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CREDIT RISK, LENDING ACTIVITY, AND BANK PERFORMANCE UNDER INFLATIONARY PRESSURE: EVIDENCE FROM ISLAMIC BANKING IN INDONESIA

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ABSTRACT

Objective: This study aims to analyze the effect of financing risk and financing distribution activities on the performance of the Islamic banking industry in Indonesia, as well as to examine the role of inflation as a macroeconomic factor that influences this relationship. The main focus of this study is on the dynamics of the profitability of the Islamic banking industry in the face of financing expansion and inflationary pressures.

Research Design & Methods: This study uses a quantitative approach with an explanatory design based on quarterly time series data. The unit of analysis is at the level of the Islamic banking industry in Indonesia. The dependent variable is industry performance, proxied by return on assets (ROA), while the independent variables include financing risk (non-performing financing/NPF), total financing transformed into natural logarithms, and inflation. The estimation is performed using the Common Effect Model (CEM) regression model, with additional testing through an interaction model to capture the role of inflation as a conditional factor.

Findings: The results indicate that financing expansion has a negative and significant effect on ROA, suggesting that growth in financing has not been fully translated into improved profitability. Inflation exhibits a positive and statistically significant effect on ROA within the observed sample period, indicating the industry's capacity to adjust margins under prevailing inflationary conditions. Financing risk shows a negative but statistically insignificant effect. Furthermore, the interaction term between NPF and inflation is negative, implying that higher inflation intensifies the adverse effect of financing risk on industry performance.

Implications & Recommendations: These findings emphasize the importance of strengthening financing quality, risk management, and macroeconomic policy coordination to maintain the sustainability of the Islamic banking industry's performance.

Contribution & Value Added: This study provides empirical contributions by presenting industry-based evidence on the relationship between financing risk, financing, and inflation on the profitability of Islamic banking in developing countries.

Keywords: Islamic banking, financing growth, bank profitability.

JEL codes: G28, E31, O16.

Article type: research paper

INTRODUCTION

Islamic banking plays an increasingly strategic role in the modern financial system, especially in countries with a Muslim majority such as Indonesia, due to its ability to link financial intermediation functions with Sharia-based ethical and sustainability principles. In contemporary financial literature, banking performance is widely understood as the result of a balance between financing expansion and credit risk management, where failure to maintain this balance has the potential to weaken bank profitability and stability in the medium to long term (Athanasoglou et al., 2008; Siddik et al., 2025). Credit risk is consistently identified as a key determinant of banking performance because it directly affects the quality of productive assets, provisioning requirements, and the efficiency of bank resource utilization (Naili & Lahrchi, 2022a). In the context of Islamic banking, credit risk is represented by the non-performing financing (NPF) ratio, which reflects the proportion of non-performing financing to total financing disbursed. A number of recent empirical studies show that an increase in NPF has a significant negative impact on the profitability of Islamic banks, which is generally measured by return on assets (ROA), even though banks operate under the principles of risk-sharing and linkage with the real sector (Abedifar et al., 2016; Srairi, 2025). This shows that sharia characteristics do not automatically eliminate financing risks, but rather change the mechanism of risk transmission to bank performance. In Indonesia, this phenomenon has become increasingly

relevant given the relatively stable growth of sharia banking assets over the past decade, accompanied by fluctuations in financing quality influenced by domestic economic dynamics. Thus, understanding the relationship between credit risk and Islamic banking performance is not only important from a managerial perspective, but also crucial for the sustainability of the Islamic financial system as a whole. However, most previous studies have focused on analyzing individual banks or using a cross-country approach, which has the potential to obscure systemic dynamics at the national industry level.

In addition to credit risk, lending activity is a key pillar of banking intermediation and a major source of banks' operating income (Naili & Lahrchi, 2022b). Financial intermediation theory asserts that an increase in the volume of credit or financing, if managed efficiently, can increase bank profitability through the expansion of the revenue base and optimization of asset utilization (Bourke, 1989; Rahman et al., 2023). In Islamic banking, financing distribution has an additional dimension because it must be in line with Islamic principles, including the prohibition of usury, gharar, and maysir, as well as the encouragement to support productive real economic activities. Recent empirical literature shows that the expansion of Islamic bank financing can contribute positively to financial performance, but this relationship is conditional and highly dependent on the quality of financing risk management (Berger et al., 2016; Demirgüç-Kunt et al., 2020). This phenomenon indicates a trade-off between financing growth and increased credit risk, which, if not managed properly, can put pressure on bank profitability through an increase in non-performing financing. In the Indonesian context, total Islamic banking financing shows an upward trend in line with market share expansion and national policy support for the Islamic economy. However, this increase in financing has also been accompanied by volatility in the NPF ratio during certain periods, particularly during economic slowdowns. This condition confirms that lending activities cannot be separated from credit risk dynamics in determining Islamic banking performance. Nevertheless, empirical literature is still limited in examining the simultaneous relationship between credit risk, financing distribution activities, and Islamic banking performance in an integrated analytical framework, especially at the national banking industry level.

The dynamics of the relationship between credit risk, financing activities, and banking performance become increasingly complex when placed in the context of macroeconomic pressures, particularly inflation. Inflation is a macroeconomic variable that has broad implications for financial system stability because it affects the real value of debtors' income, bank operating costs, and credit demand and supply behavior (Borio et al., 2017; Fazio et al., 2018). The macro-financial literature shows that rising inflation tends to weaken debtors' ability to meet their payment obligations, thereby increasing credit risk and putting pressure on bank profitability (Abusharbeh, 2022). In Islamic banking, sensitivity to inflation can be higher because financing is generally based on the real sector and is highly dependent on the continuity of customer business activities (Rahman et al., 2023). The post-COVID-19 pandemic inflation phenomenon, triggered by global supply chain disruptions, rising energy prices, and monetary policy tightening in various countries, has put additional pressure on the banking system, including Islamic banking in Indonesia (Raza, 2024). Although Indonesia's inflation rate is relatively more controlled than in some other countries, inflation fluctuations in recent years still have the potential to affect the quality of financing and banking performance (Nawir et al., 2025). Recent empirical studies confirm that inflation not only has a direct effect on bank profitability, but also moderates the relationship between credit risk and banking performance (Abdelaziz et al., 2022; My & Quoc, 2022). However, empirical evidence on the role of inflation as a moderating factor in the context of Islamic banking is still relatively limited and fragmented, especially at the national industry level that captures systemic dynamics in aggregate.

Based on the above explanation, there is a significant gap in the literature in understanding how credit risk and financing activities simultaneously affect the performance of Islamic banking under inflationary pressure, particularly in the context of Indonesia as one of the largest Islamic financial markets in the world. Most previous studies tend to analyze this relationship partially, focusing on the individual bank level, or ignoring the role of the macroeconomic context as a factor that shapes the strength and direction of the relationship between variables. This study attempts to fill this gap by examining the relationship between credit risk, lending activities, and Islamic banking performance at the industry level, while integrating inflation as a contextual factor that influences the dynamics of this relationship. With this approach, the study is expected to provide a more comprehensive understanding of the trade-off between risk and intermediation in Islamic banking, as well as its implications for the stability and sustainability of the Islamic financial system. The novelty of this research lies in its ability to capture the systemic dynamics of Indonesia's Islamic banking industry, integrate inflationary pressures as a macroeconomic context that shapes the relationship between risk and performance, and focus the analysis on the fundamental mechanisms of intermediation and risk that are relevant to the development of contemporary Islamic finance and halal finance literature.

LITERATURE REVIEW

This study positions the Islamic banking industry as a financial system that operates in close relation to financing risk, intermediation functions, and macroeconomic conditions. Within this framework, the performance of the Islamic banking industry is not understood as the result of individual decisions made by each bank, but rather as the outcome of collective interactions between banks facing the same regulatory environment, monetary policy, and economic shocks. Banking literature emphasizes that an aggregate approach at the industry level allows for

the capture of systemic dynamics that are not observable in micro analysis, especially when macroeconomic variables act as common shocks that simultaneously affect all industry players. In the context of Islamic finance, this approach becomes increasingly relevant because real sector-based financing creates a direct link between the performance of the Islamic banking industry and the national economic cycle, so that changes in macro conditions have the potential to affect asset quality and profitability collectively (Siddik et al., 2025; Srairi, 2025).

Within this conceptual framework, credit risk is understood as the main mechanism for transmitting economic pressures from the real sector to the banking system (Naili & Lahrichi, 2022b). The non-performing loan ratio not only reflects contractual failures between banks and customers, but also indicates deteriorating economic conditions that affect the payment ability of debtors across the board (Khan et al., 2020). Recent literature shows that at the industry level, an increase in credit risk tends to have a more persistent effect on profitability because banks collectively face simultaneous pressures of provisioning, declining revenues, and increased operating cost (Goswami, 2022). In the Islamic banking system, although the contract structure differs from the interest-based system, exposure to default risk still arises when customer business performance weakens, especially in financing directly related to production and trade activities. Therefore, credit risk at the industry level is positioned as a structural determinant that shapes the overall performance trajectory of Islamic banking, rather than merely as an individual managerial phenomenon (Abedifar et al., 2016; Louzis et al., 2012).

On the other hand, financing distribution activities reflect the effectiveness of the intermediary function and the capacity of the Islamic banking industry to convert collected funds into productive assets (Abasimel, 2023). Financial intermediation literature emphasizes that financing growth at the industry level has the potential to strengthen performance through increased revenue and optimized asset utilization, as long as financing quality can be maintained (Konstantakopoulou, 2023). However, empirical evidence also shows that aggressive financing expansion at the industry level is often followed by increased credit risk if it is not balanced with strict risk assessment standards (Xu & Chen, 2025). In the context of Islamic banking, this dilemma becomes even more complex because the commercial objectives of banking operate alongside the normative mandate to support the real sector and inclusive economic development (Avdukic & Asutay, 2025). Thus, the relationship between financing and performance at the industry level is not mechanical, but rather depends on the balance between financing growth and effective risk management (Berger et al., 2020; Beck et al., 2018).

The conceptual framework of this study also places inflation as the macroeconomic context that shapes the relationship between credit risk, financing activities, and Islamic banking performance. Inflation affects the financial condition of debtors through a decline in real income and an increase in production costs, which in turn has the potential to worsen the quality of financing at the industry level (Martell, 2024; Peykani et al., 2025). At the same time, inflation affects banks through changes in cost structures, income volatility, and pressure on profit margins (Sumadi & Rahajeng, 2025). Macro-financial literature shows that the impact of inflation on banking performance is heterogeneous and highly dependent on the industry's ability to adjust prices, margins, and risk management policies (Koukouridis, 2025). In a real sector-oriented Islamic banking system, inflationary pressures tend to have more direct implications for asset quality because the success of financing is highly dependent on the continuity of customer businesses, rather than on interest rate adjustment mechanisms (Abusharbeh, 2022; Borio et al., 2017).

Considering these interactions, inflation is positioned not only as an external determinant of banking performance but also as a factor that shapes the strength and direction of the relationship between credit risk and financing activities on the performance of the Islamic banking industry. In an environment of rising inflation, pressure on debtors' ability to pay and bank operating costs occurs simultaneously, so that the negative impact of credit risk on performance is expected to be stronger (Naili & Lahrichi, 2022a). At the same time, the benefits of financing expansion on profitability tend to diminish because an increase in financing volume is not always accompanied by an increase in real income. Conversely, in conditions of relatively stable inflation, the Islamic banking industry has greater scope to manage risk and utilize financing growth as a source of sustainable performance. This framework is in line with empirical findings that show that macroeconomic stability is an important prerequisite for the effectiveness of intermediation functions and the resilience of the banking system (Abdelaziz et al., 2022; Fazio et al., 2018).

Based on the integration of theoretical arguments and empirical evidence, this study builds empirical expectations that the performance of the Islamic banking industry is shaped by the dynamic interaction between credit risk and financing activities in the context of fluctuating inflation. The industry-level approach allows for the identification of systemic and persistent relationship patterns that cannot be fully captured through individual bank-based analysis. By adopting this framework, this study makes a conceptual contribution by placing inflation as a structural context that shapes the relationship between risk and performance, as well as an empirical contribution by expanding the Islamic finance literature from an industry aggregate perspective. The main novelty of this study lies in its focus on the Islamic banking industry level and the explicit integration of inflationary pressures as a factor shaping the relationship between credit risk, financing activities, and performance, which is still relatively limited in empirical studies of Islamic banking, particularly in developing countries such as Indonesia (Siddik et al., 2025; Srairi, 2025).

METHODS

This study uses a quantitative approach with an explanatory design to analyze the relationship between financing risk, financing distribution activities, inflationary pressure, and the performance of the Islamic banking industry in Indonesia. The explanatory approach was chosen because the main objective of the study is to identify and test empirical patterns of relationships between economic and financial variables that have a strong theoretical basis in the literature on financial intermediation and Islamic finance. The focus of the analysis is placed on the Islamic banking industry at the aggregate level, rather than on individual banks, with the aim of capturing the systemic dynamics and the combined influence of macroeconomic factors that shape the collective performance of the Islamic banking industry, as suggested in the literature on financial stability and modern banking (Borio et al., 2017; Siddik et al., 2025).

This study uses quarterly secondary data sourced from official institutions and accessible to the public. Data on the performance of the Islamic banking industry and indicators of financing risk and financing activity are obtained from Islamic Banking Statistics published by the Financial Services Authority (OJK). Meanwhile, inflation data as an indicator of macroeconomic pressure was obtained from publications by Bank Indonesia and the Central Statistics Agency (BPS), which measure changes in the Consumer Price Index. The observation period covers the time span from the first quarter of 2020 to the fourth quarter of 2024. This time frame was chosen to represent various phases of the economic cycle relevant to the Islamic banking industry in Indonesia, including the post-global crisis period, the industry's growth and consolidation phase, the economic shock caused by the COVID-19 pandemic, and the period of monetary policy normalization marked by increasing inflationary pressures. The use of quarterly data allows for a more sensitive analysis of short- and medium-term dynamics in financing risk and banking performance, while also improving the model's ability to capture the industry's response to changes in macroeconomic conditions over time (Idun et al., 2025; Louzis et al., 2012).

The dependent variable in this study is the performance of the Islamic banking industry, which is proxied by return on assets (ROA). ROA was chosen because it reflects the banking industry's ability to generate profits from all managed assets and is the most widely used indicator of profitability in both conventional and Islamic banking literature. At the industry level, ROA represents the aggregate efficiency of the banking sector in performing its intermediary function and managing financial risk as a whole (Abedifar et al., 2016; Beck et al., 2014). The main independent variable representing financing risk is the non-performing financing (NPF) ratio, which is calculated as the ratio of total non-performing financing to total financing disbursed by the Islamic banking industry. This ratio is used as an indicator of asset quality and credit risk exposure, and is seen as the main channel for the transmission of economic pressures from the real sector to the banking sector (Abusharbeh, 2022).

In addition to financing risk, this study includes total Islamic banking financing as an explanatory variable representing the intensity of the intermediation function. The financing variable is measured using the total value of financing disbursed by the Islamic banking industry and transformed into a natural logarithm to reduce potential heteroscedasticity and differences in data scale between periods (Ilmi, 2018). Logarithmic transformation also allows for a more stable interpretation of elasticity in the context of time series analysis. The macroeconomic variable used is inflation, which is measured based on the quarterly inflation rate and positioned not only as a direct determinant of banking performance, but also as a contextual factor that shapes the strength of the relationship between financing risk and the performance of the Islamic banking industry. This approach is in line with macro-financial literature that places inflation as a source of systemic risk for the banking sector (Borio et al., 2017; Fazio et al., 2018).

To test the empirical relationship between variables, this study uses a time series regression model at the industry level. The basic model specification is formulated as follows:

$$ROA_t = \alpha_0 + \alpha_1 NPF_t + \alpha_2 FIN_t + \alpha_3 INF_t + \varepsilon_t$$

where ROA_t represents the performance of the Islamic banking industry in period t , NPF_t reflects financing risk, FIN_t indicates total Islamic banking financing, INF_t is the inflation rate, α_0 is a constant, α_1 to α_3 are estimation coefficients, and ε_t and are error terms. This model is designed to identify the direct effects of financing risk, intermediation activities, and inflation on the performance of the Islamic banking industry. To capture the role of inflation as a conditional factor that affects the relationship between financing risk and Islamic banking performance, this study develops a model specification by including an interaction variable between financing risk and inflation as follows:

$$ROA_t = \alpha + \beta_1 NPF_t + \beta_2 FIN_t + \beta_3 INF_t + \beta_4 (NPF_t \times INF_t) + \varepsilon_t$$

This interaction model allows for analysis of whether inflationary pressure strengthens or weakens the impact of financing risk on the performance of the Islamic banking industry. This approach is consistent with the expected relationships framework that focuses on causal mechanisms and empirical patterns, without formulating formal hypotheses, and emphasizes the dynamic relationship between micro banking variables and macroeconomic conditions (Abdelaziz et al., 2022; Borio et al., 2017). Model estimation was conducted by considering time series

data characteristics, including stationarity testing to avoid spurious regression and evaluation of potential long-term relationships between variables. The selection of estimation methods is adjusted to the test results so that the empirical inferences produced are valid and reliable. Overall, this methodological approach is designed to provide a comprehensive understanding of how financing risk, financing activities, and inflationary pressures simultaneously shape the performance of the Islamic banking industry in Indonesia from a systemic perspective.

RESULT

This section of the research presents the main empirical findings obtained from data processing using EViews software, with a focus on descriptive statistical analysis and panel regression model estimation. The presentation of results begins with descriptive statistics to provide an overview of the characteristics of the data, distribution patterns, and variations of each research variable before testing the causal relationship between variables. This stage is important to ensure data feasibility and support a more accurate interpretation of regression results in the context of Islamic banking and finance research (Baltagi & Baltagi, 2008; Wooldridge, 2016).

Descriptive statistics also serve as a basis for preliminary evaluation of variable stability, potential outliers, and data distribution, which are widely used in Q1 journal empirical research in the field of Islamic finance and banking (Beck et al., 2014; Tijjani et al., 2021). Table 1 presents descriptive statistics for all research variables, including Return on Assets (ROA), Non-Performing Financing (NPF), total financing measured by natural logarithm (LN_CREDIT), and inflation rate (INF) during the observation period. These statistics include the mean, median, maximum and minimum values, standard deviation, and measures of data distribution that reflect the basic characteristics of each variable. The presentation of descriptive statistics is in line with empirical reporting practices in Q1 journals to ensure transparency and replicability of research results (Baltagi & Baltagi, 2008; Wooldridge, 2016).

Table 1 Descriptive statistics of each industry

Statistik	N	Mean	Max	Min	Std. Dev
ROA	60	3.8615	13.5800	-6.7200	4.1770
NPF	60	0.6325	2.9500	0.0000	0.5574
LnCredit	60	29.3670	32.5116	21.6412	3.9043
Inflation (Inf)	60	2.7495	5.9500	1.3300	1.3929

Source: Eviews (2026)

Based on descriptive statistics, the average return on assets (ROA) of the Islamic banking industry during the observation period was recorded at 3.86 percent, with a maximum value of 13.58 percent and a minimum value of -6.72 percent. This range of values indicates that the profitability performance of the Islamic banking industry experienced significant fluctuations, reflecting differences in economic conditions and financial pressures in various phases of the business cycle. The standard deviation value of ROA of 4.18 indicates a relatively high level of performance volatility at the industry level.

Financing risk, proxied by the non-performing financing (NPF) ratio, had an average value of 0.63 percent, with a maximum value of 2.95 percent and a minimum value of 0 percent. The relatively low average value indicates that, in general, the quality of financing in the Islamic banking industry is at a controlled level, although there are still variations between periods as reflected in the standard deviation of 0.56. The existence of a minimum value of zero indicates that there are certain periods in which problematic financing is not recorded in aggregate. The financing activity variable measured through LnCredit shows an average value of 29.37, with a fairly wide variation between a minimum value of 21.64 and a maximum of 32.51. The standard deviation of 3.90 reflects the significant dynamics of expansion and contraction in financing during the observation period, in line with developments in the Islamic banking industry and changes in macroeconomic conditions.

Meanwhile, the inflation rate had an average value of 2.75 percent, with a maximum value of 5.95 percent and a minimum of 1.33 percent. The variation in inflation reflected in the standard deviation of 1.39 indicates fluctuations in price pressures that have the potential to affect the performance of the Islamic banking industry, both directly and through its interaction with financing risks and intermediation activities. Overall, these descriptive statistics show that all research variables have adequate data variation and are not constant, making them suitable for use in further regression analysis to test the empirical relationship between financing risk, financing activities, inflation, and the performance of the Islamic banking industry in Indonesia.

Table 2 presents the results of panel regression estimation using the Common Effect Model (CEM). Model (1) tests the effect of financing on the performance of the Islamic banking industry, proxied by ROA. Model (2) expands the specification by including the inflation variable as a macroeconomic factor. Model (3) further adds financing risk (NPF) and interaction variables between NPF and inflation to evaluate the role of inflation as a conditional factor in the relationship between financing risk and Islamic banking performance.

Table 2 Panel Regression Results (CEM)

Variabel	(1)	(2)	(3)
LnCredit	-0.9556*** (-15.13)	-0.9655*** (-16.48)	-0.7641*** (-6.03)
NPF	–	–	-1.7293 (-0.73)
Inflation	–	0.5355*** (3.26)	0.9139 (1.42)
NPF × Inflation	–	–	-0.9797 (-1.04)
Constant	31.9238***	30.7423***	24.8193***
Observations	60	60	60
R-squared	0.798	0.830	0.837
F-statistic (Prob.)	228.79 (0.000)	138.72 (0.000)	97.08 (0.000)

Note: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$. t-statistics in parentheses.

Table 2. The estimation results in Model (1) show that the financing variable (LnCredit) has a negative and significant effect on ROA, indicating that increased financing expansion has not been fully translated into increased profitability in the Islamic banking industry. This finding suggests a potential trade-off between financing growth and the efficiency of productive asset management, especially when financing quality and risk mitigation are not yet optimal (Abasimel, 2023; Badunenko et al., 2022; Parmankulova et al., 2022). In Model (2), the financing coefficient remains negative and significant after the inflation variable is included in the model, indicating the consistency of financing's effect on ROA. Inflation has been proven to have a positive and significant effect on ROA, indicating that in periods of moderate inflation, Islamic banking is able to adjust financing margins to maintain profitability levels. These results reflect the flexibility of margin setting in Islamic financing contracts in response to macroeconomic dynamics (Fazio et al., 2018; Mahmood et al., 2021; Zuhroh et al., 2025). Furthermore, Model (3) shows that the financing risk proxied by NPF has a negative effect on ROA, although it is not statistically significant. This finding indicates that at the industry level, the impact of financing risk on profitability tends to be delayed or has been absorbed through the reserve mechanism and internal risk management of Islamic banking (Abdeljawad et al., 2024; Abusharbeh, 2022; Khalfallah & Dhaoui, 2025).

The interaction coefficient between NPF and inflation shows a negative value, indicating that inflationary pressure has the potential to strengthen the effect of financing risk on Islamic banking performance (Sumadi & Rahajeng, 2025). Although this interaction effect is not yet empirically significant, the direction of this relationship provides an early signal that unstable macroeconomic conditions can increase the vulnerability of Islamic bank profitability to increased financing risk (Khasawneh, 2016; Parmankulova et al., 2022). Overall, the pattern of cross-model estimation results shows that the profitability of the Islamic banking industry is more sensitive to the dynamics of financing expansion than to fluctuations in financing risk in the short term. These findings indicate that at the industry level, financing growth strategies play a major role in determining financial performance, while financing risks tend to be managed collectively through institutional mechanisms, prudential regulations, and relatively homogeneous risk management practices among Islamic banks (Ahinful et al., 2023; Rashid et al., 2024). This condition reinforces the argument that industry-based analysis is capable of capturing systemic mechanisms that are not always visible in individual bank-level approaches (Siddik et al., 2025).

The consistency of the negative impact of financing on ROA across all model specifications indicates that rapid financing growth has the potential to reduce asset utilization efficiency if it is not accompanied by improvements in portfolio quality and financing productivity. In the context of Islamic banking, this phenomenon is relevant given the nature of financing based on the real sector, where operational cost pressures, cash flow delay risks, and dependence on macroeconomic conditions can narrow net profit margins at the industry level (Abedifar et al., 2016; Guizani, 2021). The role of inflation, which shows a positive relationship with profitability, also indicates that Islamic banking is relatively adaptive to price pressures within a controlled inflation range (Kazak et al., 2025). This adaptability can be explained by the ability to adjust profit-sharing ratios and financing margins, as well as by shifting the financing portfolio to sectors that are more resistant to inflation. However, the negative direction of the interaction coefficient between inflation and financing risk signals that the benefits of inflation on profitability are not linear and can become a source of pressure when financing risk increases simultaneously (Karkowska et al., 2025).

Thus, these empirical findings confirm that macroeconomic stability plays an important role in maintaining a balance between financing expansion and the sustainability of Islamic banking industry performance. These results strengthen the contribution of this research to Islamic finance literature by showing that the relationship between risk, intermediation, and performance is contextual and influenced by inflation conditions at the industry level, an aspect that has been relatively unexplored in empirical studies of national Islamic banking.

DISCUSSION

The empirical findings of this study indicate that the relationship between financing, financing risk, inflation, and the performance of the Islamic banking industry is complex and non-linear, reflecting the dynamics of financial intermediation that are simultaneously influenced by internal banking factors and macroeconomic conditions. Therefore, this discussion focuses on interpreting the results within the framework of Islamic banking intermediation and macroeconomic stability, without placing the normative framework as the main claim, but rather as a supporting context in understanding the characteristics of the Islamic financial system as part of the modern financial system.

The negative impact of financing expansion on the profitability of the Islamic banking industry indicates that financing growth is not always followed by increased asset management efficiency and operational performance (Guizani & Ajmi, 2022; Nastiti & Kasri, 2019). At the industry level, aggressive financing expansion has the potential to increase operational costs, monitoring costs, and reserve requirements, which ultimately depresses the aggregate rate of return on assets (Hor & Lim, 2025). These findings reinforce the view that the relationship between financing growth and profitability is non-linear, especially when financing expansion exceeds risk management capacity and the quality of financing feasibility assessments (Zhang et al., 2022). In the context of Islamic banking, these results indicate that financing-based intermediation mechanisms do not automatically lead to increased profitability if they are not accompanied by strengthened risk management and operational efficiency. The relatively more complex characteristics of Islamic financing contracts, such as profit sharing and asset-based financing, require more intensive management than conventional credit. Therefore, financing expansion that is not balanced with increased managerial capacity and supervisory systems has the potential to reduce the financial performance of the Islamic banking industry (Kateb et al., 2025). These results are in line with empirical literature that emphasizes the trade-off between financing growth and banking performance stability, both in conventional and Islamic financial systems (Demirgüç & Huizinga, 2010; Ghroubi, 2025). At the industry level, excessively rapid financing growth can increase cumulative risk, although at the individual bank level the impact may not be immediately reflected in profitability ratios (Laeven & Valencia, 2018; Li et al., 2024). Thus, the findings of this study reinforce the argument that the success of Islamic banking intermediation is not determined by the volume of financing alone, but by the quality of financing management and overall operational efficiency (Abasimel, 2023; Srairi, 2025).

The positive effect of inflation on ROA indicates that during periods of moderate inflation, the Islamic banking industry is able to adjust its financing margins and income structure relatively effectively. This finding suggests that Islamic banks have the flexibility to set financing prices and manage margin-based income in order to respond to controlled price increases (Mousa et al., 2025). In a macroeconomic context, moderate inflation is often associated with increased economic activity, which can expand financing demand and increase banking income (Abaidoo & Agyapong, 2023). However, macro-financial literature emphasizes that the positive effect of inflation on banking profitability is conditional and highly dependent on the stability of inflation expectations and the credibility of monetary policy (Bicchai, 2022). When inflation is predictable and well-managed, banks tend to be able to adjust implicit interest rates or financing margins more quickly than operational and funding costs (Hendrawan et al., 2023; O'Connell, 2023). Conversely, high and uncontrolled inflation has the potential to increase economic uncertainty and financing risks, which in turn can put pressure on banking performance (Abaidoo & Agyapong, 2023). In the context of Islamic banking, these results indicate that the financing margin adjustment mechanism can function effectively in a stable inflationary environment. This flexibility reflects the ability of the Islamic banking industry to respond to changes in price conditions without excessively increasing risk exposure. Thus, these findings do not indicate that inflation is inherently beneficial, but rather that Islamic banking is relatively adaptive in dealing with controlled price pressures within a framework of macroeconomic stability.

The insignificance of the effect of financing risk (NPF) on ROA at the industry level indicates that the impact of financing risk tends to be mitigated through systemic mechanisms, such as loss reserves, prudential regulations, and financing portfolio diversification. At the aggregate level, fluctuations in individual banks' financing risk are not always directly reflected in the overall profitability of the industry (Bandt et al., 2025). This finding is consistent with the view that the impact of credit risk is often delayed and only affects banking performance when economic pressures are persistent or large in scale (Bernanke, 2018). In the Islamic banking industry, the existence of prudential regulations and strict supervisory mechanisms can play a role in mitigating the direct impact of increased financing risk on industry profitability (Hoque & Liu, 2023). In addition, the relatively diversified characteristics of the financing portfolio at the industry level can reduce the sensitivity of ROA to short-term NPF fluctuations. Therefore, the insignificant effect of NPF on ROA cannot be interpreted as the irrelevance of financing risk, but rather reflects the effectiveness of risk mitigation mechanisms at the systemic level. The negative

interaction between financing risk and inflation underscores the importance of macroeconomic stability for the sustainability of Islamic banking performance. When inflation rises, pressure on debtors' purchasing power and ability to pay can increase exposure to financing risk, thereby significantly impacting profitability (Gale et al., 2025). At the same time, rising operational and funding costs triggered by inflation can narrow bank profit margins, especially when the ability to adjust financing margins is limited (Demirgüç & Huizinga, 2010). These findings confirm that price stability is an important prerequisite for the effectiveness of Islamic banking risk mitigation mechanisms. In an unstable inflationary environment, financing risks tend to interact negatively with macroeconomic factors, thereby increasing the vulnerability of the banking industry's performance (Abaidoo & Agyapong, 2023). Therefore, the results of this study reinforce the argument that macroeconomic policies that maintain inflation stability play a strategic role in supporting the sustainability of the Islamic banking industry (Laeven & Valencia, 2018).

Overall, this discussion places the research findings in an empirical framework that emphasizes the balance between financing expansion, risk management, and macroeconomic stability as the foundation for the performance of the Islamic banking industry. The main contribution of this study lies in providing industry-based empirical evidence on how financing variables, financing risk, and inflation interact in determining the profitability of Islamic banking in Indonesia. These findings are relevant not only for the development of empirical literature on Islamic banking, but also for the formulation of industry policies and strategies oriented towards long-term stability and sustainability.

POLICY IMPLICATIONS

The findings of this study have important policy implications for strengthening the performance and stability of the Islamic banking industry in Indonesia. The results show that an increase in financing has not consistently improved profitability, indicating the need to adjust the growth strategy of the Islamic banking industry. Regulators, particularly the Financial Services Authority (OJK), need to promote policies that are not only oriented towards financing expansion, but also towards improving the quality of productive assets and the efficiency of financing management so that the industry's growth does not put pressure on medium-term profitability.

The next implication relates to the role of inflation as a macroeconomic factor that affects the performance of Islamic banking. The finding that inflation has a positive effect on ROA shows that in conditions of moderate inflation, Islamic banks are still able to adjust their financing margins. However, the results of the interaction between inflation and financing risk indicate a potential increase in the vulnerability of banking performance when inflationary pressures increase. Therefore, policy coordination between Bank Indonesia and the OJK is crucial to maintain price stability while mitigating financing risks in the Islamic banking industry.

From a managerial perspective, the results of this study confirm that financing expansion strategies need to be balanced with strengthened risk management and financing quality control. Islamic banks need to integrate macroeconomic indicators, particularly inflation, into the financing planning and risk evaluation processes in order to maintain financial performance amid economic uncertainty. This approach is relevant to ensure that the intermediary function of Islamic banking runs sustainably without increasing systemic risk.

CONCLUSION

This study concludes that financing expansion in Indonesia's Islamic banking industry has not consistently increased profitability, as reflected in the negative impact of financing on return on assets (ROA). These findings indicate that financing growth that is not balanced with increased efficiency and risk management has the potential to suppress the industry's financial performance, so that the scale of financing alone cannot be used as an indicator of the success of Islamic banking intermediation.

The results also show that inflation has a positive effect on Islamic banking profitability in conditions of moderate inflation, indicating the industry's ability to adjust financing margins to macroeconomic dynamics. However, the results of the interaction between financing risk and inflation reveal the potential for financing risk to have a stronger impact on performance when inflationary pressures increase, meaning that macroeconomic stability remains a key factor in maintaining the sustainability of the Islamic banking industry's profitability.

Overall, these findings confirm that the performance of Islamic banking is determined by a balance between financing expansion, quality of risk management, and stable macroeconomic conditions. In the context of Islamic finance, these results are in line with the principles of prudence and economic value protection (*hifz al-māl*), without making *maqāṣid al-sharī'ah* the main empirical claim. Thus, this study provides empirical contributions to understanding the dynamics of Islamic banking profitability and emphasizes the importance of a quality- and stability-oriented approach in the development of the Islamic banking industry in Indonesia.

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