Journal of Business Management and Islamic Banking
Vol. 03 No. 1, 2024
pp. 57-70
E-ISSN: 2964-2787

Equity-Based vs Debt-Based Financing: Which One is More Profitable for Islamic Banks in Indonesia?

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Article Info

Article History
Received : 14-11-2024
Revised : 24-11-2024
Accepted : 24-11-2024
Published : 25-11-2024

Article DOI:
https://doi.org/10.14421/jbmib.v3i1.2341

ABSTRACT

Research Aims: The debt-based syndrome is mushrooming across the Islamic Banks worldwide. However, in Indonesia equity-based financing has significant increase in the las several years. Thus, the study aims to examine whether debt-based financing or equity-based financing is more profitable in Indonesia Islamic Banks.

Methodology: Fixed effect model (FEM) is used to measure the panel data. For robustness test LSDV is used.

Research Findings: The result revealed that debt-based financing has negative significant influence on the profitability of Islamic Banks (ROA and ROE), while equity-based financing has positive significant influence on profitability of Islamic Banks (ROA and ROE). Moreover, the results are robust.

Originality: Present paper attempt to capture the actual conditions of Islamic Banks in Indonesia through the samples used. As the best of author knowledge, this is the first paper which compare between debt-based and equity-based on the profitability of Islamic banks in Indonesia.

Research limitation and implication: This research provides some practical contributions for policymaker to boost equity-based financing in dual banking system.

***Keywords**: Equity-Based Financing, Debt-Based Financing, Islamic Bank Profitability.*

INTRODUCTION

Islamic bank is one of the fastest-growing financial industries in the last decades. According to the Refinitiv database, Islamic banks have USD 2,349 billion of the total asset representing the 70% of the Islamic finance total asset around the world (Refinitiv, 2021). Moreover, the development of Islamic banks occurred not only in developed countries but also in developing countries such as Indonesia. Since its presence in 1990, Indonesia become the first rank in Islamic Finance Country Index in 2021 . Furthermore, Indonesia also posits the second rank in Islamic Finance Development Index in 2021 (Refinitiv, 2021). This indicates that Indonesia is a serious concern in the development of Islamic finance, especially in Islamic banks. According to Financial Service Authority, the total asset of Islamic banks in

Indonesia reach Rp 646,2 billion in September 2021 and grow 12,22% from the previous year (OJK, 2021).

Unlike conventional banks, Islamic banks have various sources of income through financing modes, such as equity-based, debt-based, and social-based (Ismal, 2010; Berger et al., 2019; Albanna & Nurdany, 2021). Equity-based financing includes mudharabah and musyarakah contract, while debt-based financing contains murabaha, salam, istishna, and ijarah contracts. Each mode of financing has a different income structure, for instance, equity financing is depending on profit and loss sharing, while debt-based financing is depending on the margin. However, Islamic banks tend to use debt-based financing rather than equity-based financing regarding the risk of the contract that exists in the equity-based contract (Louhichi & Boujelbene, 2017; Miah & Suzuki, 2020; Danlami et al., 2022). Moreover, the implementation of equity-based financing is depending on the characteristic of Islamic banks and the supervisory sharia board in the management (Meslier et al., 2020). Nevertheless, the profitability of Islamic banks is influenced by financing modes either equity-based or debt-based financing (Belkhaoui et al., 2020).

Interestingly, Indonesian Islamic Banks have a similar proportion of financing structures between equity-based and debt-based financing where debt-based financing is roughly 48,65% of total financing, while equity-based financing reaches 48,34% of total financing. Debt-based financing includes murabaha (46,22%), istishna (0,61%), and ijarah (1,82%). Meanwhile, musyarakah financing and mudharabah financing reach 45,69% and 2,65% respectively (OJK, 2021). This indicates that either equity or debt-based financing is crucial for Islamic banks to generate profit. However, the big portion of musyarkah financing means that Islamic banks hold riskier assets rather than any other contract, nevertheless, the riskier asset has a higher return will be (Warninda et al., 2019). Moreover, an increasing portion of equity-based financing is driven by the competition between Islamic banks (Risfandy et al., 2020).

Since equity and debt-based financing has a similar portion, the question arises whether equity-based or debt-based financing that more profitable for Islamic banks in Indonesia. Several studies showed that debt-based financing significantly influences the profitability of Islamic banks in GCC countries while having a big portion of equity-based financing increases the credit risk (Belkhaoui et al., 2020). Meanwhile, (Ismal, 2010) argued that both equity and debt-based financing have sustainable returns for Islamic banks in Indonesia, thus Islamic banks well managed the risk of volatile returns from equity-based financing. Moreover, (Wahyudi et al., 2020) found that only equity-based financing affects the return on equity of Islamic banks in Indonesia. (Wahyudi et al., 2019) revealed that debt and equity-based financing influence the profitability of Islamic banks in Indonesia where the size of Islamic banks failed to moderate between the financing and the profitability, this indicates that the size of the Islamic banks is not vital for generating profit rather than the total financing that they have. Nevertheless, (Zulkhibri, 2018) suggests that the financing behavior of Islamic banks is in line with conventional lending behavior and not influenced by changes in monetary policy. To generate profit Islamic Banks operate as financial intermediation where financing is one of the fundamental sources of income, in Islamic banks have two types of financing there are equity-based and debt-based financing.

Thus, the objective of this paper is to evaluate whether equity-based or debt-based financing that is more profitable for Islamic banks in Indonesia, since they have a similar allocation of financing. However, the results of the studies relating to equity-based and debt-based financing in Islamic banks are varied and still inconclusive. Therefore, addressing the topic is necessary to fill the gap in the literature relating to equity-based and debt-based financing on the profitability of Islamic banks (Belkhaoui et al., 2020; Ismal, 2010; Wahyudi et al., 2020; Wahyudi et al., 2019). The paper has contributed to the literature in several respects, the best of the author's knowledge, this is the first study to examine equity-based and debt-based financing in Indonesia with the latest years. Second, this paper also complements the prior study relating to Islamic bank's lending channels in a single country (Akhatova et al., 2016; Aysan et al., 2018; Risfandy et al., 2020; Baele et al., 2014). Third, this article also complements the prior study on equity-based versus debt-based financing on profitability in Indonesia (Wahyudi et al., 2020; Wahyudi et al., 2019). However, prior studies use different samples and times of Islamic banks, because, in the last five years, Islamic banks in Indonesia have had corporate actions such as mergers (among 3 state-owned Islamic banks) and conversion from conventional to full-fledged Islamic banks. Therefore, the samples in this study are relevant to the actual condition of Islamic banks in Indonesia. Moreover, the result of this study implies to Islamic bank management to consider the type of financing to generate more profit and for the regulatory can developed the appropriate regulations and develops the Islamic bank's environment that is in line with their characteristic and sharia-compliant. This paper is divided into five parts, where the first part is the introduction, the second part is the literature review, the third part is the methodology, and the last two parts are the result and analysis, and conclusion.

LITERATURE REVIEW

Islamic banks in Indonesia have tremendously grown since their existence in 1990. In the dual banking system adoption, Islamic banks play a crucial role in elevating the social and economy of Indonesian society (Fianto et al., 2018). Unlike conventional banks, Islamic banks have unique characteristics in which they have more than one financing type, there are equity-based financing and debt-based financing. Each type of financing has a different return scheme, whereas equity-based financing has profit and loss sharing return and debt-based financing has profit margin return (Ismal, 2010; Berger et al., 2019; Albanna & Nurdany, 2021).

The equity-based financing includes a musyarakah contract, where the Islamic banks and the customers share their equity to finance a specific project or business. Another equity-based financing is the mudharabah contract, where Islamic banks posit as the capital provider and the customers posit as the project or business management without capital charge. Either mudharabah or musyarakah gives the return to Islamic banks depending on the profit and loss from the counterparty. Studies revealed that equity-based financing is riskier than debt-based financing (Belkhaoui et al., 2020). Moreover, the musyarakah contract is not riskier than the mudharabah contract due to the in musyarakah contract both parties have to provide capital and Islamic banks can enter into the management system, while in mudharabah contract capital loss is charged for Islamic banks (Meslier et al., 2020; Ismal, 2010).

On the other hand, debt-based financing contains several contracts cush as murabahah, istishna, and ijarah contracts. Whereas the murabaha contract is a sale plus markup contract. The assets are bought on behalf of consumers and then sold at a pre-set price, whether they are for company or personal use. As a result, clients pay for the assets in a single payment or a series of payments. Up until the full amount of payments is received, the bank retains ownership of the assets. Meanwhile, istishna is similar to the Murabaha contract, however, the difference between them is if istishna is used to buy specific objects such as the materials for construction or any object with specific terms and conditions. Ijara is a lease agreement for business or financial use. Clients can rent out assets from banks for a set monthly fee once the bank purchases the assets on their behalf. Although the financier retains ownership, it may be gradually transferred to the clients (Meslier et al., 2020). All the contracts in debt-based financing give a fixed return to the Islamic banks, thus, in terms of risk, debt-based financing has a lower risk (Khan, 2015).

Nevertheless, In today's financial environment, the majority of Islamic banks favor using Non-PLS financing. First, PLS contracts are susceptible to agency issues because, in comparison to self-financed businesses, PLS entrepreneurs may be less motivated to work harder and more likely to declare lesser earnings (Meslier et al., 2020). Moreover, Principal-agent problems that result in information asymmetry and unfavorable selection can be brought on via PLS financing. For instance, when borrowers (entrepreneurs) fail to disclose all pertinent information, such as actual expenses and revenues, the banks might not be compensated fairly under the profit-sharing agreements. Last but not least, the principal-agent issue necessitates PLS funding (Ghavami, 2022; Warninda et al., 2019).

Myriad studies showed different findings, (Shahari et al., 2015) found that equity-based financing is more volatile compared to debt-based financing. this implies to Islamic banks use more debt-based financing. (Fatihah et al., 2019) found that equity-based financing increases the liquidity risk of Islamic banks in Indonesia. This indicates that equity financing turns into default more frequently rather than debt-based financing. Moreover, (Wahyudi et al., 2019) found that both equity and debt-based financing are determined the Islamic bank's profitability. The result is in line with (Fianto et al., 2018) found that both equity and debt-based financing increase the level of economy and society of households in Indonesia. Nevertheless, a big portion of equity-based financing will impose a higher credit risk rather than debt-based financing. Thus, using debt-based financing is more safety for Islamic banks (Belkhaoui et al., 2020). Moreover, (Warninda et al., 2019) argued that the mudharabah contract is not riskier than the musyarakah contract in equity-based financing of Islamic banks.

RESEARCH METHOD

The study aims to assess the profitability of Islamic banks whether debt-based or equity-based more profitable for Islamic banks in Indonesia. We use quarterly panel data from all the Islamic banks in Indonesia from 2017 Q1 to 2021 Q4. The data is taken from the Financial Service Authority (OJK), Bank Indonesia, Indonesia Statistical Bureau (BPS), and the Islamic bank's website.

This study is proposed by (Belkhaoui et al., 2020) where the proxies of profitability are return on assets (ROA) and return on equity (ROE) as the dependent variable. For independent variables, we use equity-based financing per total asset and debt-based financing per total asset. Moreover, we also add several control variables such as Islamic Banks' characteristics and macroeconomic variables. Islamic banks' characteristic variables contain capital adequacy, financing default, and finance-to-deposit ratio while inflation and interest rate are used as macroeconomic variables.

The panel regression is used to assess the collected data. Panel data regression analysis the Fixed Effect Model (FEM) has an advantage over REM in panel data regression because it can regulate the properties of both measurable and unmeasured data (Schunck, 2013). Thus, the Fixed Effect Model (FEM) is the most suitable estimation technique for this study. Moreover, since we have limited samples to be estimated and to gain a robust result, we apply a bias-corrected least square dummy variable (LSDV) model as a robustness test following (Ibrahim & Rizvi, 2017; Ali et al., 2022; Ibrahim et al., 2018) that is used for Islamic Banking research. It is well known that LSDV can handle the bias for small T, regardless of the number of samples (N). The following is the panel regression formula:

Equation 1:

$$ROA_{it} = \beta_0 + \beta_1 EQ_{it} + \beta_2 DB_{it} + \beta_3 IBchar_{it} + \beta_4 Macro_{it} + e_{it}$$

Equation 2:

$$ROE_{it} = \beta_0 + \beta_1 EQ_{it} + \beta_2 DB_{it} + \beta_3 IBchar_{it} + \beta_4 Macro_{it} + e_{it}$$

Where ROA_{it} is the return on asset of Islamic bank *i* at the time *t*, ROE_{it} is the return on equity of Islamic banks *i* at the time *t*, EQ_{it} is the equity-based financing of Islamic bank *i* at the time *t*, DB_{it} is the debt-based financing of Islamic banks *i* at the time *t*, $IBchar_{it}$ are the Islamic bank's characteristics *i* at the time *t*, and $Macro_{it}$ are the macroeconomic variables. Moreover, the explanation of the variables is as follows:

Table 1. Variables Explanation

Variables	Formula	Explanation	References
Dependent variables			
ROE	$\frac{net\ profit}{equity}$	percentage	(Belkhaoui et al., 2020; Wahyudi et al., 2019; Wahyudi et al., 2020)
ROA	$\frac{income\ after\ tax}{total\ asset}$	percentage	(Belkhaoui et al., 2020; Wahyudi et al., 2019;Wahyudi et al., 2020)
Independent variables			
Equity-based (EQ)	$\frac{(mudharabah + musyarakah)}{total\ asset}$	percentage	(Belkhaoui et al., 2020;Warninda et al., 2019; Fianto et al., 2018)
Debt-based (DB)	$\frac{(mudaharabah + istishna + ijarah)}{total\ asset}$	percentage	(Hoque & Liu, 2021)
Islamic Banks Characteristics			
KPPM	$\frac{capital}{risk\ weighted\ asset}$		
NPF	$\frac{non-performing\ financing}{total\ financing}$	percentage	(Hesse, 2010; Abedifar et al., 2013)
FDR	$\frac{total\ \text{financing to the third party nonbank}}{total\ deposit}$	percentage	(Hesse, 2010; Abedifar et al., 2013)
Macroeconomic variables			
INFL	Quarterly inflation	percentage	(Hesse, 2010; Abedifar et al., 2013)
BIrate	BI 7 days repo rate	percentage	(Hesse, 2010; Abedifar et al., 2013)

RESULTS AND DISCUSSIONS

In this section, we discuss the result of the statistical data. Starting from the descriptive statistic, matrix correlation, and hypotheses testing. Table 1 describes the descriptive statistics of observed data. The result showed that debt-based financing in Indonesia is bigger than equity-based financing. The mean value of debt-based financing reaches 43.66% while equity-based financing is around 29.64%. Interestingly, the min value of equity-based is 0 and the max value is 74.27%, this indicates that several banks in Indonesia do not use equity-based financing in their lending channel, while others allocate their financing in equity-based more than 50%. In contrast, debt-based financing has min value of roughly 0.532% and a max value is 99.55%. This indicates that the majority of the Islamic Banks in Indonesia use debt-based financing as their main channel. Moreover, the reality of debt-based financing syndrome not only occurs in Indonesia but also occurs in Islamic banks around the world.

Table 2. Descriptive Statistic

	Obs.	Mean	Std. Dev.	Min.	Max.
ROA	180	1.704	3.734	-10.77	13.58
ROE	180	6.659	12.17	-49.05	37.16
DBTA	180	43.66	27.51	0.532	99.55
EQTA	180	29.64	21.01	0.000	74.27
KPPM	180	23.67	9.475	10.16	58.10
NPF	180	2.133	1.693	0.000	4.980
FDR	180	87.97	19.71	38.33	196.7
INFL	180	0.110	0.361	0.013	1.680
BIRATE	180	4.600	0.859	3.500	6.000

Table 2 describes the hypotheses testing relating to the research question. Columns (1) and (2) describe the estimation of all the variables including control variables and macroeconomic variables. Column (3) and (4) explains the estimation of all variables excludes the macroeconomic variables. The results are still hold, that equity-based financing and debt-based financing significantly influenced the profitability of Islamic banks in Indonesia (ROA and ROE) in all estimations. Nevertheless, equity-based financing has a positive direction while debt-based financing has a negative direction on the profitability of Islamic banks (ROA and ROE) in all calculations. This result implies that equity-based financing increases the asset and equity of Islamic banks, in contrast, debt-based financing reduces the asset and equity of Islamic banks in Indonesia.

Table 3. Hypotheses Analysis

	(1) ROA	(2) ROA	(3) ROA	(4) ROA
DBTA	-0.0229**		-0.0340**	
	(0.0096)		(0.0149)	
EQTA		0.0357*		0.0412*
		(0.0215)		(0.0237)
KPPM	-0.0182	-0.0058	-0.0117	-0.0159
	(0.0240)	(0.0238)	(0.0271)	(0.0271)
NPF	-0.1786	-0.2131	-0.1788	-0.2099
	(0.1517)	(0.1519)	(0.1550)	(0.1553)
FDR	0.0015	-0.0084	0.0014	-0.0113
	(0.0078)	(0.0085)	(0.0081)	(0.0086)
INF	-0.2082	-0.0594		
	(0.3175)	(0.3155)		
BIRATE	0.3575**	0.2233		
	(0.1567)	(0.1437)		
C	1.7946	0.9638	3.7720***	2.3136**
	(1.2442)	(1.3229)	(0.9716)	(1.0296)
Bank FE	Yes	Yes	Yes	Yes
Q. FE	No	No.	Yes	Yes
Obs.	178	178	178	178
R2	0.066	0.049	0.056	0.043

Standard error in parentheses. *, **, and *** denote significant at 10%, 5%, and 1%.

	(1) ROE	(2) ROE	(3) ROE	(4) ROE
DBTA	-0.1425***		-0.2538***	
	(0.0457)		(0.0710)	
EQTA		0.2807***		0.3696***
		(0.1017)		(0.1127)
KPPM	-0.2748**	-0.1947*	-0.2354*	-0.2584**
	(0.1140)	(0.1128)	(0.1288)	(0.1289)
NPF	-0.1344	-0.3323	-0.1473	-0.3707
	(0.7194)	(0.7189)	(0.7371)	(0.7380)
FDR	-0.0443	-0.1157***	-0.0324	-0.1375***
	(0.0368)	(0.0401)	(0.0384)	(0.0409)
INFL	-0.9044	0.0490		
	(1.5061)	(1.4930)		
BIRATE	1.0954	0.3024		
	(0.7435)	(0.6800)		
C	18.7668***	12.4500**	26.7784***	14.7321***
	(5.9016)	(6.2591)	(4.6213)	(4.8930)
Bank FE	Yes	Yes	Yes	Yes
Q. FE	No	No	Yes	Yes
Obs.	178	178	178	178
R2	0.1038	0.0926	0.1441	0.1331

Standard errors in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Furthermore, the table below explains the correlation between independent variables. The result showed that all the independent variables do have not a high correlation (almost 1). Thus, the recent model has not had perfect collinearity. Further value is described in the table below.

Table 4. Matrix Correlation

	DBTA	EQTA	KPPM	NPF	FDR	INFL	BIRATE
DBTA	1.000						
EQTA	-0.818	1.000					
KPPM	0.014	-0.214	1.000				
NPF	-0.457	0.581	-0.520	1.000			
FDR	-0.071	0.325	0.110	0.255	1.000		
INFL	-0.123	0.007	0.108	-0.008	0.078	1.000	
BIRATE	0.262	-0.032	-0.218	-0.010	-0.032	-0.215	1.000

The table below explains the robustness check of the variables. The estimation of all variables is explained in columns (1) and (2), meanwhile, columns (3) and (4) describe the result estimation excluding macroeconomic variables. The result showed that debt-based financing consistently influenced the performance of Islamic banks both ROA and ROE significantly negatively, meanwhile equity-based financing influenced the ROA and ROE positively, nevertheless, equity-based financing only influenced significantly on the ROE side. The results are robust for debt-based and equity-based financing on the return on asset and return on equity, however, the equity-based financing is insignificant on the return on asset. In addition, the findings are rational where equity-based financing as the equity-share mode of finance directly influences the equity of Islamic banks. This indicates that the investment through equity-based financing boosts the amount of equity along with the right risk management on it.

Table 5. Robustness Check

	(1) ROA	(2) ROA	(3) ROA	(4) ROA
L.ROA	0.4636***	0.4716***	0.5104***	0.5055***
	(0.0742)	(0.0731)	(0.0850)	(0.0782)
DBTA	-0.0226**		-0.0278	
	(0.0103)		(0.0193)	
EQTA		0.0338		0.0392
		(0.0231)		(0.0244)
KPPM	-0.0274	-0.0162	-0.0202	-0.0234
	(0.0308)	(0.0297)	(0.0335)	(0.0326)
NPF	-0.2275	-0.2688	-0.2476	-0.2816
	(0.1887)	(0.1876)	(0.2007)	(0.1979)
FDR	0.0043	-0.0055	0.0040	-0.0079
	(0.0102)	(0.0096)	(0.0104)	(0.0097)
INFL	-0.0726	0.0800		
	(0.3089)	(0.2843)		
BIRATE	0.2673	0.1299		
	(0.1910)	(0.1710)		
Bank FE	Yes	Yes	Yes	Yes
Q. FE	No	No	Yes	Yes
Obs.	169	169	169	169

Table 6. Robustness Check

	(1) ROE	(2) ROE	(3) ROE	(4) ROE
L.ROE	0.7530***	0.7581***	0.7673***	0.7669***
	(0.0746)	(0.0691)	(0.0713)	(0.0689)
DBTA	-0.1050**		-0.1649**	
	(0.0520)		(0.0681)	
EQTA		0.1931*		0.2616**
		(0.1128)		(0.1294)
KPPM	-0.1276	-0.0681	-0.0681	-0.0773
	(0.1397)	(0.1323)	(0.1612)	(0.1596)
NPF	0.5643	0.3994	0.4005	0.2269
	(0.8140)	(0.8270)	(0.8254)	(0.8312)
FDR	-0.0148	-0.0654	-0.0090	-0.0815*
	(0.0350)	(0.0423)	(0.0366)	(0.0417)
INFL	-0.1789	0.5023		
	(1.4992)	(1.4606)		
BIRATE	0.6462	0.0570		
	(0.8173)	(0.7658)		
Obs.	168	168	168	168

The objective of this paper is to analyze the equity-based and debt-based financing on the profitability of Islamic banks in Indonesia since debt-based financing in Islamic banks has a bigger portion than equity-based, however, in Indonesia's case, equity-based financing has a similar portion to debt-based financing. In this section, the analysis begins with debt-based financing on the profitability of Islamic banks than followed by equity-based financing.

Debt based-financing which generates margins for Islamic Banks has negatively influenced the return on asset and return on equity as well. The result is in line with (Wahyudi et al., 2019), but contradicts (Abusharbeh, 2014; Belkhaoui et al., 2020) which found that debt-based financing influenced positively the profitability of Islamic banks in Indonesia and GCC countries. This implies that the risk management of debt-based financing in Indonesian Islamic Banks is not well managed. Nevertheless, some researchers argued that debt-based financing has lower risk compare to equity-based financing, however, if the risk is not well mitigated then the non-performing issue is waiting (Widarjono, 2018). Having a big portion of the debt-based financing channel must be followed with the good risk management and mitigations. This finding is supported by the negative significant influence of the finance-to-deposit ratio (FDR) and capital adequacy ratio (KPPM) on the profitability of Islamic Banks. This implies that risk management failure on a big portion of debt-based financing will reduce their capital, furthermore, this condition led the Islamic banks to deal with the probability of default (Danlami et al., 2022). However, this condition implies that the profitability of Islamic banks in Indonesia is driven by fee-based income rather than financing channels (Azad et al., 2019 ; Yanikkaya et al., 2018). Moreover, the debt-based syndrome of the Islamic bank's product faces criticism due to the similarity to their conventional credit channel (Šeho et al., 2020; Azmat et al., 2015).

On the other hand, equity-based financing positively and significantly influenced the profitability of Islamic Banks (ROA and ROE). The finding is in line with (Danlami et al., 2022), however, contradicts (Belkhaoui et al., 2020) which found that equity-based financing is negatively influenced the profitability of Islamic Banks. Suggesting that agency problem, moral hazard, and cost monitoring in equity financing is not a big deal in the case of Indonesian Islamic Banks. Unlike other countries, Indonesia has been successful in disbursing a big portion of equity-based financing, nevertheless, (Suzuki et al., 2019) argued that equity financing in Indonesia is not of the purely "participatory" financing type and applies more in quasi *murabahah* syndrome. In addition, imposing a penalty on equity-based financing is allowed in Indonesia (based on the *fatwa* of national sharia council, *fatwa* no.7 and 8 regarding *mudharabah* and *musyarakah* contarct), even though the penalty is reported as a non-halal income for Islamic banks. However, the way of Indonesian Islamic Banks in pushing equity-based financing is interesting, at the same time will increase the competition among Islamic Banks itself to use equity-based financing rather than debt-based financing. (Risfandy et al., 2020) suggest that equity-based financing in Indonesia is determined by the compettion amomg Islamic Banks. Furthermore, developing fee-based income for Islamic Banks is important also (Azad et al., 2019). This implies that equity-based financing can attract more entrepreneurs, and equity-based financing has lower volatility on the interest rate risk (Šeho et al., 2020).

The findings of this study suggest that Islamic Banks in Indonesia apply risk management appropriately to defend from the non-performing financing of debt-based financing along with controlling their financing-to-deposit ratio. Imposing equity-based financing is recommended to increase the competition among Islamic Banks and at the same time will increase their capital adequacy and profitability. For the regulators, the result of the paper implies that developing new products and services based on the equity-based contract is necessary to strengthen the fundamental of Islamic Banks and maintain stability. Moreover, the result also suggests for other developing countries which apply dual banking systems make Indonesian Islamic Banks a lesson learned to be significantly distinguished from their conventional counterpart in disbursing equity-based financing. However, the paper has several limitations such as the limited data and samples in this study which use single country analysis, thus implying cross countries data is crucial to gain the comprehensive result of equity and debt-based financing in Islamic Banks. The second is using another formula to measure the profitability and financing structures proxies are crucial to getting detailed results and robust of which contract is the most determinant of profitability in Islamic Banks. The third is using another methodology such as a dynamic panel also required to have a robust result.

CONCLUSION AND RECOMMENDATION

The profitability of Islamic Banks is determined by the financing structures in their asset. Distinguishing from the conventional which only have credit in their lending channel, Islamic Banks have debt-based and equity-based in their financing structures. The study aims to examine whether debt-based or equity-based is more profitable for Islamic Banks in Indonesia, besides, Indonesian Islamic Banks have a big portion for equity-based financing.

The result found that debt-based financing has negatively significantly influenced the Return on Assets and Return on Equity of Islamic Banks in Indonesia, while equity-based financing generates an inverse result. This implies that Islamic Banks in Indonesia can handle agency problems, high-cost monitoring, and moral hazards in disbursing equity-based financing. Implying that Indonesian Islamic Banks successful in pushing equity-based financning and reduce the amount of debt-based financing gradually. In addition, since the debt-based syndrome mushrooming the Islamic Banks across the world, the findings of this study can be a lesson learned how to pushing the equity-based financing in dual banking system.

Furthermore, the findings of this paper has huge practical implications for Islamic Banking ecosystem that applying equity-based financing in bigger portions is reasonable along with the good risk management and flexibility of the *fatwa* regarding the *muhdarabah* and *musyarakah* contracts. In addition, equity-based financing able to attract new entrepreneurs for capital reason then negative stigma of Islamic Banks have no distinction with their conventional is diminished.

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