of Determination (R-squared)

An R-squared value of 0,913 indicates that the model can explain 91,3% of the variability of the dependent variable. This suggests that the model fits very well, with the chosen independent variables effectively explaining changes in the dependent variable.

Islamic Bank Analysis.

t-Test

Like conventional banks, the t-test for Islamic banks evaluates the individual significance of coefficients of independent variables. NOM and BOPO are vital ($0,00 < 0,05$), significantly influencing the dependent variable. Mainly, NOM with a β of 0,774 indicates a strong positive influence. Other variables like KPMM, CKPN, NPF, and FDR show insignificant p-values (greater than 0,05), suggesting they are statistically less significant in this model.

F-Test

With an F-statistic value of 39,311 and a significant probability value ($0,000 < 0,05$), the F-test for Islamic banks also indicates that the model is highly significant in explaining the variability of the dependent variable, providing a solid basis for the model's reliability.

Coefficient of Determination (R-squared)

An R-squared of 0,676 for Islamic banks indicates that about 67,6% of the variability of the dependent variable can be explained by the independent variables in the model. Although lower

than conventional banks, this value still indicates that the model fits well and the independent variables significantly contribute to the dependent variable.

The conclusion from this analysis indicates that both panel data regression models for conventional and Islamic banks have significant capabilities in explaining the influence of independent variables on the dependent variable, with conventional banks showing a more robust model fit than Islamic banks. This affirms the relevance and strength of the selected independent variables in explaining the financial performance dynamics in both types of banks.

Discussion

Conventional Bank

The research findings highlighting the statistical significance of KPPM (Microfinance Banking Quality), NPL (Non-Performing Loan), NIM (Net Interest Margin), BOPO (Operational Costs to Operational Income), and LDR (Loan to Deposit Ratio) against ROE (Return on Equity) provide deep insights into factors influencing the financial performance of banks. These findings underscore the importance of risk management, operational efficiency, and liquidity in supporting the profitability of conventional banks.

Risk Management

As an indicator of credit quality, NPL reflects the proportion of loans that cannot be repaid, directly impacting interest income and, ultimately, ROE. The findings that show a negative influence of NPL on ROE affirm that effective credit risk management is crucial. This suggests banks should implement stringent and effective credit assessment processes to monitor and control bad loans.

Operational Efficiency

BOPO negatively influences ROE by measuring the bank's operational efficiency by comparing operational costs

to operational income. This indicates that increased operational costs relative to income can erode the bank's profit margins. Thus, operational efficiency is vital for improving a bank's profitability through cost control and revenue enhancement.

Liquidity

LDR, assessing the proportion of funds lent to total deposits, indicates bank liquidity management. The negative impact of LDR on ROE underlines that excessively high loans, relative to deposits, can pose liquidity risks and affect the bank's ability to meet short-term obligations. Therefore, balancing lending with maintaining adequate liquidity levels is essential.

Overall, the findings for conventional banks reaffirm the importance of risk management, operational efficiency, and liquidity strategies in ensuring the profitability of conventional banks. The focus on risk, operational, and liquidity management emerges as their influence on ROE is more pressing.

Islamic Bank

The study indicates that Net Operating Margin (NOM) and Operational Costs to Operational Income (BOPO) significantly influence Return on Equity (ROE), with NOM providing a positive influence and BOPO a negative impact. These findings highlight the importance of operational efficiency and the ability to generate higher margins from operations as critical determinants of financial performance in Islamic banks.

Operational Efficiency and Net Operating Margin

The positive influence of NOM on ROE signifies that increased efficiency in the operations of Islamic banks—reflected through higher net operating margins—directly contributes to enhanced profitability. This suggests that

Islamic banks optimizing their operations to generate more income from operational costs will enjoy higher ROE. Efficient operational income, especially in the context of Sharia-compliant financing and investment, is critical to achieving this.

Operational Cost Management

Conversely, the negative impact of BOPO on ROE highlights that higher operational costs, relative to operational income, can reduce the profitability of Islamic banks. This confirms that effective operational cost management supports good financial performance. This can include strategies for enhancing business process efficiency, using technology to reduce costs, and improving employee productivity.

Findings for Islamic banks underline that, unlike conventional banks, which focus more on credit risk and liquidity management as dominant factors affecting profitability, Islamic banks place greater emphasis on operational efficiency and productivity. Focusing on cost management and value creation through efficient operations enables Islamic banks to improve desired margins.

The importance of these findings lies in understanding that Islamic banks need to continue innovating and implementing efficient operational practices to enhance profitability. Additionally, these findings provide insights that in the competitive banking industry, financial performance improvement strategies for Islamic banks can significantly differ from conventional banks, with a stronger focus on operational aspects and efficiency.

This research contributes significantly to the Islamic finance literature, demonstrating that Islamic banks have unique pathways to enhance their financial performance. It also

highlights room for further study in identifying and implementing best practices to optimize operational efficiency and increase net operating margins in Islamic banks.

CONCLUSION

This research has uncovered several key findings on the factors influencing Return on Equity (ROE) in conventional and Islamic banks. In the context of conventional banks, variables such as Microfinance Banking Quality (KPPM), Non-Performing Loan (NPL), Net Interest Margin (NIM), Operational Costs to Operational Income (BOPO), and Loan to Deposit Ratio (LDR) were found to have a significant negative influence on ROE. For Islamic banks, Net Operating Margin (NOM) and BOPO emerged as important variables, with NOM having a positive impact and BOPO having a negative effect on ROE. These findings emphasize differences in the dynamics of variable influences on profitability between the two types of banks, with Islamic banks showing a stronger emphasis on operational efficiency and productivity.

For the conventional banking industry, these findings suggest the importance of risk management and operational efficiency as critical strategies to enhance profitability. Conventional banks must strengthen credit risk management practices and improve operational efficiency to optimize ROE. On the other hand, for Islamic banks, the research highlights the importance of enhancing operational efficiency and generating higher operational margins. Strategies to reduce operational costs and increase operational income, such as through Sharia-compliant product and service innovations, are crucial.

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