Sustainable Business in Islamic Banking: Challenges, Opportunities, and Determinants of Profitability

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Abstract

This study examines the challenges and opportunities for sustainable business in Islamic banking by investigating the effect of firm age, financing to deposit ratio (FDR), operational efficiency (BOPO), and Islamicity performance on profitability. The research question explores how these internal and Sharia-compliance indicators drive the rentability of Islamic banks in Indonesia. Using panel data from Islamic commercial banks over 2015–2023, the study applies multiple regression analysis to evaluate both partial and simultaneous effects. Empirical results reveal that firm age and FDR have a positive and significant effect on profitability, BOPO has a significant negative effect, while Islamicity performance shows no significant impact. These findings suggest that operational efficiency and financial structure remain primary determinants of sustainable profit growth, whereas Sharia compliance indicators may require longer-term integration to influence financial outcomes. The study contributes to the literature by highlighting how Islamic banks can navigate sustainability challenges and opportunities to enhance profitability.

Keywords: Islamic Banking, Sustainable Business, Profitability, Operational Efficiency.

Introduction

Islamic banking has become a vital pillar of the global financial system (Aggarwal & Yousef, 2000; Khasawneh, 2016; Windriya et al., 2023), offering Sharia-compliant solutions that emphasize ethical finance (Kusumaningtias, 2024; Tamburaka et al., 2021), risk-sharing (Hafeez et al., 2022), and social responsibility (Pratama & Deviyanti, 2022). Over the last decade, the industry has experienced rapid growth, particularly in Muslim-majority countries such as Indonesia, which holds significant potential for Islamic financial development. As competition intensifies in the banking sector, achieving sustainable business performance has emerged as both a critical goal and a challenging task for Islamic banks. Sustainable business in this context requires not only financial profitability but also the ability to adhere to Sharia principles while contributing to long-term economic stability and the Sustainable Development Goals (SDGs) (Ahmad & Ahmad, 2021; Fandira et al., 2023; Wulandini & Darlin, 2024).

Figure 1 provides an overview of the profitability growth (ROA) of five Islamic commercial banks in Indonesia between 2015 and 2023, illustrating both the potential and volatility of their financial performance. While some banks demonstrated stable returns, others experienced significant fluctuations, particularly during 2021, reflecting the sector's sensitivity to operational efficiency, financing structure, and external economic conditions. This volatility indicates the presence of inherent risks that may threaten sustainable profitability, emphasizing the need to examine the underlying factors driving these fluctuations. These trends highlight the importance of understanding how internal capabilities and Sharia-compliant practices interact to shape sustainable business outcomes. Accordingly, this study investigates the combined impact of firm age, FDR, BOPO, and IPI on the profitability of Islamic banks, addressing a critical gap in the literature by linking financial performance with the broader framework of sustainable business practices (Ordonez-Ponce et al., 2021; Wulandini & Darlin, 2024).

Figure 1. Profitability Growth of Islamic banks in Indonesia (Source: Data processed from Islamic bank financial reports 2015–2023)

Despite the promising landscape, Islamic banks face several challenges and opportunities in maintaining profitability (Bilgin et al., 2021; Khan, 2021). Internal factors such as firm age, financial intermediation measured through the Financing to Deposit Ratio (FDR), and operational efficiency (BOPO) are widely recognized as key determinants of banking performance. Additionally, Sharia compliance indicators like the Islamicity Performance Index (IPI) are increasingly scrutinized as measures of ethical and sustainable finance. However, the empirical evidence regarding their combined influence on profitability remains limited, especially within the context of sustainable business practices in Indonesia (Wahyudi, 2020).

This study aims to examine the effect of firm age, FDR, BOPO, and Islamicity performance on the profitability of Islamic banks in Indonesia, highlighting how these determinants can help navigate both challenges and opportunities in building sustainable business strategies. By providing empirical evidence, this research contributes to the literature on Islamic banking performance, offering practical insights for policymakers, practitioners, and scholars in enhancing the long-term sustainability and competitiveness of the sector (Hapsoro & Falih, 2020a, 2020b; Mubarok et al., 2024; Ordonez-Ponce et al., 2021; Safitri et al., 2022).

Literature Review

The performance of Islamic banks can be examined through several complementary theoretical perspectives, particularly Resource-Based Theory (RBT) (Collis, D.J., dan Montgomery, 2005) and Stakeholder Theory (Mahajan et al., 2023). Resource-Based Theory posits that an organization's sustainable competitive advantage arises from its unique resources and capabilities, which are valuable, rare, inimitable, and non-substitutable. In the context of Islamic banks, firm age represents the accumulation of organizational knowledge, market reputation, and operational experience, which strengthen their capacity to achieve stable and sustainable profitability. Similarly, operational efficiency (BOPO) reflects a critical internal capability, as the ability to manage operational costs effectively ensures that banks can convert their resources into higher financial performance, even under competitive market pressures (Prabowo et al., 2024).

Stakeholder Theory expands this perspective by emphasizing that a bank's success depends on how well it addresses the needs and expectations of its diverse stakeholders, including depositors, investors, regulators, employees, and Sharia supervisory boards . In Islamic banking, fulfilling Sharia requirements is not only a regulatory necessity but also a reputational asset that strengthens stakeholder trust and supports long-term sustainability. The Islamicity Performance Index (IPI) serves as a comprehensive indicator of Sharia compliance, encompassing aspects such as profit-sharing ratios, non-permissible income, zakat distribution, and social responsibility activities. High IPI scores demonstrate ethical alignment with stakeholders' values, which can indirectly influence financial performance by enhancing public confidence and market credibility (Aravik et al., 2023; Bayumi et al., 2024).

Integrating RBT and Stakeholder Theory provides a robust framework for evaluating Islamic banks' sustainable business performance, highlighting that both internal capabilities and stakeholder alignment are essential for navigating challenges and capturing opportunities in an increasingly competitive and ethical financial environment.

Previous studies highlight mixed evidence on the determinants of Islamic banks' profitability. While firm age and FDR are frequently associated with positive financial outcomes (Yosi Maytesa & Asmuni, 2023), BOPO often shows a negative relationship, reflecting the adverse impact of high operational costs. Research on IPI remains inconclusive: some studies report that strong Sharia compliance enhances sustainable performance (Zakiyyah et al., 2023), while others find limited short-term effects. This inconclusive evidence represents a gap that motivates the current study (Himawan & Widiastuti, 2021; Iqbal et al., 2022; Saddam et al., 2024; Tunggal & Ngatno, 2018; Wahyudi, 2020; Yosi Maytesa & Asmuni, 2023) .

Based on the theoretical foundation and prior empirical findings, the following hypotheses are proposed:
H1: Firm age positively affects the profitability of Islamic banks.
H2: Financing to Deposit Ratio (FDR) positively affects the profitability of Islamic banks.
H3: Operational efficiency (BOPO) negatively affects the profitability of Islamic banks.
H4: Islamicity Performance Index (IPI) positively affects the profitability of Islamic banks.
H5: Firm age, FDR, BOPO, and IPI simultaneously affect the profitability of Islamic banks.

Methods

This study adopts a quantitative research approach using panel data to analyze the determinants of Islamic banks' profitability and sustainable business performance. Quantitative methods are widely applied in banking and financial research because they allow for empirical validation of relationships between financial indicators and performance outcomes, ensuring objectivity and replicability (Lawrence, 2021; Sugiyono, 2016). This method is suitable for answering the research question, which examines how firm age, financing to deposit ratio (FDR), operational efficiency (BOPO), and Islamicity Performance Index (IPI) influence profitability in the context of sustainable business.

The sample was selected using purposive sampling, with the criterion that banks must provide complete financial and Sharia-compliant performance data for 2015–2023. Based on this criterion, five Islamic commercial banks in Indonesia were included: Bank Muamalat, Bank BCA Syariah, Bank Mega Syariah, Bank BJB Syariah, and Bank Panin Syariah. Secondary data were collected from annual reports, financial statements, and official publications of the Financial Services Authority (OJK) to ensure reliability and completeness.

To analyze the data, the study employs panel regression analysis, including fixed-effect and random-effect models, with the Hausman test used to select the most appropriate specification. The t-test is applied to evaluate the partial effects of each independent variable, while the F-test assesses the simultaneous effects of all variables. This research design allows for robust examination of how internal factors and Sharia compliance indicators shape Islamic banks' profitability and contribute to sustainable business performance.

Results and Discussion

The results of this study provide comprehensive insights into the determinants of profitability in Indonesian Islamic commercial banks within the framework of sustainable business practices. Using panel data from 2015 to 2023, the analysis examines the impact of firm age, Financing to Deposit Ratio (FDR), operational efficiency (BOPO), and the Islamicity Performance Index (IPI) on Return on Assets (ROA). The discussion begins with the selection of the most appropriate panel regression model, followed by the interpretation of the estimated coefficients, statistical tests, and their theoretical as well as practical implications. This structured approach ensures that the empirical findings are not only statistically valid but also meaningful in explaining the opportunities and challenges faced by Islamic banks in achieving sustainable profitability.

Table 1. Panel Model Selection Tests

Test	Prob. Value	Significance (α = 0.05)	Decision	Preferred Model
Chow Test (CEM vs FEM)	0.0107	< 0.05	Reject CEM	FEM
Hausman Test (FEM vs REM)	0.0159	< 0.05	Reject REM	FEM
Lagrange Multiplier Test (CEM vs REM)	0.3717	> 0.05	Fail to reject CEM	CEM

(Source: Data processed from Islamic bank financial reports 2015–2023)

The Chow test result (Prob = 0.0107 < 0.05) suggests that the Fixed Effect Model (FEM) is preferred over the Common Effect Model (CEM). Similarly, the Hausman test (Prob = 0.0159 < 0.05) indicates that FEM is more appropriate than the Random Effect Model (REM). However, the Lagrange Multiplier test shows Prob = 0.3717 > 0.05, which means that the Common Effect Model is preferred over REM. Considering the overall results, the Common Effect Model (CEM) was selected as the final model for this study. This decision aligns with the LM test, which evaluates the suitability of the panel data structure, and reflects that cross-sectional and time effects are not significantly different. Using CEM ensures that the analysis remains parsimonious while accurately estimating the relationships between the selected variables and the profitability of Islamic banks.

The multicollinearity test was conducted by examining the correlation coefficients among the independent variables. As shown in Table 2, all correlation values are below the threshold of 0.85, indicating that multicollinearity is not a concern in this study.

Table 2. Correlation Coefficients Among Independent Variables

Variables	X1 (Firm Age)	X2 (FDR)	X3 (BOPO)	X4 (IPI)
X1 (Firm Age)	1.000	-0.5454	-0.0514	-0.1759
X2 (FDR)	-0.5454	1.000	0.1657	0.0335
X3 (BOPO)	-0.0514	0.1657	1.000	0.0059
X4 (IPI)	-0.1759	0.0335	0.0059	1.000

(Source: Data processed from Islamic bank financial reports 2015–2023)

All correlation coefficients between the independent variables in this study range from –0.5454 to 0.1657, which are substantially below the commonly accepted critical threshold of 0.85. This finding indicates that the independent variables—firm age, Financing to Deposit Ratio (FDR), operational efficiency (BOPO), and the Islamicity Performance Index (IPI)—are not highly correlated with one another. Satisfying the no multicollinearity assumption is crucial in panel regression analysis because excessive collinearity among predictors can distort the estimation of coefficients, inflate standard errors, and reduce the statistical power of hypothesis testing. The absence of multicollinearity in this model ensures that each independent variable contributes unique and non-redundant explanatory power in capturing variations in the profitability (ROA) of Islamic commercial banks in Indonesia. Consequently, the regression results can be interpreted with confidence, as the effects of each determinant are isolated and not confounded by overlapping information among predictors.

Heteroskedasticity testing was conducted to assess whether the residuals of the regression model maintain constant variance (homoscedasticity) or exhibit unequal variance across observations, which may compromise the reliability of the estimated coefficients. Detecting heteroskedasticity is critical in panel data analysis because non-constant error variances can lead to inefficient estimates and biased standard errors, ultimately affecting the validity of hypothesis testing. In this study, the presence of heteroskedasticity was examined through a residual scatterplot and formal statistical tests to ensure the robustness of the model. Figure 1 illustrates the residual distribution for the dependent variable, Return on Assets (ROA), showing that the residuals are randomly dispersed around zero without forming any discernible pattern. This indicates the absence of heteroskedasticity, thereby confirming that the regression model satisfies the homoscedasticity assumption and the estimated results are statistically reliable for further interpretation.

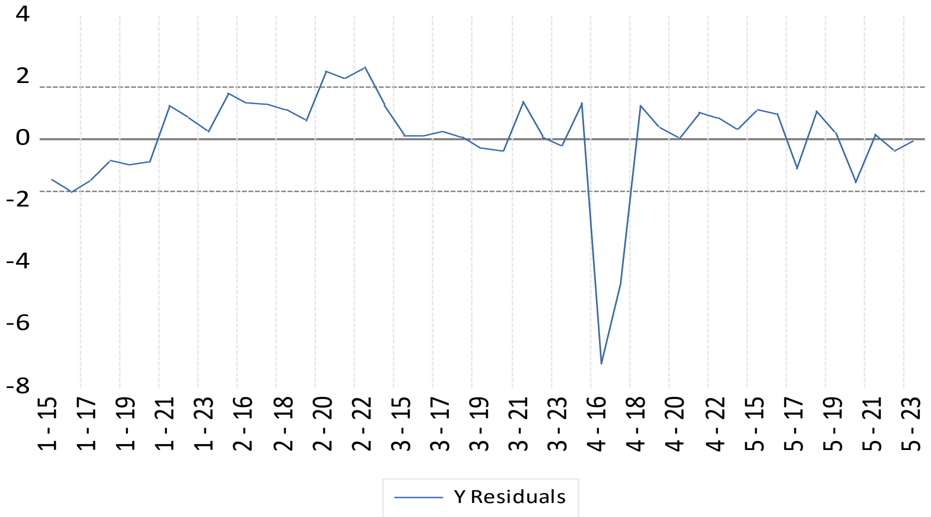

Figure 2. Residual Plot for Heteroskedasticity Test (Source: Data processed from Islamic bank financial reports 2015–2023)

From the residual plot, it can be observed that the distribution of residuals fluctuates randomly around zero without forming a clear pattern, except for a single sharp deviation in observation 4-16. Most residuals remain within the ±2 range, indicating that variance is relatively constant across the sample. Therefore, the model can be considered free from heteroskedasticity problems, and the residuals satisfy the homoscedasticity assumption for panel regression analysis.

Table 3. t-test and F-test Results

Variable	t-statistic	Sig. (p-value)	Interpretation
Firm Age (X1)	4.547	0.000	Positive and significant
Financing to Deposit Ratio (X2)	6.065	0.000	Positive and significant
BOPO (X3)	-8.133	0.000	Negative and significant
Islamicity Performance Index (X4)	0.433	0.666	Not significant
F-statistic	**Sig. (p-value)**		-
20.492	0.000		All variables simultaneously significant

(Source: Data processed from Islamic bank financial reports 2015–2023)

Table 5 presents the results of the t-test (partial effects) and F-test (simultaneous effects), which examine the impact of firm age, Financing to Deposit Ratio (FDR), operational efficiency (BOPO), and the Islamicity Performance Index (IPI) on the profitability of Islamic banks in Indonesia during 2015–2023.

The analysis reveals that firm age has a positive and significant effect on profitability ($t = 4.547$, $p < 0.05$), indicating that older Islamic banks benefit from accumulated experience, operational maturity, and stronger market reputation. These elements enhance their ability to generate sustainable profits, consistent with the Resource-Based Theory, which emphasizes the role of unique internal resources in driving long-term competitive advantage. Similarly, FDRdemonstrates a positive and significant effect ($t = 6.065$, $p < 0.05$), suggesting that efficient intermediation—where deposits are effectively channeled into financing—directly contributes to higher profitability. This result confirms that sound financial structure is a crucial driver of sustainable growth in Islamic banks .

In contrast, operational efficiency (BOPO) shows a negative and significant effect on profitability ($t = –8.133$, $p < 0.05$), meaning that higher operational costs erode earnings. This finding underscores the importance of cost control and operational discipline for achieving long-term business sustainability, as inefficiencies can reduce competitive strength in the banking sector. Meanwhile, the Islamicity Performance Index (IPI) exhibits a positive but statistically insignificant effect ($t = 0.433$, $p > 0.05$), indicating that Sharia compliance does not yield immediate financial benefits. Its contribution is likely to manifest in the longer term through enhanced stakeholder trust, market credibility, and reputational capital.

The F-test result ($F = 20.492$, $p < 0.05$) confirms that all independent variables collectively have a significant effect on the profitability of Islamic banks. This implies that sustainable performance is shaped by a combination of internal capabilities, financial intermediation, and compliance with Sharia principles. In practice, Islamic banks need to focus on improving operational efficiency and managing their financing strategies while strengthening Sharia-based initiatives to capture long-term opportunities for sustainable profitability.

Figure 2 illustrates the interconnection between challenges, opportunities, and sustainability linkages in Islamic banking. The left column highlights key challenges, including high operational costs (BOPO) that reduce profitability, the limited short-term financial impact of Sharia compliance (IPI), and the need to maintain an optimal Financing to Deposit Ratio (FDR) to manage liquidity and credit risk. These challenges reflect the internal pressures that Islamic banks face in achieving sustainable financial performance (Ibrahim et al., 2018; Ishartono; Raharjo, 2023; United Nations, 2015).

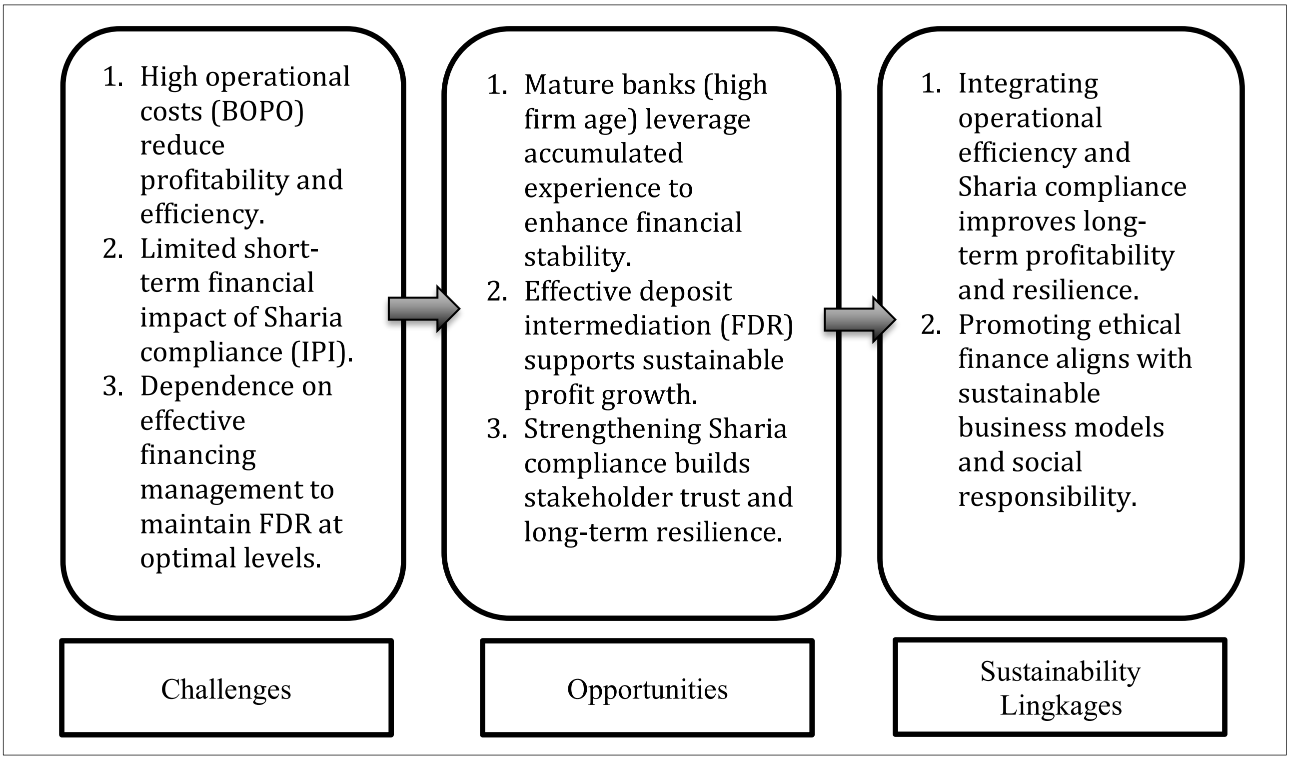

Figure 3. Challenges, Opportunities, and Sustainability Linkages in Islamic Banking (Source: Author's elaboration based on data processed from Islamic bank financial reports (2015–2023) and SDG framework)

The middle column illustrates the opportunities that Islamic banks can capitalize on through effective management strategies and sustainable operational practices. Mature banks with longer operational experience possess accumulated institutional knowledge, robust internal systems, and established market credibility, which collectively enhance their financial stability and capacity to weather economic fluctuations. This accumulated expertise enables banks to optimize strategic decision-making, improve risk management frameworks (Arsyadona & Siregar, S., Harahap, Sugianto, 2020; Han et al., 2023a, 2023b; Khairul Fatihin et al., 2024; Kusumaningtias, 2024; Sumarliah, 2021; Veithzal Rivai & Rifki Ismal, 2013), and leverage long-standing stakeholder relationships to support consistent performance.

Efficient financial intermediation, reflected through an optimal Financing to Deposit Ratio (FDR), plays a pivotal role in sustaining profit growth by ensuring that funds collected from depositors are productively channeled into financing activities that generate returns while maintaining liquidity adequacy. In parallel, strengthening Sharia compliance not only ensures adherence to ethical finance principles but also fosters trust among depositors, regulators, and the wider community. This combination of effective intermediation and strong ethical positioning enhances the bank's resilience, creates opportunities for product innovation aligned with Islamic values, and supports a sustainable trajectory of long-term growth in an increasingly competitive and regulated financial landscape (Ledhem & Mekidiche, 2020; OECD, 2021; World Bank, 2022).

The right column demonstrates how these determinants collectively converge into broader sustainability linkages, emphasizing the role of Islamic banking in promoting ethical (Bello et al., 2020) and resilient financial ecosystems . Operational efficiency, when combined with strong Sharia compliance, enhances the ability of banks to generate sustainable long-term profitability while simultaneously fostering stakeholder confidence and (Bayumi, 2022; Pudhail & Baihaqi, 2017) institutional credibility. This synergy enables Islamic banks to withstand external economic shocks, optimize resource utilization, and position themselves as competitive players in the modern financial landscape. Beyond the immediate financial returns, such alignment with Sharia principles serves as a strategic asset in building a business model that is socially responsible and future-oriented (Dess et al., 2013; Ellen MacArthur, 2020; World Economic Forum., 2021).

Moreover, these integrated linkages directly support the advancement of the Sustainable Development Goals (SDGs). By generating stable returns and enabling inclusive access to financial services, Islamic banks contribute to SDG 8 (Decent Work and Economic Growth). Their emphasis on responsible financing and risk-sharing models aligns with SDG 12 (Responsible Consumption and Production), while their commitment to ethical governance and transparency reinforces SDG 16 (Peace, Justice, and Strong Institutions). Collectively, these contributions illustrate that profitability and sustainability are not mutually exclusive but rather interdependent pathways. Islamic banking, therefore, holds a critical position in navigating contemporary challenges, leveraging emerging opportunities, and advancing a financial ecosystem that balances economic performance with long-term social and environmental well-being (Bayumi, 2022; Bayumi & Diem, 2023).

Conclusion

This study examines the impact of firm age, Financing to Deposit Ratio (FDR), operational efficiency (BOPO), and the Islamicity Performance Index (IPI) on the profitability of Islamic banks in Indonesia from 2015 to 2023. The findings reveal that firm age and FDR have a positive and significant effect on profitability, demonstrating that organizational maturity and effective financial intermediation are critical for sustainable performance. BOPO shows a negative and significant effect, confirming that higher operational costs reduce profitability. Meanwhile, IPI exhibits a positive but insignificant effect, suggesting that the benefits of Sharia compliance may emerge over the long term through enhanced stakeholder trust and reputational value.

This study contributes to the literature by highlighting the importance of balancing financial efficiency with Sharia compliance to achieve sustainable business performance in Islamic banking. However, several limitations should be acknowledged. The sample is limited to five Islamic commercial banks, and the study only considers a set of internal financial and Sharia indicators, without incorporating macroeconomic or regulatory factors that may influence profitability. These limitations could affect the generalizability of the findings. Future research should expand the sample size, include more diverse variables such as external economic indicators and risk management measures, and consider longer time horizons to capture the evolving impact of Sharia compliance on financial outcomes. Such studies will provide deeper insights into how Islamic banks can strengthen their resilience and sustainability in increasingly competitive financial markets.

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