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ANALYSIS OF PROFITABILITY DETERMINANTS IN ISLAMIC BANKS IN INDONESIA AND MALAYSIA

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ABSTRACT

The Islamic banking sector in Indonesia and Malaysia has grown significantly, with Islamic banks operating under Sharia principles, differing from conventional banks in business models and risk management. This study analyzes the impact of income diversification, capital adequacy, asset quality, operational efficiency, and liquidity on the profitability of Islamic banks, using secondary data from the annual financial reports of 20 Islamic banks from 2019–2023. The variables examined include Return on Assets (ROA), income diversification (DIV), capital adequacy ratio (CAR), non-performing financing (NPF), operational efficiency (BOPO), and liquidity. The findings show that income diversification, capital adequacy, operational efficiency, and the financing-to-deposit ratio (FDR) significantly impact profitability. However, the NPF ratio shows a negative but statistically insignificant effect on profitability, likely due to effective risk management. The FDR ratio has a positive and significant effect, indicating that proper financing allocation enhances profitability. Asset quality and operational efficiency are identified as the most significant factors affecting Islamic bank profitability in Indonesia and Malaysia. While income diversification, capital adequacy, and liquidity do not show significant effects, they remain important for careful management. This research provides key insights for Islamic bank management in improving profitability by focusing on credit risk and operational efficiency.

A. INTRODUCTION

The Islamic banking industry has grown significantly in many countries, including Indonesia and Malaysia (Naja et al., 2023). Unlike conventional banks, Islamic banks operate under Sharia principles and face challenges in maintaining financial stability and profitability amid intense competition (Bashir & Gorton, 2023). Key strategies include income diversification, capital adequacy, and asset quality management (Kinini et al., 2023). Diversification reduces reliance on a single revenue source, while capital adequacy and asset quality safeguard stability against financing risks (Mala et al., 2023; Sunarya, 2019)

Research suggests that income diversification enhances profitability (Mala, 2023). Capital adequacy, measured by the Capital Adequacy Ratio (CAR), helps banks absorb risks and sustain long-term profitability (Bintoro & Rahmadhani, 2021; Olawale, 2024). Asset quality, reflected in the Non-Performing Financing (NPF) ratio, negatively impacts Return on Assets (ROA), making credit risk management crucial (Rahmawati, 2021).

Operational efficiency and liquidity also influence profitability (Sugiarto & Sriyatun, 2024). Efficiency, measured by the operational cost-to-income ratio (BOPO), improves profitability (Phuanerys & Yanuar, 2020), while liquidity, assessed by the Financing to Deposit Ratio (FDR), ensures banks meet short-term obligations (Anggraeny et al., 2024; Irawati & Puspitasari, 2019).

This study examines the impact of income diversification, CAR, NPF, operational efficiency, and liquidity on Islamic bank profitability in Indonesia and Malaysia. Unlike prior research that explores these factors individually, this study investigates their combined effects to provide a comprehensive understanding of optimal strategies for enhancing Islamic bank profitability.

The Influence of Income Diversification on Profitability

Income diversification is a strategy banks use to enhance profitability and reduce risk (Chiorazzo et al., 2008; Thakur & Arora, 2024). In Islamic banking, income diversification may include multiple revenue sources, such as fee-based income, profit-sharing (through mudharabah and musharakah contracts), and securities trading (Mala et al., 2023). Income diversification theory posits that by broadening revenue sources, banks can better withstand market fluctuations and enhance long-term financial stability (Chiorazzo et al., 2008). Empirical research by Anggraeni and Berniz (2022) indicates that banks with better-diversified income streams tend to have more stable financial performance and higher profitability.

The Influence of Capital Adequacy (CAR) on Profitability

Capital Adequacy Ratio (CAR) measures the extent of a bank's capital to cover financing risks (Obeid, 2023). Strong capital enables banks to bear higher risks, expand financing activities, and maintain financial stability amid market fluctuations (Sunarya, 2019). Research by Nisar et al. (2018) and Olawale et al. (2024) found that CAR has a significant positive effect on profitability, with banks holding more capital often achieving better profitability. Additionally, Bintoro and Rahmadhani's (2021)

research shows CAR functions as a "risk buffer," allowing banks to maintain operational stability.

The Influence of Asset Quality (NPF) on Profitability

Asset quality, measured by the Non-Performing Financing (NPF) ratio, reflects the level of financing risk a bank faces (Gaur & Gupta, 2023). High NPF indicates challenges in credit management, which can reduce bank profitability (Nurdin & Jaya, 2024; Rahmawati, 2021). A study by Rahmawati et al. (2021) found that increased NPF has a significant negative impact on Islamic bank profitability in Indonesia, as higher problematic financing reduces operating income and raises operational costs associated with financing restructuring.

The Influence of Operational Efficiency (BOPO) on Profitability

Operational efficiency is measured by the Operating Cost to Operating Income (BOPO) rasio (Irawan et al., 2025). The lower the BOPO ratio, the more efficient a bank is in managing its operating expenses, positively impacting profitability (Phuanerys & Yanuar, 2020). Operational efficiency theory suggests that banks that effectively reduce operating costs achieve greater profit margins, ultimately increasing profitability. Phuanerys & Yanuar (2020) found that Islamic banks with higher cost management efficiency tend to be more profitable than those with higher BOPO ratios.

The Influence of Liquidity (FDR) on Profitability

Bank liquidity is measured by the Financing to Deposit Ratio (FDR), reflecting the proportion of financing provided relative to total deposits (Wahyudi et al., 2024). An optimal FDR can enhance profitability, as banks can channel deposits into productive financing (Irawati & Puspitasari, 2019). However, an excessively high FDR may increase liquidity risk, which can ultimately reduce profitability if the bank fails to meet its short-term obligations (Anggraeni & Berniz, 2022).

Based on the theoretical background and previous studies, this research formulates several hypotheses to explore the relationships between income diversification, capital adequacy, asset quality, operational efficiency, and liquidity on the profitability of Islamic banks in Indonesia and Malaysia. The following hypotheses are proposed to assess these key factors:

H1: Income diversification has a positive effect on the profitability of Islamic banks.
H2: Capital Adequacy Ratio (CAR) has a positive effect on the profitability of Islamic banks.
H3: Non-Performing Financing (NPF) has a negative effect on the profitability of Islamic banks.
H4: Operational efficiency (BOPO) has a negative effect on the profitability of Islamic banks.
H5: Financing to Deposit Ratio (FDR) has a positive effect on the profitability of Islamic banks.

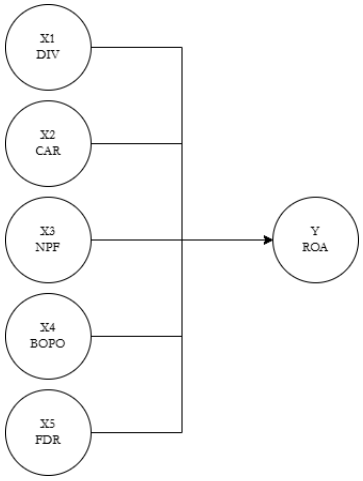
Conceptual Framework

The conceptual framework of this study is designed to illustrate the relationship between independent variables—income diversification, capital adequacy (CAR), asset quality (NPF), operational efficiency (BOPO), and liquidity (FDR)—and the dependent variable, which is the profitability of Islamic banks measured through Return on Assets (ROA).

This study adopts an approach grounded in financial theory and prior empirical studies to explain how each independent variable may influence the profitability of Islamic banks in Indonesia and Malaysia. This conceptual framework aids in understanding the mechanisms underlying the relationships between these variables and reflects the researchers' expectations regarding the outcomes of the empirical tests.

The diagram below illustrates the conceptual framework of this study, indicating the causal relationships between the independent variables and the dependent variable:

Figure 1. The Conceptual Framework



Source: Author

Income Diversification (DIV)

Income diversification is expected to have a positive impact on the profitability of Islamic banks (Susanto et al., 2024). The underlying theory suggests that by diversifying income sources, Islamic banks can reduce dependence on a single revenue stream, such as murabaha-based financing, while enhancing income from fee-based activities and securities trading. According to Chiorazzo et al. (2008), banks with more diversified income tend to achieve greater financial stability, thereby increasing profitability.

Capital Adequacy (CAR)

The Capital Adequacy Ratio (CAR) represents the level of capital a bank holds to cover potential losses from financing and investment activities. A high CAR

provides banks with greater flexibility to expand financing and withstand the risk of problematic financing. As noted in Sunarya's (2019) and Olawale (2024) research, higher CAR is directly linked to increased profitability, as banks with strong capital are better equipped to absorb losses.

Asset Quality (NPF)

Asset quality, measured by the Non-Performing Financing (NPF) ratio, is anticipated to have a negative effect on Islamic banks' profitability. A high NPF ratio indicates an increased level of problematic financing, which diminishes bank profitability. Rahmawati et al. (2021) found that elevated NPF levels can drain bank revenues and increase operational costs associated with collections or restructuring of troubled financing.

Operational Efficiency (BOPO)

The ratio of operational costs to operational income (BOPO) reflects how efficiently a bank manages its operational expenses to generate revenue. Lower BOPO ratios indicate greater efficiency, positively impacting profitability. Phuanerys & Yanuar (2020) support the theory that operationally efficient banks can maintain higher profit margins.

Liquidity (FDR)

The Financing to Deposit Ratio (FDR) illustrates the extent to which a bank uses deposit funds for productive financing. An optimal FDR is expected to positively impact profitability, as banks effectively channel financing resources (Navita et al., 2023). However, an excessively high FDR may pose liquidity risks, potentially reducing profitability if the bank struggles to meet short-term obligations.

Impact on Profitability (ROA)

Profitability in this study is measured by Return on Assets (ROA), indicating the bank's efficiency in managing assets to generate profit (Rakshit, 2023). Each independent variable is expected to impact ROA directly or indirectly, whether through enhanced financial stability (DIV and CAR), improved risk management (NPF), operational efficiency (BOPO), or optimal liquidity (FDR).

This conceptual framework forms the basis for empirical testing in this study, with the relationships between the independent variables and profitability examined using a panel data regression model. Consequently, this research aims to provide a more comprehensive understanding of the factors affecting the profitability of Islamic banks in Indonesia and Malaysia.

B. METHOD

This study utilizes secondary data obtained from the annual financial reports of 20 Islamic banks operating in Indonesia and Malaysia over the 2019–2023 period. The sample includes ten Islamic banks from each country. The financial data collected encompass variables such as Return on Assets (ROA), income diversification (DIV),

capital adequacy (CAR), asset quality (NPF), operational efficiency (BOPO), and liquidity (FDR).

The primary reason for using annual financial reports is their reliability and compliance with prevailing accounting standards. Annual reports offer detailed and comprehensive insights into the financial health of banks, including revenue structure, asset quality, and capital position. The 2019–2023 period was selected based on the availability of recent data, along with economic trends and changes in Islamic banking regulations in the region, providing insights into the impact of macroeconomic factors and financial market conditions on Islamic banks' profitability.

Sample and Procedure

This study employs purposive sampling to select Islamic banks that meet the following criteria:

a. The bank must publish annual financial reports from 2019 to 2023.
b. The bank must operate entirely under Sharia principles and hold a license in its respective country (Indonesia or Malaysia).
c. The bank must have substantial capital and assets, ensuring representativeness for the Islamic banking industry in both countries.

Purposive sampling was chosen as the study focuses on the profitability of Islamic banks in two countries, making sample selection criteria essential for obtaining relevant data. Smaller banks or those with incomplete financial records were excluded. Indonesia and Malaysia were chosen due to their substantial Muslim populations and rapidly growing Islamic banking sectors.

Financial reports were sourced from official sites, including each bank's website, and databases such as the Financial Services Authority (OJK) for Indonesia and Bank Negara Malaysia (BNM) for Malaysia. All data were verified with official sources to ensure validity and accuracy.

Measurement

The study uses several key indicators to measure the independent and dependent variables, described as follows:

Profitability (ROA): Measured using the Return on Assets (ROA) ratio, which serves as a primary indicator of profitability:

$$ROA = \frac{\text{Net Income}}{\text{Total Assets}}$$

Higher ROA values indicate greater efficiency in asset utilization for generating profits.

Income Diversification (DIV): Measured using an income diversification ratio, referencing Chiorazzo et al. (2008):

$$DIV = 1 - (SH_{NET}^2 + SH_{NON}^2)$$

Capital Adequacy (CAR): Calculated using the standard regulatory formula:

$$CAR = \frac{\text{Total Capital}}{\text{Risk} - \text{Weighted Assets}} \text{ x } 100$$

Asset Quality (NPF): Measured through the Non-Performing Financing (NPF) ratio:

$$NPF = \frac{\text{Non} - \text{Performing Financing}}{\text{Total Financing}} \text{ x } 100$$

This ratio assesses the bank's asset quality and credit risk potential.

Operational Efficiency (BOPO): Measured by the ratio of operating expenses to operating income (BOPO):

$$BOPO = \frac{\text{Operating Expenses}}{\text{Operating Income}} \text{ x } 100$$

Liquidity (FDR): Measured by the Financing to Deposit Ratio (FDR):

$$FDR = \frac{\text{Total Financing}}{\text{Total Deposits}} \text{ x } 100$$

Data Analysis

The collected data will be analyzed using EViews software to conduct panel data regression. EViews was selected for its ability to handle both cross-sectional and time-series data, which aligns with the nature of this panel data study. Panel data analysis allows the combination of data across time periods and banks, providing more robust analysis and reducing estimation bias.

The study will employ a panel data regression model using the Fixed Effects Model (FEM) to account for unique characteristics across Islamic banks that may not be directly observable. A Hausman test will be conducted to choose between the Fixed Effects Model and the Random Effects Model.

The regression equation for this study is as follows:

$$ROA_{it} = \alpha_0 + \alpha_1 DIV_{it} + \alpha_2 CAR_{it} + \alpha_3 NPF_{it} + \alpha_4 BOPO_{it} + \alpha_5 FDR_{it} + \epsilon_{it}$$

Which is:

ROA_{it} = Bank profitability i pada tahun t

DIV_{it} = Revenue diversification bank i pada tahun t

CAR_{it} = Capital adequacy of bank i pada tahun t

NPF_{it} = Asset quality (non-performing financing ratio) of bank i pada tahun t

$BOPO_{it}$ = Operational efficiency of bank i pada tahun t

FDR_{it} = Liquidity of bank i pada tahun t

ϵ_{it} = Error term

Prior to regression analysis, classical assumption tests will be conducted, including:

- **Multicollinearity Test**: Using the Variance Inflation Factor (VIF) to ensure no multicollinearity among independent variables.
- **Heteroscedasticity Test**: To check for non-constant variance in error terms.

Following regression, statistical tests will evaluate the significance of independent variables on the dependent variable. Hypothesis testing will use significance levels of 5% and 1%, focusing on regression coefficients and p-values for each variable.

C. RESULT AND DISCUSSION

To illustrate the characteristics of the data collected and processed in this study, descriptive statistical analysis was conducted on each variable. The parameters examined include the mean, minimum, and maximum values. Additionally, standard deviation and variance were assessed to enhance understanding of data distribution. Table 1 presents the results of this analysis, with further explanations provided in the following section.

Table 1. The Results of Descriptive Analysis of Variables

	DIV	CAR	NPF	BOPO	FDR	ROA
Mean	0.553000	0.115500	0.125500	0.817000	0.580200	0.028900
Maximum	0.670000	0.230000	0.240000	0.940000	0.720000	0.042000
Minimum	0.430000	0.020000	0.030000	0.700000	0.440000	0.015000
Std. Dev.	0.060478	0.055220	0.058816	0.060478	0.065828	0.006411

Source: Data processed by the researcher through EViews Software V.13, 2024.

The descriptive analysis results reveal the mean and variability for six main variables: DIV, CAR, NPF, BOPO, FDR, and ROA. The DIV (Income Diversification) variable has an average of 55.3% with a low standard deviation (0.060478), indicating consistency across firms. CAR (Capital Adequacy Ratio) averages 11.55%, but shows moderate variation with a standard deviation of 0.05522, suggesting differences in capital adequacy levels. NPF (Non-Performing Financing) is low, with an average of 12.55%, indicating that problematic financing is relatively controlled. BOPO

(Operating Expenses to Operating Income) averages 81.7%, suggesting that a significant portion of the banks' revenue is allocated to operational costs.

The FDR (Financing to Deposit Ratio) variable shows an average of 58.02%, indicating that a substantial amount of deposited funds is allocated to financing, with moderate variation among firms. Meanwhile, ROA (Return on Assets) averages at a low level of 2.89%, with a small standard deviation (0.006411), reflecting uniform but modest profitability. Overall, these findings provide insights into efficiency, profitability, financing risk, and capital adequacy among the firms studied.

Model Selection Test

Two main testing stages were conducted to select the best estimation method for the panel data regression analysis. In the first stage, the Chow Test was applied to compare the Common Effect Model (CEM) and the Fixed Effect Model (FEM). If the test results indicate that CEM is preferable, this model is recommended for data analysis. In the second stage, the Hausman Test was used to determine which model is more suitable between FEM and the Random Effect Model (REM). This test aids in identifying whether more consistent estimates are obtained through the fixed effects or random effects model, based on the assumptions and characteristics of the data.

Table 2. Chow Test Results and Hausman Test Results

Effects Test		**Statistic**	***d.f.***	**Prob.**
Cross-section F		284.638396	(19,75)	0.0000
Cross-section Chi-square		429.194319	19	0.0000
Test Summary	**Chi-Sq. Statistic**		**Chi-Sq. *d.f.***	**Prob.**
Cross-section random		5408.129530	5	0.0000

Source: Data processed by the researcher through EViews Software V.13, 2024.

The results of the Chow Test and Hausman Test in Table 2 indicate that FEM is more appropriate than both CEM and REM. For the Chow Test, the Cross-section F value (284.64) and Cross-section Chi-square value (429.19) were both significant (p-value = 0.0000), leading to the rejection of the null hypothesis that CEM is preferable over FEM. Furthermore, in the Hausman Test, the Chi-square value (5408.13) was also significant (p-value = 0.0000), which means the null hypothesis that REM is more suitable than FEM is rejected. Based on these results, FEM is identified as the appropriate model for this study, as it better captures the cross-sectional variation within the data.

Classical Assumption Test

Table 3. Testing Classical Assumptions

Normality Test			
			Series: Residual
Observations			100
Jarque-Bera			2.020480
Probability			0.364132
Multicollinearity Test			
Variable	**Coefficient Variance**	**Uncentered VIF**	**Centered VIF**
C	0.001387	38.56255	N/A
DIV	0.001364	8.872361	1.045485
CAR	0.004862	23.86450	1.032564
NPF	0.001554	9.045862	1.015483
BOPO	0.005632	1.556332	1.025842
FDR	0.004526	7.568216	1.035478
Heteroskedasticty Test: White			
$F_{\text{-statistic}}$	1.284578	Prob. F (9,95)	0.2745
$Obs^{*}R_{\text{-squared}}$	11.35485	Prob. $_{\text{Chi Square(9)}}$	0.2478
Scaled explained SS	7.785652	Prob. $_{\text{Chi Square(9)}}$	0.5642
Breush-Godprey Serial Correlation LM Test:			
$F_{\text{-statistic}}$	10.17856	Prof. F(2,99)	0.0001
$Obs^{*}R_{\text{-squared}}$	17.45872	Prob. $_{\text{Chi Square(2)}}$	0.0001

Source: Data processed by the researcher through EViews Software V.13, 2024

The results of the Classical Assumption Test indicate that the model meets several classical assumptions, though issues persist with certain others. In the Normality Test (Jarque-Bera), a p-value of 0.364132 suggests that residuals are normally distributed, as it is greater than 0.05. The Multicollinearity Test shows low VIF (Variance Inflation Factor) values, all below 10, indicating no significant multicollinearity among the independent variables. In the Heteroskedasticity Test (White Test), a p-value of 0.2478 exceeds 0.05, suggesting no heteroskedasticity. However, the Breusch-Godfrey Serial Correlation LM Test reveals a p-value of 0.0001, indicating the presence of autocorrelation in the data.

Panel Data Regression Analysis

$$Y = 0.0846229852451 + 0.0256672760299*X1 + 0.0134592568918*X2 - 0.00101806402861*X3 - 0.09725573434*X4 + 0.0139851239758*X5 + [CX=F]$$

This panel regression equation illustrates how each independent variable—X1, X2, X3, X4, and X5—affects the dependent variable Y within the Fixed Effects Model (denoted by [CX=F]). The intercept value of 0.0846 represents the average Y value when all independent variables are zero. Positive coefficients for X1 (0.0257), X2 (0.0135), and X5 (0.0140) indicate that increases in these variables contribute positively

to Y, assuming other variables remain constant. Specifically, a 1-unit increase in X1, for example, is estimated to increase Y by 0.0257.

Conversely, negative coefficients for X3 (-0.0010) and X4 (-0.0973) suggest that increases in these variables tend to decrease Y. Notably, X4 has the largest negative impact among all variables, indicating that an increase in X4 has a more significant effect in reducing Y than other variables. Overall, this model provides insights into the role each variable plays in determining Y, with X4 exerting a strong negative influence, while X1 and X2 contribute smaller, positive impacts.

4.5. Hypothesis Testing

Table 4. Hypothesis Testing Results or $T_{\text{-tests}}$

Variable	Coefficient	Std. Error	$t_{\text{-Statistic}}$	Prob.	Explanation
C	0.084623	0.006294	13.44488	0.0000	
DIV	0.025667	0.001662	15.44064	0.0000	Accepted
CAR	0.013459	0.001367	9.848281	0.0000	Accepted
NPF	-0.001018	0.002004	-0.508016	0.6129	Rejected
BOPO	-0.097256	0.005215	-18.64958	0.0000	Accepted
FDR	0.013985	0.004705	2.972409	0.0040	Accepted

Source: Data processed by the researcher through EViews Software V.13, 2024

Implications of Results for Income Diversification (DIV) on Islamic Bank Profitability

The analysis shows a positive coefficient for the DIV variable at 0.0257, indicating that an increase in income diversification tends to enhance the profitability of Islamic banks. With a p-value of 0.0000 (less than 0.05), this effect is statistically significant, affirming that income diversification can be a key strategy for boosting profitability. Consequently, hypothesis H1 is accepted. This positive impact suggests that the more diversified an Islamic bank's revenue sources, the greater its profit potential. Diversification helps banks spread risk and increase revenues from various products or services, ultimately improving overall profitability.

Implications of Capital Adequacy Ratio (CAR) on Islamic Bank Profitability

The CAR variable coefficient is 0.0135, demonstrating a positive relationship between capital adequacy and profitability. A p-value of 0.0000 (below 0.05) indicates statistical significance. Thus, an increase in CAR is likely to enhance profitability, potentially because adequate capital enables banks to manage risks effectively. Based on this result, H2 is accepted. The positive and significant influence of CAR on profitability suggests that sufficient capital strengthens banks' resilience to risk while enabling revenue growth opportunities, such as extending financing to clients.

Implications of Non-Performing Financing (NPF) on Islamic Bank Profitability

The NPF variable has a negative coefficient of -0.0010, aligning with the expected direction. However, with a p-value of 0.6129 (greater than 0.05), the

relationship is statistically insignificant. This indicates that while an increase in NPF tends to reduce profitability, its effect is not strong enough to be statistically significant in this study. Thus, hypothesis H3 is rejected. This finding suggests that the ratio of non-performing financing does not significantly impact the profitability of Islamic banks in this sample. Effective risk management or strict reserve policies may mitigate the impact of NPF, resulting in minimal effects on profit despite increases in NPF.

Implications of Operational Efficiency (BOPO) on Islamic Bank Profitability

The BOPO coefficient is -0.0973, indicating that improved operational efficiency (lower BOPO) has a strong negative impact on Islamic bank profitability. With a p-value of 0.0000 (below 0.05), this influence is statistically significant, showing that higher BOPO (inefficiency) reduces profitability. Accordingly, H4 is accepted. This significant negative effect highlights the importance of operational efficiency for supporting profitability. A high BOPO reflects high operational costs relative to income, which reduces net profit. Therefore, Islamic banks need to maintain a low BOPO by improving operational efficiency to enhance profitability.

Implications of Financing to Deposit Ratio (FDR) on Islamic Bank Profitability

The FDR variable has a positive coefficient of 0.0140, indicating that the financing-to-deposit ratio positively correlates with profitability. With a p-value of 0.0040 (below 0.05), this relationship is statistically significant, suggesting that increasing FDR can boost profitability by efficiently channeling deposit funds into productive financing. Based on this result, H5 is accepted. The positive impact of FDR implies that Islamic banks that actively allocate deposits toward financing can improve their income and profitability, supporting an aggressive financing strategy that optimizes deposit funds for higher returns.

The regression results provide several key findings on factors influencing the profitability of Islamic banks in Indonesia and Malaysia:

Income Diversification (X1) significantly affects profitability, supporting prior research such as Chiorazzo et al. (2008), which found that income diversification generally has a positive effect on bank profitability. Diversified income sources increase profit potential by reducing dependency on a single revenue stream.

Capital Adequacy (X2) shows a significant effect on profitability, consistent with studies such as Nisar et al. (2018), indicating a positive relationship between CAR and profitability. In this context, adequate capital provides Islamic banks with resilience to risk and revenue growth opportunities.

Asset Quality (NPF, X3) shows an insignificant negative impact on profitability, aligning with prior studies (Rahmawati et al., 2021) that suggest higher non-performing financing ratios tend to lower profitability. However, in this study, the effect is not statistically significant, possibly due to effective credit risk management strategies.

Operational Efficiency (BOPO, X4) has a strong negative effect on profitability, supporting Phuanerys & Yanuar (2020), which posits that banks with efficient operational cost management achieve higher profit margins.

Liquidity (FDR, X5) significantly influences profitability, potentially because an optimal FDR can enhance income through productive financing, while high FDR levels may increase liquidity risks.

D. CONCLUSION

This study examines the influence of income diversification, capital adequacy, asset quality, operational efficiency, and liquidity on the profitability of Islamic banks in Indonesia and Malaysia. The findings reveal that several factors significantly affect profitability. Income diversification (DIV) and capital adequacy ratio (CAR) positively and significantly impact profitability, emphasizing the importance of diverse revenue streams and adequate capital in enhancing profitability. Operational efficiency (BOPO) has a significant negative impact, indicating that high operational costs reduce profitability. The financing-to-deposit ratio (FDR) also has a positive and significant effect, suggesting that greater financing allocations improve profitability. However, asset quality, measured by non-performing financing (NPF), has an insignificant negative effect, indicating that problematic financing does not statistically impact profitability.

These findings suggest that strategies to enhance profitability should focus on financing risk management and operational efficiency. Islamic banks are advised to continue diversifying revenue sources to enhance stability and profitability potential. Recommended steps for Islamic banks include maintaining and improving CAR to strengthen risk resilience and growth opportunities, focusing on more efficient operational cost management, implementing effective credit risk management to minimize potential future negative impacts, and ensuring adequate liquidity risk management to meet short-term obligations without disruptions.

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