

DO PEER BANKS AFFECT ISLAMIC BANK FINANCIAL LEVERAGE DECISIONS?

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Abstract

This research aims to analyze the influence of peer banks on Islamic banks financial leverage decisions. The empirical model was tested using fixed-effect panel data regression with robust standard error and the data of Islamic banks in Indonesia for the years 2007-2020. The results of this study show that peer banks have a significant positive effect on Islamic bank financial leverage decisions, and it is robust during the global financial crisis. The positive impact of peer banks on Islamic bank financial leverage shows that the higher the financial leverage of the peer banks will make the Islamic bank raises its financial leverage. This research contributes to the literature and policymakers on the presence of peer banks effect, especially in Islamic bank financial leverage decisions. Islamic bank financial leverage decisions are not only affected by the circumstances of the Islamic bank itself but are also influenced by other Islamic banks' behavior.

Keywords: *Islamic Bank; Peer Bank; Financial Leverage; Capital Structure*

Abstrak

Penelitian ini bertujuan untuk menganalisis pengaruh peer banks terhadap keputusan leverage keuangan bank syariah. Pengujian model empiris menggunakan regresi data panel fixed-effect dengan robust standard error dan data bank syariah di Indonesia tahun 2007-2020. Hasil penelitian ini menunjukkan bahwa peer banks berpengaruh positif terhadap keputusan leverage keuangan bank syariah dan pengaruh tersebut konsisten di masa krisis keuangan global. Pengaruh positif peer banks menunjukkan bahwa semakin tinggi leverage keuangan peer banks akan membuat bank syariah menaikkan leverage keuangannya. Penelitian ini memberikan kontribusi terhadap literatur dan pembuat kebijakan tentang adanya pengaruh peer banks, terutama dalam keputusan leverage keuangan bank syariah. Keputusan leverage keuangan bank syariah tidak hanya dipengaruhi oleh keadaan bank syariah itu sendiri, tetapi juga dipengaruhi oleh perilaku bank syariah lain.

Kata kunci: Bank syariah; *peer bank*; leverage keuangan; struktur modal



INTRODUCTION

Among the challenges in the banking system, banking leverage is a significant indicator in the banking management sector, which refers to how resources are used in the balance sheet to finance assets. Banking leverage reflects the relationship between assets and resources in banks' balance sheets. With its correct application, the amount of profitability earned and many of the banks' problems in dealing with risks are relieved (Ahadifar et al., 2021). Identify the cause of the bank crisis; the size of banking leverage is regarded as the first unseparated banking indicator. Determining to what extent banking leverage is utilized is one of the most crucial and challenging issues faced by banks. The leverage allows a financial institution to increase potential profits and losses on a certain financial position from an investment source. The profits and losses incorporate those that can achieve more than possible directly through investing in the institution's financial resources (Ahadifar et al., 2021).

Financial intermediaries play a significant role in raising economic activities by facilitating an economy's borrowing and lending opportunities. Therefore, it is worth exploring how financial firms, especially banks, specify their capital structure (Shah et al., 2017). A bank's leverage indicates the debt or other financial instruments or borrowed capital utilized by the bank to gain more income for the investors and shareholders. The topic of leverage is crucial for banks since it indicates their financial needs, especially in their capability to lend or finance, deliver returns for their depositors and shareholders, and signal their performance potential (Mohd Noor, 2018).

Bank's leverage is highly composed of deposit liabilities, which makes it have different characteristics than non-financial firms. Banks and financial firms are also highly levered compared to non-financial firms. These differences in leverage reinforce the importance of systematically exploring the financial sector's leverage as the non-financial sector (Hameed et al., 2019). Previous research has indicated that a company's financial decisions are not only influenced by the circumstances of the company itself but are also determined by other companies' behavior (peer effect). Previous studies show that companies use information from their competitors to make financial decisions (Park et al., 2017). Some of the studies include the influence of peer companies on capital structure decisions (Francis et al., 2016; Leary & Roberts, 2014; Zhong & Zhang, 2018).

In the meantime, studies on peer effects in capital structure decisions conducted by previous researchers are mostly on non-financial companies or companies in general (Lee et al., 2017). There are still few studies on peer effects influence on capital structure decisions of financial or banking



companies. Research on peer effects on bank capital structure has been carried out by Lee et al. (2017) on the US banks' capital structure. Meanwhile, there are Islamic banks besides conventional banks in countries with dual banking systems. Islamic banks have different operational characteristics from conventional banks, which must comply with sharia principles. Islamic ethical constraints and the involvement of the Sharia Supervisory Board in Islamic banks' governance system could theoretically alter their capital structure compared to conventional banks (Toumi et al., 2012). Unlike conventional banks, Islamic banks' operations are not interest-based, which are fundamentally ruled by the *Shari'ah* laws that disallow interest transactions. Islamic banks principally turn to equity creation through profit-loss-sharing (PLS) financial transactions. Therefore, there is a need to examine Islamic banks' financial leverage (Shah et al., 2017; Shah et al., 2019).

The capital structure decision in Islamic banks is ruled by Shariah principles which forbid issuing interest-based loans or taking interest-based deposits (Al-Hunnayan, 2020; Bukair, 2019). Then, Islamic banks use different instruments than conventional banks to mobilize funds, including shareholders' equity, investment accounts, and current accounts. In Islamic banks, financial decisions are influenced by the purpose of obeying ethical (sharia) principles. These principles, at least, give some constraints to expected utility goals, which leads to the fact that the nature of Islamic banks' capital structures differs from that of conventional banks. The characteristic of Islamic banks is the absence of conventional debt and the presence of a new type of liability, a profit-sharing investment account (PSIA). About conventional debt, the usury principle prohibits interest (any income generated by the passage of time alone). Thus, Islamic banks cannot collect deposits (or other liabilities) at a predetermined interest rate. In comparison, profit sharing investment account (PSIA) is a consequence of the profit and loss-sharing principle (Toumi et al., 2012).

Previous research about Islamic bank financial leverage or capital structure determinants includes the research by Guizani & Ajmi (2021) on the capital structure decisions of Islamic banks in Malaysia, and Al-Hunnayan (2020) and Alzahrani et al., (2021) on Islamic banks' capital structure decision in the GCC. Another research was conducted by Sheikh & Qureshi (2017) about capital structure determinants of Islamic banks in Pakistan. Meanwhile, another study by Bukair (2019) was about factors influencing Islamic banks' capital structure in developing economies. These previous studies have not examined the influence of peer banks on financial leverage.

The different characteristics of Islamic banks from conventional banks (Guizani & Ajmi, 2021; Shah et al., 2017). The limitations of financial leverage



or capital structure instruments faced by Islamic banks should be sharia-based (Al-Hunnayan, 2020; Shah et al., 2019; Toumi et al., 2012). research is required on Islamic banks' financial leverage decisions, especially regarding the extent to which peer banks affect the Islamic banks' financial leverage decisions. In other words, this research aims to analyze whether Islamic banks follow others in making financial leverage decisions. To the best of our knowledge, this research will be the first to analyze the effect of peer banks on Islamic banks' financial leverage.

LITERATURE REVIEW

Based on the literature review, there are two specific theories concerning peer effects in capital structure decision-making: social learning theory and dynamic competition theory. Social learning theory argues that the external environment influences individual recognition and decisions. Peers, as a significant part of the environment, especially those similar and related, greatly affect the individual's decision-making. When a firm's managers, as individuals, realize that information held by themselves or the company is not sufficient to create reasonable decisions. They may be driven to learn and imitate their peers' capital structure decisions, producing peer effects based on learning. Whereas, in the dynamic competition theory, as a competitive organization, the company is an entity with a clear objective of maximizing profits. Its product market competitiveness brings interactive responses between firms and competitors in capital structure decisions. Under intense competition in the output market, strategic capital structure decision is important. Therefore, companies must monitor competitors' capital structure decisions and react strategically (Francis et al., 2016; He & Wang, 2019; Zhong & Zhang, 2018).

Meanwhile, several researchers, including Alzahrani, Rana, & Ahmad (2021), Guizani & Ajmi (2021), Al-Hunnayan (2020), Bukair (2019), and Sheikh & Qureshi (2017) have investigated the determinants of Islamic banks' capital structure. However, they have not investigated the peer bank effect. Therefore, there is a need to investigate the influence of peer banks on Islamic bank financial leverage.

Previous studies show that there is an influence of other firms in the same industry (peer effect) on the financial leverage decision. Lee et al. (2017) research on the US banks' capital structure shows a positive influence on peer bank behavior. Peer firm capital structure positively affects Chinese firms' capital structure decisions (Zhong & Zhang, 2018). The study by He & Wang (2019) indicates that the changes in peers' market leverage ratios positively



impact Chinese firms' capital structures. Meanwhile, the research on cross-country data shows that peer firm average leverage positively influences the firm's leverage decision (Francis et al., 2016). Then, the hypothesis of this research is as follows:

H₁: Peer banks significantly influence Islamic banks' financial leverage decisions.

METHOD

This research uses yearly unbalanced panel data of thirteen (13) Indonesian Islamic banks from 2007-2020. This study uses Indonesian Islamic bank data because Indonesia is the country that has the greatest population of Muslims. Then the development of Islamic banks in Indonesia could not be ignored. This research uses panel data regression with robust standard error (Equation (1)) to analyze the peer bank effect on the financial leverage decision of Islamic banks. The dependent variable LEV is Financial Leverage, Total Liabilities to Total Assets (Al-Hunnayan, 2020; Guizani & Ajmi, 2021; Sheikh & Qureshi, 2017). This ratio describes the proportion of total liabilities to total assets. The peer bank effect (PLEV) is measured by the average Financial Leverage of other Islamic banks (competitors) (Lee et al., 2017). Control is a control variable composed of bank-level and country-level control variables.

Bank-level control variables are (1) SIZE, measured by the Logarithm of Total Assets (Hameed et al., 2019); (2) ROA, which is Return on Assets (Guizani, 2021); (3) NPF is Non-performing Financing (Erülgen, Rjoub, & Adalier, 2020); (4) FDR is Financing to Deposit Ratio (Allen & Powell, 2013; Fauziah & Iskandar, 2015); and (5) LIQ, which is Liquid Assets to Total Deposits (Al-Mutairi & Naser, 2015; Pervin & Noreen, 2018). The country-level control variables are (1) GDP is GDP growth (Hameed et al., 2019); (2) INF is the inflation rate (Ahadifar et al., 2021); and (3) EXC is the USD exchange rate (Ahadifar et al., 2021).

$$LEV = \beta_0 + \beta_1 PLEV_{i,t} + \sum \gamma_n CONTROL + e_{i,t} \quad (1)$$

This study also analyzes the robustness of the peer-bank effect in the period of the global financial crisis. It applies a crisis dummy to represent the possible impact of the 2008 Global Financial Crisis. The crisis dummy equals 1 for the financial statement years 2008 and 2009 (Amin et al., 2018; Louhichi & Boujelbene, 2016). The variables details are as follows Table 1:

**Table 1. Variable Description**

| Variable | Measurement | Reference |
|---------------------------------|---|---|
| Dependent Variable | | |
| Financial Leverage (LEV) | Total Liabilities to Total Assets | Al-Hunnayan, 2020; Guizani & Ajmi, 2021; Sheikh & Qureshi, 2017 |
| Independent Variable | | |
| Peer Bank Effect (PLEV) | Average Financial Leverage of Other Islamic Banks | Lee et al., 2017 |
| Bank-level Control Variable: | | |
| Bank Size (SIZE) | The logarithm of Total Assets | Hameed et al., 2019 |
| Profitability (ROA) | Return on Assets | Guizani, 2021 |
| Credit Risk (NPF) | Non-performing Financing | Erülgen, Rjoub, & Adalier, 2020 |
| Loan Ratio (FDR) | Financing to Deposit Ratio | Allen & Powell, 2013; Fauziah & Iskandar, 2015 |
| Liquidity (LIQ) | Liquid Assets to Total Deposits | Al-Mutairi & Naser, 2015; Pervin & Nowreen, 2018 |
| Country-level Control Variable: | | |
| GDP Growth (GDP) | GDP Growth | Hameed et al., 2019 |
| Inflation Rate (INF) | Inflation Rate | Ahadifar et al., 2021 |
| Exchange Rate (EXC) | USD Exchange Rate | Ahadifar et al., 2021 |

Source: Authors analysis (2022)

RESULT AND DISCUSSION

Based on descriptive statistics in Table 2, the average financial leverage, Total Liabilities to Total Assets (LEV) for all Islamic banks in the sample, is 0.8705. The highest and lowest financial leverage are 0.9452 and 0.6423, respectively. The value of the standard deviation is 0.0658. The average value of financial leverage, which is more than 50%, shows that most Islamic banks have high financial leverage.

Table 2 shows the average peer-bank financial leverage, which is peer-bank Total Liabilities to Total Assets (PLEV), is 0.8706. The lowest and highest peer-bank financial leverage are 0.8313 and 0.9328, respectively. The standard deviation value is 0.0231. Further analysis shows that the average peer bank financial leverage (PLEV) is slightly higher than the average financial leverage (LEV). The average bank-level control variable, the Logarithm of Total Assets (SIZE), is 29.99 and ranges from 27.13 to 32.47.

The Return on Assets (ROA) has an average percentage of 0.9%, and it ranges between -10.77% and 13.58%. The average proportion of Non-Performing Financing (NPF) is 3.5%, and it varies from 0.0% to 22%. The average Financing to Deposit Ratio (FDR) proportion is 89.58%, with the



minimum and maximum values being 41.02% and 198.87%, respectively. The average liquidity, Liquid Assets to Total Deposits (LIQ), is 0.3752 and varies between 0.1547 and 1.7729.

Table 2. Descriptive Statistics

| | Average | Minimum | Maximum | Std. Dev. |
|------|---------|---------|---------|-----------|
| LEV | 0.8705 | 0.6423 | 0.9452 | 0.0658 |
| PLEV | 0.8706 | 0.8313 | 0.9328 | 0.0231 |
| SIZE | 29.9922 | 27.1302 | 32.4745 | 1.1811 |
| ROA | 0.0092 | -0.1077 | 0.1358 | 0.0259 |
| NPF | 0.0352 | 0.0000 | 0.2204 | 0.0288 |
| FDR | 0.8958 | 0.4102 | 1.9887 | 0.1765 |
| LIQ | 0.3752 | 0.1547 | 1.7729 | 0.1956 |
| GDP | 0.0461 | -0.0207 | 0.0635 | 0.0230 |
| INF | 0.0457 | 0.0192 | 0.1023 | 0.0186 |
| EXC | 4.0795 | 3.9430 | 4.1638 | 0.0780 |

Source: Authors analysis (2022)

Meanwhile, for the country-level control variables, the average GDP growth is 4.6%, and the lowest and highest percentages are -2.07% and 6.34%, respectively. The average value of the Inflation Rate (INF) is 4.57%, and it ranges between 1.9% and 10.23%. The average USD Exchange Rate (EXC) is 4.0795 with minimum and maximum values are 3.9430 and 4.1638 respectively. The correlation matrix of the variables used in this study is presented in Table 3. It indicates no multicollinearity problem since the correlations between the independent variables used in this research are smaller than 80%.

Table 4 shows the fixed-effects panel data regression results of the peer-bank effect on Islamic bank financial leverage. We use fixed-effects panel data regression as the suitable panel data regression according to the Hausman test. Based on Equation (1), Table 4 column (1) results show that peer banks' financial leverage has a positive and significant effect on Islamic banks' financial leverage. The positive effect of the peer bank financial leverage shows that the higher the financial leverage of peer banks will increase Islamic bank financial leverage.

For the robustness test, we add the global financial crisis (CRI) variable to the Equation. The results in column (2) of Table 4 show that the global financial crisis (CRI) significantly impacts Islamic bank financial leverage. The outcomes in column (2) strengthen the results in column (1) that peer bank financial leverage has a positive and significant effect on Islamic bank financial



leverage. The impact of peer-bank financial leverage on Islamic bank financial leverage is still robust during the global financial crisis.

Table 3. Correlation Matrix

| | PLEV | SIZE | ROA | NPF | FDR | LIQ | GDP | INF | EXC |
|------|--------|--------|--------|--------|--------|--------|--------|--------|-------|
| PLEV | 1.000 | | | | | | | | |
| SIZE | -0.358 | 1.000 | | | | | | | |
| ROA | -0.027 | 0.113 | 1.000 | | | | | | |
| NPF | -0.085 | 0.070 | -0.459 | 1.000 | | | | | |
| FDR | 0.216 | -0.251 | -0.055 | 0.199 | 1.000 | | | | |
| LIQ | -0.160 | -0.250 | 0.075 | -0.125 | -0.239 | 1.000 | | | |
| GDP | 0.487 | -0.182 | -0.060 | 0.007 | -0.001 | -0.231 | 1.000 | | |
| INF | 0.437 | -0.267 | -0.144 | 0.029 | 0.159 | -0.044 | 0.534 | 1.000 | |
| EXC | -0.601 | 0.284 | 0.087 | 0.163 | -0.112 | 0.105 | -0.519 | -0.600 | 1.000 |

Source: Authors analysis (2022)

Table 4. Regression Results

| | Coefficient (std. error) | Coefficient (std. error) |
|-------------------------|-----------------------------|-----------------------------|
| PLEV | 0.248 (0.108)** | 0.253 (0.099)** |
| SIZE | 0.024 (0.014) | 0.034 (0.015)** |
| ROA | -0.286 (0.125)** | -0.275 (0.133)* |
| NPF | -0.025 (0.115) | -0.016 (0.112) |
| FDR | -0.093 (0.027)*** | -0.091 (0.030)** |
| LIQ | -0.100 (0.035)** | -0.102 (0.037)** |
| GDP | -0.088 (0.189) | -0.025 (0.171) |
| INF | 0.279 (0.151)* | 0.179 (0.124) |
| EXC | -0.160 (0.119) | -0.206 (0.116) |
| CRI | | 0.031 (0.008)*** |
| Constant | 0.706 (0.324)* | 0.574 (0.294)* |
| R-squared | 0.5092 | 0.5020 |
| F-Statistics | 34.05 | 334.51 |
| Prob. (F-Stat.) | 0.000 | 0.000 |
| No. of Obs. (bank-year) | 129 | 129 |

Note: * significant at 10%; ** significant at 5%; *** significant at 1%

Source: Authors analysis (2022)



Meanwhile, Table 4 also exhibits the influence of bank-level and country-level control variables. The logarithm of Total Assets (SIZE) positively affects Islamic bank financial leverage. In contrast, Return on Assets (ROA), Financing to Deposit Ratio (FDR), and Liquid Assets to Total Deposits (LIQ) have negative effects. The Inflation Rate (INF) positively influences Islamic banks' financial leverage. The regression results in Table 4 show that peer banks affect Islamic banks' financial leverage and are robust in the global financial crisis periods. The positive effect of peer banks can be caused by the average financial leverage of Islamic banks being slightly lower than the average peer bank financial leverage (Table 2). When Islamic banks follow peer banks financial leverage decisions, it will increase the financial leverage.

The significant effect of peer-bank on Islamic bank financial leverage. Previous research has that a company's financial and operational decisions are not just affected by the circumstances of the company itself but are also influenced by the behavior of other firms (peer effect) (Leary & Roberts, 2014; Park et al., 2017). The positive impact of peer-bank on Islamic bank financial leverage follows the research of Lee et al. (2017). That shows a positive effect of peer-bank behavior on the capital structure of US banks. The study of Zhong & Zhang (2018) and He & Wang (2019) on Chinese firms' capital structure decisions and the research by Francis et al. (2016) on cross-country firms' leverage decisions.

Meanwhile, the influence of bank-level and country-level control variables follows previous studies. The positive influence of the Logarithm of Total Assets (SIZE) follows the research of Hameed et al. (2019). The negative effect of Return on Assets (ROA) corresponds with the study of Guizani (2021). The negative impacts of Financing to Deposit Ratio (FDR) and Liquid Assets to Total Deposits (LIQ) are consistent with the research by Allen & Powell (2013) and Al-Mutairi & Naser (2015) respectively. The positive effect of the Inflation Rate (INF) follows the research by Ahadifar et al. (2021).

Based on the literature, a more competitive industry, with more young companies and high leverage volatility, tends to show a stronger peer effect (He & Wang, 2019). Different financial behaviors of peer companies can help the company make better decisions, mainly if it performs in a competitive industry. Therefore, for managers, peers' financial decisions information is a strategic instrument for decision-making in difficult circumstances (Zaighum & Karim, 2019). Companies follow their peers and mimic behavior when motivated to learn and build a reputation (Francis et al., 2016; He & Wang, 2019). Meanwhile, according to Leary & Roberts (2014), the peer effect on capital structure occurs when the actions or characteristics of the peer company explicitly enter the company's financing objective function. Islamic



banks in Indonesia are in a growing industry that has intense competition not only with conventional banks but also between Islamic banks themselves. As a growing industry, there are also many young Islamic banks. Therefore, this situation may influence peer banks' influence on financial leverage decisions.

CONCLUSION

This research analyzes peer bank effects on Islamic bank financial leverage decisions. Using the data of Islamic banks in Indonesia, several conclusions can be made based on the results and discussions. Peer banks' financial leverage has significant positive effects on Islamic banks' financial leverage, and its effects are still robust during the global financial crisis. Based on this study, Islamic bank financial leverage management is affected by other Islamic banks. The positive influence of peer banks on Islamic banks' financial leverage means that the higher the financial leverage of the peer banks will, make the more Islamic bank will increase their financial leverage. The implication of this study to the literature and policymakers is regarding the peer bank effect, especially in the financial leverage decisions of Islamic banks. The financial leverage decision of Islamic banks is not only influenced by the condition of the Islamic bank itself but also by the behavior of other Islamic banks.

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