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THE EFFECT OF BUSINESS ENVIRONMENT ON THE ISLAMIC BANK PERFORMANCE IN INDONESIA: MEDIATING ROLE OF INNOVATION MANAGEMENT

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Abstract

The performance of Islamic banks, which have a much smaller market share and asset share than conventional banks, is contradictory to the Muslim population, which is the majority in Indonesia. Based on this background, this study aims to examine the effect of the business environment on the performance of Islamic banks, the influence of the business environment on innovation management, the influence of innovation management on Islamic bank performance, and the mediating effect of innovation management in the relationship between the business environment and the performance of Islamic banks. This study uses a causality research method. Explanatory research was carried out using a quantitative approach with cross-sectional data collection. The unit of analysis in this study is the Islamic banking service industry, so the target population is Islamic banks with a population according to data from the Financial Services Authority (OJK) totaling 197 Islamic banks consisting of three categories, namely Islamic Commercial Banks, Islamic Business Units, and Islamic People Financing Bank (BPRS). The number of samples taken was 130. The measurement scale in this study used an ordinal scale using the Likert method. The Structural Equation Modeling method was used to analyze the data. The research findings reveal that; the business environment does not have a significant effect on the performance of Islamic banks, the business environment has a significant effect on innovation management, innovation management has a significant effect on the performance of Islamic banks, and innovation management also mediates the influence of the business environment on the performance of Islamic banks. The mediating effect of innovation management is greater than its direct influence on the performance of Islamic banks. These findings show the important role of innovation management in improving the performance of Islamic banks. Innovation management that is developed by adapting to changes in the business environment will contribute more to improving the performance of Islamic banks. Thus, the results of this study provide managerial implications that Islamic bank management needs to consider the development of innovation management to improve Islamic bank performance, taking into account changes in the business environment.

Keywords: Business Environment, Innovation Management, Islamic Bank Performance.

INTRODUCTION

In the period 2017-2021, total Islamic financial assets which include the Islamic capital market, Islamic Non-Bank Financial Industry (IKNB Syariah), and Islamic banking in Indonesia have grown. The total assets of Islamic banking are the accumulation of the total assets of Islamic Commercial Banks (BUS), Islamic Business Units (UUS), and Islamic People Financing Banks (BPRS). The share of Islamic banking assets to national banking experienced a non-significant increase in the range of 6.74%, up 0.23% compared to the previous year (source: Financial Services Authority, 2022). Whereas according to the Financial Services Authority, the development of sharia banking is directed at providing the greatest benefit to society and contributing optimally to the national economy.

The market share of Islamic banks in Indonesia in 2021 is 6.74% while the remaining 93.26% is still controlled by conventional banks. Meanwhile, to increase the market share of Islamic banking, efforts are needed to encourage the performance of Islamic banking (Widarjono, 2018). The growth of Islamic banking assets in the period 2017 to 2021 has fluctuated, where the percentage of growth in 2021 is lower than in 2017, 2018, and 2019. Meanwhile, the growth of Financing Provided has continued to decline in the period 2017 to 2021. The growth of third party deposit funds has also tended to decrease in the 2017-2019 period. This condition is contradictory to the large Muslim population in Indonesia which reaches 86.88% of the total Indonesian population (Kusnandar, 2021). However, Islamic banks in Indonesia are relatively not fully optimal in taking advantage of these business opportunities. The presence of Islamic banks provides additional diversification of the financial business model in Indonesia.

On the other hand, organizations are facing unprecedented radical changes. The business environment is becoming increasingly turbulent, rapidly changing and unpredictable, increasingly diverse, and increasingly complex, with intense competitive pressures. It must be adapted so that the company can survive and prosper. Given the increasing challenges in a competitive environment, successful organizations must continuously adapt to changing conditions. (Klovienė and Gimzauskiene, 2015).

This is reinforced by the opinion of Pearce and Robinson (2015) that the external environment can influence the choice of direction and action, organizational structure, and the company's internal processes. Changes in external forces can lead to changes in consumer demand for industrial and consumer products and services. In the context of macroeconomic management, the widespread use of various Islamic financial products and instruments will strengthen the relationship between the financial sector and the real sector and create harmonization between the two sectors.

Meanwhile, previous studies have shown that the business environment can have an impact on company performance. Ibrahim and Primiana (2015) concluded that the business environment influences company performance. In addition, Klovienė and Gimzauskiene (2015) revealed that there is a relationship between the business environment and the company's performance measurement system. Another finding by Olokoyo et al. (2021) reveal that economic growth, trade, and interest rates, stand out as important macroeconomic predictors of bank performance in Nigeria. Meanwhile, in the Islamic banking sector, Damanhur et al. (2018) show that the inflation variable has a significant effect on the non-performing loan (NPF) ratio.

The findings of Damanhur et al. (2018) also show that the Gross Domestic Product variable also has a significant effect on the NPF ratio in the Sharia Unit of the Aceh Regional Development Bank (BPD). On the other hand, research findings also show different results where business environment aspects do not affect bank performance aspects.

For example, one of Shair's findings (2021) is that competition reduces the growth of technical efficiency in banks.

The results of this study indicate gaps about differences in the influence of the business environment on company performance. Therefore, this study intends to include innovation management as a mediation variable between the business environment and company performance. Previous research has shown the role of innovation management in company performance.

Olalere et al. (2021) show that financial innovation has a significant positive effect on the company value of Islamic banks in Malaysia. In addition, Ahmad et al. (2021) found that innovation can affect the performance of Islamic banks in Pakistan. Feimi et al. (2016) show that market dynamics positively and significantly impact innovation.

LITERATURE REVIEW

2.1 Business Environment

David (2013) suggests that external forces are divided into five broad categories, namely: (1) economic power, (2) social, cultural, demographic, and environmental forces, (3) political, governmental, and legal forces, (4) technological strength, (5) competitive strength. According to Pearce and Robinson (2015), the concept of the external environment is factors outside the company's control that affect the choice of direction and action, organizational structure, and internal company processes.

Changes in external forces can be changes in consumer demand for industrial and consumer products and services. External forces affect the types of products developed, the nature of promotions and market segmentation strategies, the types of services offered, and the choice of businesses to buy or sell. The external environment is divided into a remote environment, an industrial environment, and an operating environment. Based on that, business environment variables are measured by indicators: economic, political, social, cultural, government policies, technological developments, competition in the banking industry, customer profiles.

Innovation Management

Tornjanski et al. (2015) revealed that changes in the business environment over the past 30 years have made the banking sector experience a period of transformation which has resulted in the adoption of new business models suitable for dealing with uncertainty and complexity. Innovation in the banking industry is recognized as an influential factor that fundamentally changes the banking economy and the financial system in general. Tidd and Bessant (2013) put forward several forms of innovation, namely: product innovation, process innovation, position innovation, and paradigm innovation.

Serikan and Kızıloğlu (2015) measure innovation management in the banking sector with three indicators namely innovation systems, competitors and technology, and new services. Based on this study, innovation management in this study is measured by eight indicators which include: Islamic bank products have special attractive characteristics, Islamic bank products vary according to customer needs, Islamic bank product designs have more benefits than other bank products, characteristics of banking services excellence compared to other banks, guarantees for the quality of Islamic bank products, fulfillment of customer needs that have not been met by other bank services, development of new techniques in interacting with customers, identification of customer segments that have not yet used Islamic banks to be targeted as potential Islamic bank customers.

Performance of Islamic Banks

The company's performance indicators are sales growth and profitability (Best, 2009). Profitability, market share, or cost reduction are performance measures (Wheelen et al., 2015). In the field of Islamic banking, Ali (2020) measures the performance of Islamic banks using solvency ratios, profitability (ROA and ROE), efficiency, liquidity, and asset quality. Likewise, Ousama et al. (2019) measure the performance of Islamic banks based on profitability ratios, namely ROA and ROE.

Based on that, the performance variables of Islamic banks in this study are measured by eight indicators, namely: ROA, ROE, NIM, asset growth in the last five years, financing growth in the last five years, fund growth in the last five years, growth in market share of Islamic banks compared to conventional banks, and growth in market share of Islamic banks compared to group/parent companies.

Hypothesis Development

The business environment affects company performance (Ibrahim and Primiana, 2015). The business environment is related to the company's performance measurement system (Kloviené and Gimzauskiene, 2015). Inflation, GDP growth, and the real effective exchange rate have a significant impact on bank profitability (Combey and Togbenou, 2017).

Economic growth, trade, and interest rates stand out as important macroeconomic predictors of bank performance (Olokoyo et al., 2021). Inflation and gross domestic product variables have a significant effect on the NPF ratio (Damanhur et al., 2018). Based on that, the first hypothesis is formulated:

H1: The business environment influences the performance of Islamic banks.

Feimi et al. (2016) show that market dynamics positively and significantly impact innovation. Based on these findings, a second hypothesis was developed, namely:

H2: The business environment has a significant effect on innovation management.

Ndunga et al. (2016) show that the financial performance of commercial bank branches is positively influenced by innovation. Adoption of innovation by commercial banks presents a high potential for improving financial performance resulting in increased returns for shareholders.

Olalere et al. (2021) show that financial innovation has a significant positive effect on the company value of Islamic banks in Malaysia. In addition, Ahmad et al. (2021) found that innovation can affect the performance of Islamic banks in Pakistan. Based on these findings, a third hypothesis was developed, namely:

H3: Innovation management has a significant effect on innovation management.

Jatnika et al. (2019) showed that business model innovation mediates the effect of religiosity on business performance. Haret and Simiyu (2017) in a study on Islamic banks in Kenya investigated the influence of the external environment on the financial performance of Islamic banks.

Digital technology has changed the way businesses interact with customers and revolutionized the way banks serve customers and interact with them so that Islamic banks that utilize innovative technology can do more to serve shareholders and customers it has an impact on bank performance.

Based on these findings, it can be understood explicitly that the use of innovation management has an impact on the influence of the business environment, especially the technological environment on bank performance. Based on these findings, the fourth hypothesis was developed, namely:

H4: Innovation management mediates the influence of the business environment on innovation management.

METHODOLOGY

Based on the research objectives, this study used a causality research method, namely examining the causal relationship between the variables of the model described in the research paradigm. Explanatory research was carried out using a quantitative approach with cross-sectional data collection, namely data/information from the research taken at one time. The unit of analysis in this study is the Islamic banking service industry, so the target population is

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Islamic banks with a population according to data from the Financial Services Authority (OJK) totaling 197 Islamic banks consisting of three categories, namely Islamic Commercial Banks, Islamic Business Units, and Islamic People Financing Bank (BPRS).

The unit of observation or respondent is the management/top management of each of these banks. A cross-sectional study approach was used in this study and data collection was carried out by stratified sampling. The number of samples taken in this study was 130. The measurement scale in this study uses an ordinal scale using the Likert method which produces ordinal data. The ordinal measurement scale is a scale in which the data shows a certain order or sequence (Ferdinand, 2014). The SEM (Structural Equation Modeling) method was used to analyze the data. SEM is a method used to test research models, in which the method examines the structural relationships of the proposed conceptual framework where there are complex and built relationships between one or several variables and simultaneously analyzes indicators, latent variables (unobservable variables), and errors. Measurement.

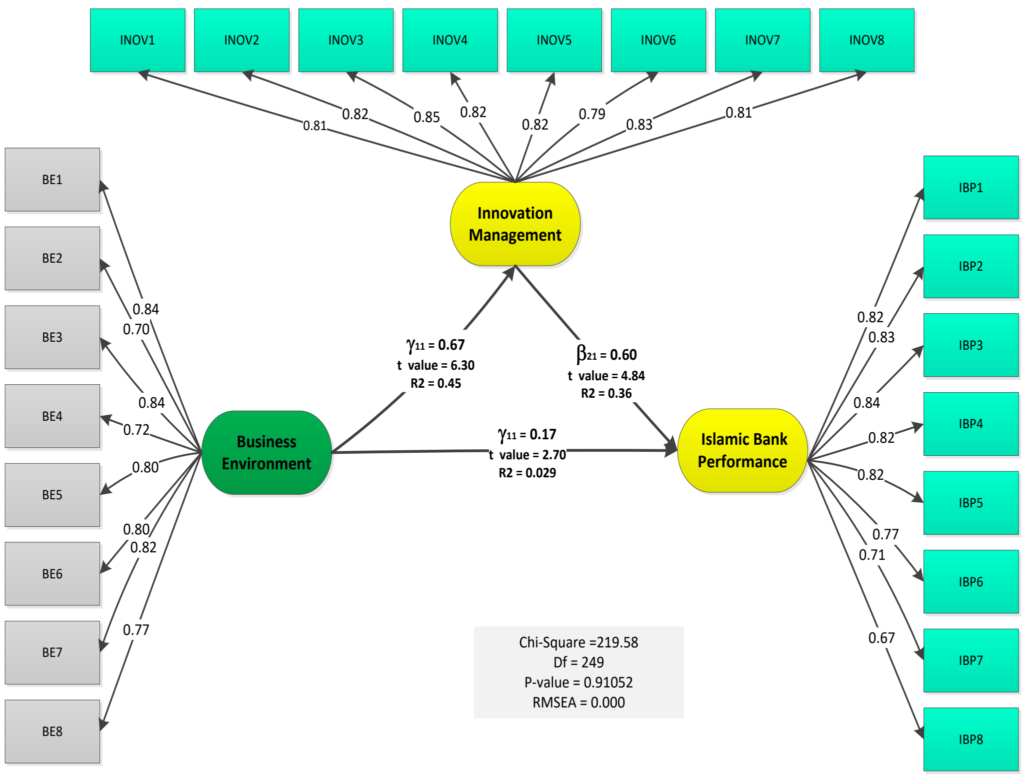
4. RESULT AND DISCUSSION

4.1 Model Evaluation (Goodness of Fit)

4.1.1 Structural Model Analysis

The results of the structural model analysis are described as follows:

Figure 1: Structural Model



Source: primary data processed by LISREL (2023)

The degree of agreement between the absolute fit and the RMSEA of this research model shows <0.05, the Chi-Square value of this study with Degrees of Freedom with a p value > 0.05 (α) so according to the Chi-Square index the fit of this research model is very good (Hair et al., 2010), so it can be concluded that the research model is in accordance with empirical conditions.

4.1.2 Measurement Model Analysis

The measurement model describes the relationship between each construct and indicators where the values are used to test validity and reliability. This analysis can be explained by the value of discriminant validity, loading factor, Construct Validity, and Composite Reliability. Construct Validity is explained by the factor loading value. Composite Reliability and Cronbachs Alpha are used to see the reliability or level of reliability of dimensions in measuring research variables. Analysis of the relationship between the indicator variables and their latent variables which are referred to as the measurement equation (measurement equation) is shown as follows.

Table 1: Measurement Model Test Results

Variable	Indicator	Loading factor (λ)	t Statistics	Prob	Average Variance Extracted (AVE)	Composite Reliability
Business Environment	LB1	0.84	10.16	0.000	0.621	0.929
	LB2	0.70	7.75	0.000		
	LB3	0.84	10.22	0.000		
	LB4	0.72	8.16	0.000		
	LB5	0.80	9.52	0.000		
	LB6	0.80	9.36	0.000		
	LB7	0.82	9.77	0.000		
	LB8	0.77	8.97	0.000		
Innovation Management	INOV1	0.81	-	-	0.671	0.942
	INOV2	0.82	9.55	0.000		
	INOV3	0.85	9.96	0.000		
	INOV4	0.82	9.56	0.000		
	INOV5	0.82	9.5	0.000		
	INOV6	0.79	9.08	0.000		
	INOV7	0.83	9.73	0.000		
	INOV8	0.81	9.31	0.000		
Islamic Bank Performance	IBP1	0.82	-	-	0.620	0.928
	IBP2	0.83	9.92	0.000		
	IBP3	0.84	10.03	0.000		
	IBP4	0.82	9.68	0.000		
	IBP5	0.82	9.64	0.000		
	IBP6	0.77	8.9	0.000		
	IBP7	0.71	7.89	0.000		
	IBP8	0.67	7.37	0.000		

Source: LISREL 8.5(2023)

The table above shows the results of measuring the first-order construct for variables with a factor loading (λ) > 0.50 with a prob <0.05 meaning that the indicator has good enough validity to explain latent constructs (Hair et al., 2010; Ghozali, 2008). The results show that the six variables have valid dimensions and indicators with arithmetic > t table at α = 0.05.The Construct Reliability (CR) value shows that all dimensions and indicators have a fairly high consistency with a value of > 0.7 (Nunnaly, 1994). Discriminant validity is explained by the value of the square root of the average variance extracted (AVE). The recommended value is above 0.5. And the results show that AVE > 0.5. So in general that the indicators and dimensions reflect all latent variables.

Hypothesis Testing

The results of hypothesis testing are shown in Table 2.

Table 2: Hypothesis Test

No	Hypothesis	Coeff. Estimate	standar error	t stat	Prob.	R^2
1	Business Environment → Islamic Bank Performance	0.170	0.110	1.56	0.122	0.029
2	Business Environment → Innovation Management	0.67*	0.110	6.30	0.000	0.449
3	Innovation Management → Islamic Bank Performance	0.600*	0,120	4.84	0.000	0.360
4	Business Environment → Innovation Management → Islamic Bank Performance	0.402**	0.104	3.87	0.000	0.402

*Significant at $\propto = 0.05$ (t table = 1.98)

**sobel test

Based on table 3 above it is concluded that:

Business Environment has no significant effect on Islamic Bank Performance with prob 0.122 > α (0.05), so hypothesis 1 is rejected.

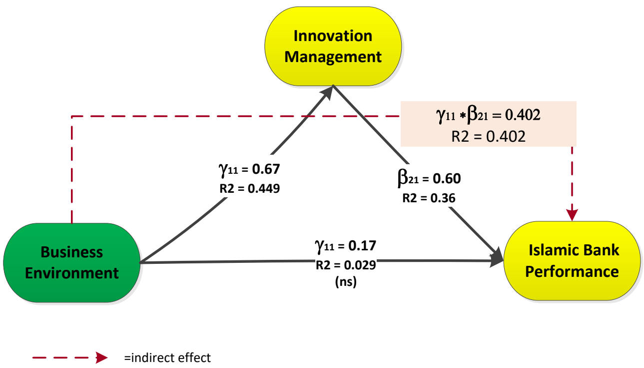
Business Environment has a direct coefficient of 0.670 and significant on Innovation Management with prob. 0.000 <α (0.05), so hypothesis 2 is accepted.

Innovation Management has a a direct coefficient of 0.600 and significant on Islamic Bank Performance with prob. 0.000 <α (0.05), so hypothesis 3 is accepted.

Business Environment has an indirect coefficient of 0.402 and significant Islamic Bank Performance through Innovation Management with prob. 0.000 < α (0.05), then hypothesis 4 is accepted.

Based on the results of hypothesis testing, the findings model is obtained as follows:

Figure 2: Research Finding



The research findings reveal that the business environment has no significant effect on the performance of Islamic banks. This is in contrast to the research findings of Ibrahim and Primiana (2015), Klovienė and Gimzauskiene (2015), Combey and Togbenou (2017), Olokoyo et al. (2021), and Damanhur et al. (2018). Meanwhile, the business environment has a significant effect on innovation management, in line with the findings of Feimi et al. (2016).

On the other hand, innovation management has a significant effect on business performance.

This is in line with the findings of Ndunga et al. (2016), Olalere et al. (2021), and Ahmad et al. (2021). Innovation management also mediates the influence of the business environment on the performance of Islamic banks. This is in line with the findings of Jatnika et al. (2019) and Haret and Simiyu (2017).

The findings of this study reveal that the mediating effect of innovation management is greater than its direct effect on the performance of Islamic banks. This reveals that the business environment can contribute to the performance of Islamic banks through innovation management. The adapted business environment becomes the input for developing innovation management which will have an impact on improving the performance of Islamic banks. However, if the business environment is only understood without being accompanied by innovation management efforts, then this will not encourage an increase in the performance of Islamic banks. This is because innovation management is capable of delivering an understanding of aspects of the business environment into something that can increase value in encouraging the performance of Islamic banks.

Thus, innovation management has an important role for Islamic banks which needs to be considered to keep abreast of developments in the business environment to improve their performance. The innovation management variable is constructed by eight indicators. Of these eight indicators, the indicator that gives the most dominant influence is the design of Islamic bank products that have more benefits than other bank products (with a loading factor of 0.85), followed by the development of new techniques for interacting with customers (0.83), Islamic bank products vary according to customer needs (0.82), the characteristics of superior banking services compared to other banks (0.82), guarantees for the quality of Islamic bank products (0.82), Islamic bank products have special attractive characteristics (0.81), identification of customer segments that have not used Islamic banks to be targeted as potential Islamic bank customers (0.81), and fulfillment of customer needs that have not been met by other bank services (0.79). This reveals that the development of Islamic bank product designs with more benefits than other banks can make the biggest contribution to driving the performance of Islamic banks. Customers are interested in using Islamic bank services when their products have greater benefits than the benefits received from other bank products. The more customers who experience more benefits, will have impact on improving the performance of Islamic banks.

CONCLUSION AND RECOMMENDATION

This research was conducted at the Islamic banking industry analysis unit in Indonesia, to examine the influence of the business environment on the performance of Islamic banks, the influence of the business environment on innovation management, the influence of innovation management on Islamic bank performance, and the mediating influence of innovation management in the relationship between the business environment and sharia bank performance. Based on the results of hypothesis testing, it was found that the business environment does not directly affect the performance of Islamic banks, but has a significant effect on innovation management. Innovation management has a significant effect on the performance of Islamic banks. Innovation management is also able to mediate the influence of the business environment on the performance of Islamic banks. The mediating effect of innovation management is greater than its direct influence on the performance of Islamic banks.

These findings indicate the important role of innovation management as a variable that can improve the performance of Islamic banks. Innovation management that is developed by adapting to changes in the business environment will contribute more to improving the performance of Islamic banks. Thus, the results of this study provide managerial implications that Islamic bank management needs to consider the development of innovation management to improve Islamic bank performance, taking into account changes in the business environment. The development of Islamic bank product designs with more benefits than other banks is an aspect of innovation management that needs to be prioritized. The more customers who experience more benefits, it will an impact on improving the performance of Islamic banks.

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