

Macroeconomic and Bank-Specific Factors Affecting Islamic Bank Profitability in Indonesia

Toufan Aldian Syah

Universitas Jenderal Soedirman Purwokerto Indonesia
cv_das@yahoo.com

Abstract

This study examines how macroeconomic and bank-specific variables influence the profitability of Islamic Commercial Banks in Indonesia. Using qualitative-documentary analysis, the research integrates both internal performance metrics—such as capital adequacy, cost efficiency, and credit quality—and external macroeconomic indicators including GDP growth and inflation. Framed by the Resource-Based View and Financial Intermediation Theory, the study finds that profitability is most sustainable when internal capabilities are strategically aligned with macroeconomic stability. Inflation and GDP growth significantly impact bank earnings, while internal variables such as capital structure and operational efficiency remain critical performance drivers. The findings reveal that profitability is a dynamic outcome of both internal governance and environmental conditions. This research advances existing literature by providing a holistic framework for assessing Islamic bank performance and offers practical implications for policymakers and bank managers seeking to improve financial resilience within a sharia-compliant context.

Keywords: *Islamic Bank Profitability, Macroeconomic Indicators, Internal Bank Variables, Capital Adequacy, Indonesia.*

INTRODUCTION

The growth and resilience of Islamic Commercial Banks (ICBs) in Indonesia have garnered increasing attention amid global shifts in financial systems and rising demand for ethical finance. As a dual-banking country, Indonesia integrates both conventional and Islamic finance, yet the contribution of Islamic banking remains comparatively modest in terms of total financial assets (World Bank, 2020). Within this context, profitability emerges as a critical metric, both for institutional sustainability and for ensuring stakeholder confidence. Profitability, often proxied by Return on Assets (ROA), encapsulates a bank's ability to manage its resources efficiently while meeting the expectations of depositors and investors (Alqahtani et al., 2017). However, bank profitability is influenced by a complex interplay of internal and external variables, including capital structure, operational costs, inflation, and economic growth.

Theoretical and empirical studies have established the relevance of both macroeconomic and bank-specific determinants in shaping profitability trends in the banking industry (Dietrich & Wanzenried, 2014). Macroeconomic variables such as GDP growth and inflation rates often influence lending capacity, interest income, and default risk, thereby indirectly affecting bank earnings (Ali et al., 2011). On the other hand, bank-specific variables such as capital adequacy ratio, non-performing financing (NPF), cost-to-income ratio, and liquidity ratio directly shape a bank's internal performance structure (Rachdi & Zarghli, 2011). These variables serve not only as operational benchmarks but also as indicators of institutional resilience and competitiveness in a dynamic financial ecosystem.

Despite an expanding literature, studies specifically examining the determinants of profitability in Indonesian Islamic banks remain limited, particularly those incorporating a comprehensive model that combines both macroeconomic and internal institutional variables. Many prior studies isolate either macroeconomic or firm-specific factors, resulting in fragmented conclusions that fail

to capture the holistic nature of banking performance (Sufian & Habibullah, 2010). Furthermore, the distinct operational principles of Islamic finance—including the prohibition of *riba* and adherence to sharia contracts—necessitate specialized models that account for the dual religious and economic mandates unique to ICBs (Dusuki & Abdullah, 2007).

This study thus fills an important gap by integrating multiple theoretical perspectives, particularly the Resource-Based View (RBV), which emphasizes the strategic utilization of internal capabilities, and Financial Intermediation Theory, which addresses the external function of banks as intermediaries between savers and borrowers. By situating Indonesian ICBs within these frameworks, this research seeks to provide a nuanced understanding of profitability that considers both the internal resource alignment and external environmental pressures. Such an integrative approach enables more robust analysis and deeper insights into how Islamic banks can navigate economic volatility while optimizing institutional performance (Barney, 1991; Diamond, 1984).

The central research questions of this study are as follows: (1) How do macroeconomic variables affect the profitability of Islamic Commercial Banks in Indonesia? (2) What is the influence of bank-specific variables on Islamic bank profitability? (3) How do macroeconomic and bank-specific factors interact to shape overall profitability trends in Islamic banks? Addressing these questions is vital for both academic and practical reasons, as it provides actionable insights for policymakers, regulators, and Islamic bank managers in enhancing strategic resilience. The objectives of this study are to analyze the individual and interactive effects of selected variables on profitability and to propose recommendations that support financial sustainability within the Islamic banking sector.

LITERATURE REVIEW

The profitability of Islamic Commercial Banks (ICBs) has long attracted scholarly interest due to its central role in sustaining competitive advantage and fulfilling sharia-compliant mandates. Research indicates that profitability is shaped by both external macroeconomic dynamics and internal bank-specific performance metrics. Macroeconomic indicators such as GDP growth, inflation, and exchange rate volatility are commonly associated with banking sector performance (Athanasoglou et al., 2008). Simultaneously, internal variables including cost-to-income ratio, asset quality, and capital adequacy have shown consistent correlation with Return on Assets (ROA) and Return on Equity (ROE) in various contexts (Ali et al., 2011). In the Indonesian context, several studies have highlighted the positive influence of efficient capital management and liquidity ratios on Islamic bank profitability (Wibowo & Syaichu, 2013).

However, many studies lack an integrative framework that examines both domains concurrently.

The academic discourse surrounding Islamic banking also emphasizes its structural uniqueness, driven by risk-sharing principles, asset-backing requirements, and the prohibition of interest-based income. These features alter the traditional profitability models applied in conventional banking systems. For instance, research by Hassan and Bashir (2005) underscores that the dual governance model—religious compliance and financial regulations—affects managerial decisions and risk exposure, which in turn impacts profitability. Moreover, studies rooted in the Resource-Based View (RBV) posit that internal strategic capabilities such as human capital, technological infrastructure, and risk management systems serve as pivotal enablers of profitability in Islamic banking institutions (Barney, 1991). Integrating this with macro-level analysis through Financial Intermediation Theory offers a more holistic understanding of performance, thus supporting the analytical approach adopted in this research.

Theoretical Framework

The theoretical foundation of this study rests on the intersection of two major frameworks: the Resource-Based View (RBV) and Financial Intermediation Theory. The RBV asserts that sustainable profitability stems from the strategic deployment of unique, inimitable internal resources that offer competitive advantages (Barney, 1991). In the context of Islamic Commercial Banks (ICBs), these resources include managerial competence, sharia-compliant financial products, risk management mechanisms, and capital adequacy. Islamic banks must strategically align their internal resources to navigate regulatory complexities and ensure alignment with religious doctrine while remaining profitable. The RBV thus highlights the internal capabilities that banks must cultivate to survive and thrive in a highly competitive and volatile financial environment (Wernerfelt, 1984; Almarri & Gardiner, 2014).

Financial Intermediation Theory complements the RBV by emphasizing the role of banks as institutions that mitigate informational asymmetries between savers and borrowers (Diamond, 1984). It asserts that profitability is largely derived from a bank's efficiency in channeling funds, managing risks, and minimizing transaction costs. In Islamic banking, this intermediation process is shaped by the necessity to adhere to sharia principles such as the avoidance of *riba*, *gharar*, and *maysir*. Consequently, ICBs adopt profit-sharing contracts like *mudharabah* and *musharakah*, which alter the conventional risk-return dynamics. This affects the way profitability is modeled and assessed, making traditional financial intermediation models insufficient unless adapted for Islamic contexts (Zaher & Hassan, 2001).

Furthermore, institutional theory offers a supportive lens through which to understand the regulatory and cultural dimensions influencing bank behavior. Islamic banks operate within a dual regulatory structure that includes both financial governance (via OJK – Indonesia's Financial Services Authority) and religious oversight (via DSN-MUI – National Sharia Council). These layered requirements impose both constraints and opportunities, influencing strategic priorities such as investment portfolio structure, risk appetite, and capital allocation. The theory suggests that institutional conformity—through legitimacy and compliance—can enhance access to capital, customer trust, and ultimately profitability (Scott, 2001).

Agency theory also plays a peripheral yet relevant role in this research. As Islamic banks often manage profit-sharing investment accounts (PSIA), the principal-agent relationship becomes critical in ensuring transparency, governance, and aligned incentives. Unlike conventional banks, Islamic banks do not offer guaranteed returns, increasing the importance of risk communication and operational transparency. Agency conflicts, if unmanaged, can result in reduced customer trust and long-term profitability erosion (Archer & Abdel Karim, 2007). Hence, effective governance and disclosure are central internal mechanisms influencing profitability, aligning with the RBV's emphasis on strategic capabilities.

Integrating these theoretical models allows for a comprehensive examination of profitability in ICBs from both internal and external perspectives. While RBV identifies the internal enablers of performance, Financial Intermediation Theory and institutional analysis account for environmental constraints and opportunities. This theoretical triangulation provides a robust lens to understand how macroeconomic variables interact with internal bank-specific characteristics to shape Islamic bank profitability in Indonesia.

Previous Research

Early empirical investigations into Islamic bank profitability, such as Hassan and Bashir (2005), emphasized the importance of both macroeconomic stability and bank-specific features, including size and capital adequacy. Their cross-country analysis revealed that macroeconomic variables

like GDP growth and inflation significantly influence Islamic banking performance, although institutional and regional variations remain substantial. The study contributed foundational insights but lacked country-specific focus, particularly for Indonesia.

In a study by Sufian and Habibullah (2010), the authors analyzed the profitability determinants of Islamic banks in Malaysia and Indonesia using panel data regression. Their results demonstrated that cost efficiency and capitalization were among the strongest predictors of profitability. They also noted that inflation had a negative impact on ROA, challenging prior assumptions of its positive influence. However, the analysis was confined to early 2000s data and did not integrate theoretical perspectives such as RBV or intermediation theory.

Rachdi and Zarghli (2011) examined bank-specific and macroeconomic factors in the MENA region, finding that profitability was positively related to asset quality and macroeconomic growth, but negatively impacted by inflation volatility. Their findings supported the dual influence of internal and external variables but did not explore the unique institutional environment of Islamic finance in Southeast Asia, particularly Indonesia's dual regulatory system.

More recent research by Naceur and Omran (2011) analyzed commercial banks in the MENA region and concluded that both internal performance metrics and political stability were crucial to profitability. However, Islamic banks were included only marginally, and their distinct operational models were not the primary focus. This limits the applicability of their findings to ICBs operating under sharia constraints.

In the Indonesian context, a study by Wibowo and Syaichu (2013) examined how financing risk, capital adequacy, and bank size affected ROA among Islamic banks from 2008 to 2012. They found that higher capital adequacy ratios positively influenced profitability, while non-performing financing ratios exerted a negative effect. However, the study did not account for macroeconomic indicators such as inflation and GDP, limiting its external validity.

Further research by Utami and Darmawan (2018) employed a more integrative approach to examine both macroeconomic and bank-specific variables in Indonesian Islamic banks. Their regression model confirmed the significant influence of both internal efficiency and external macroeconomic stability on profitability. Nevertheless, their theoretical framing was descriptive rather than analytical, omitting broader frameworks like RBV and Financial Intermediation Theory that could enhance explanatory power.

Collectively, these studies confirm the multidimensional nature of profitability determinants in Islamic banking. However, few have attempted a fully integrated analysis within the Indonesian context that combines macroeconomic and microeconomic factors using multiple theoretical lenses. This creates a clear research gap. Specifically, there is a need for an analytical model that explains how both internal strategic resources and external economic conditions interact to influence profitability in Islamic banks under Indonesia's unique dual-governance structure. This study addresses this gap and contributes new perspectives that are contextually and theoretically grounded

METHOD

This study adopts a qualitative-documentary approach, relying on the textual analysis of secondary data to explore the influence of macroeconomic and bank-specific variables on Islamic Commercial Bank profitability in Indonesia. The nature of the data is non-numeric and interpretive, emphasizing conceptual linkages between institutional performance indicators and macroeconomic trends. This qualitative orientation is particularly suited for complex, theory-

driven inquiries where interpretative richness is prioritized over statistical generalization (Creswell & Poth, 2018, p. 77). The qualitative format enables the exploration of institutional behavior, strategic management, and external pressures through conceptual frameworks such as RBV and Financial Intermediation Theory.

The primary sources of data include scholarly journal articles, books, theses, policy reports, and publications from international financial organizations. All references are drawn from traceable and reputable sources such as the World Bank, IMF, BPS–Statistics Indonesia, as well as Sinta-accredited Indonesian journals. The inclusion criteria are based on publication credibility, relevance to Islamic banking profitability, and date of publication not later than 2021. This ensures both theoretical validity and contemporary relevance. Key texts include studies on Islamic bank performance, macroeconomic modeling, and sharia-compliant financial systems (Iqbal & Mirakhor, 2011, p. 98; Khan, 2015, p. 211).

Data collection is conducted through document analysis, which involves systematic reading, coding, and interpretation of texts. Sources are categorized by thematic relevance—macroeconomic indicators, internal bank metrics, regulatory frameworks, and strategic management models. This method ensures consistency and traceability in analyzing how various data points correspond to each research question. Thematic triangulation is used to identify converging patterns across different types of literature, thereby enhancing credibility (Bowen, 2009).

Data analysis is based on interpretive and thematic techniques. This involves identifying recurring motifs, contradictions, and explanatory themes that support or challenge the initial research assumptions. The process is recursive and iterative, allowing for deeper engagement with the material. Concepts from RBV and Financial Intermediation Theory are used as analytical lenses to frame these themes, ensuring theoretical alignment (Eisenhardt & Graebner, 2007). Interpretation is not only descriptive but also inferential, linking textual evidence to broader conceptual arguments.

Conclusion drawing is conducted through synthesis and thematic integration. Findings are organized in relation to the three research questions and validated against both theoretical models and previous empirical studies. Each conclusion is the product of triangulated insights from multiple sources, ensuring robustness and internal coherence. The goal is to construct a conceptually integrated and practically actionable model of how macroeconomic and bank-specific variables shape Islamic bank profitability in Indonesia. This method ensures that findings are not only contextually rich but also strategically relevant for stakeholders in banking and policy-making.

RESULTS AND DISCUSSION

The analysis of profitability determinants in Indonesian Islamic Commercial Banks reveals intricate interdependencies between internal capabilities and external macroeconomic conditions. Framed by the Resource-Based View (RBV), internal variables such as capital adequacy, cost-to-income ratio, and asset quality represent strategic resources that banks must optimize to ensure sustained profitability (Barney, 1991). At the same time, Financial Intermediation Theory highlights the essential role of banks in transforming savings into productive investments, which becomes increasingly complex in a sharia-compliant environment (Diamond, 1984). This dual framework provides an interpretive model that aligns well with the multidimensional nature of Islamic banking operations.

Existing literature underscores that Islamic banking profitability is not solely a product of

endogenous managerial strategies but also significantly shaped by macroeconomic stability (Hassan & Bashir, 2005; Rachdi & Zarghli, 2011). However, prior studies often examined these variables in isolation. This research offers a more integrative perspective, where macroeconomic volatility and institutional capacity interact, amplifying or mitigating their respective effects on profitability. New insights from Indonesian empirical contexts suggest that a hybrid performance model—rooted in internal strategic governance and aligned with economic indicators—is vital for enhancing resilience in Islamic banks (Utami & Darmawan, 2018).

By embedding the research findings within these theoretical models, the study contributes to bridging the gap between fragmented empirical observations and conceptual generalizations. The following three subsections elaborate the findings thematically, each corresponding to one of the embedded research questions.

1. The Influence of Macroeconomic Variables on Profitability

The first research question addresses how macroeconomic variables influence the profitability of Islamic Commercial Banks in Indonesia. Findings indicate that inflation and GDP growth play crucial roles in shaping the operational landscape of these banks. Moderate inflation positively correlates with profitability by allowing banks to adjust profit margins; however, excessive inflation erodes purchasing power and increases default risk, thereby negatively impacting Return on Assets (Ali et al., 2011; Athanasoglou et al., 2008). In the Indonesian context, inflation volatility during global financial shocks was observed to suppress Islamic bank earnings due to rigid profit-sharing contract structures and delayed re-pricing mechanisms (World Bank, 2020).

GDP growth positively influences profitability by expanding economic activities and credit demand, especially in productive sectors favored by Islamic finance such as trade and agriculture. As GDP increases, business confidence improves, reducing default risk and enhancing asset quality (Sufian & Habibullah, 2010). Moreover, economic growth enhances household income and savings, supporting banks' funding sources through wadiah and mudarabah accounts. The relationship between GDP growth and Islamic bank profitability thus underscores the importance of macroeconomic expansion in driving financial sector sustainability.

Exchange rate stability, though less emphasized in earlier models, also emerged as a relevant macroeconomic determinant. A stable rupiah supports import-export activities, which are often financed through Islamic trade finance products such as murabahah and musyarakah. Volatility in exchange rates increases risk and reduces transaction volume, indirectly affecting profitability (Naceur & Omran, 2011). Hence, macroeconomic variables collectively serve as both enablers and constraints, depending on their stability and interaction with bank-specific strategies.

This finding aligns with Financial Intermediation Theory, where macroeconomic stability lowers informational asymmetries and transaction costs, enhancing intermediation efficiency. It also challenges prior assumptions that macroeconomic impacts are marginal in sharia-compliant institutions, showing that despite religious principles, economic forces significantly shape bank outcomes.

2. The Effect of Bank-Specific Variables on Profitability

The second research question focuses on the influence of internal bank-specific variables on the profitability of Islamic Commercial Banks. Results show that capital adequacy ratio (CAR) and cost-to-income ratio (CIR) are the most consistent predictors of profitability. A higher

CAR enhances investor confidence and cushions banks against unexpected losses, aligning with the RBV perspective that capital serves as a strategic resource (Wibowo & Syaichu, 2013). In Islamic banking, this is particularly important due to the absence of interest-based hedging mechanisms.

Conversely, a high CIR negatively affects profitability, reflecting inefficiency in managing operational expenses. This indicator reveals how well a bank utilizes its income to cover costs, and a lower ratio suggests better efficiency and resource utilization (Rachdi & Zarghli, 2011). In Indonesia, variation in CIR across Islamic banks often correlates with differences in IT infrastructure, human capital investment, and product diversity—factors emphasized in the RBV framework (Almarri & Gardiner, 2014).

Non-performing financing (NPF) is another critical factor. High NPF levels reflect credit risk and reduce income, particularly in profit-sharing contracts where losses are distributed between banks and clients. Islamic banks face unique credit risk structures due to the participatory nature of contracts such as *musharakah* and *mudarabah*, making risk assessment and partner monitoring essential. The study finds that banks with lower NPF ratios consistently report higher ROA, reaffirming the need for robust credit appraisal and monitoring systems.

Liquidity ratios also influence profitability. Islamic banks must maintain sufficient liquidity to meet withdrawal demands without relying on interest-based interbank markets. Efficient liquidity management through instruments like *mudharabah* interbank investment and Bank Indonesia's sharia-compliant facilities directly contributes to profitability. These findings confirm that internal capabilities and governance practices are vital in determining performance, in line with RBV assertions.

This internal efficiency must also be viewed in the context of the regulatory framework. Compliance with both financial regulations and sharia rulings imposes additional operational complexity. However, banks that manage these constraints strategically often convert them into value propositions, thereby enhancing profitability. Thus, bank-specific variables, when optimized, become powerful tools for sustainable performance.

3. Interactions Between Macroeconomic and Bank-Specific Variables

The third research question investigates the interaction between macroeconomic and bank-specific variables and their joint effect on profitability. The study finds that macroeconomic shocks amplify the sensitivity of internal variables, suggesting a contingent relationship rather than a linear one. For instance, during inflationary periods, the cost-to-income ratio increases as operational costs rise faster than income adjustments, particularly in fixed-rate contracts like *murabahah*. This double pressure significantly reduces ROA unless counteracted by internal efficiency measures (Ali et al., 2011).

Similarly, during periods of economic expansion, banks with strong capital adequacy and diversified product portfolios experience greater gains. This is because economic growth fosters investment and financing opportunities, which only well-prepared banks can leverage. Banks with weak capital structures or limited human resources often fail to translate macroeconomic opportunities into profitability, demonstrating the importance of resource alignment as emphasized in the RBV model (Barney, 1991).

This interaction was particularly evident during the COVID-19 pandemic when macroeconomic contractions strained profitability across the sector. However, banks that had previously invested in digital infrastructure and flexible financing products managed to maintain positive ROA figures, showing that pre-existing internal capabilities determine how

banks respond to external stressors. Such findings support a dynamic rather than static model of performance, where internal resilience mediates the effect of external volatility.

The theoretical contribution of this finding lies in linking RBV and Financial Intermediation Theory through a contingent lens. It illustrates that strategic internal capabilities are most valuable when aligned with macroeconomic contexts. Banks must not only develop internal strengths but also synchronize them with environmental cues to sustain profitability.

Therefore, profitability in Indonesian Islamic banks is best understood as a product of strategic fit—where the capacity to manage internal variables like capital, costs, and risks must match the external economic environment. This integrative insight fills the empirical and theoretical gap identified in earlier literature and provides actionable knowledge for Islamic banking strategy.

Such is the view and way of Islam to overcome and solve existing labor problems. The solution offered by Islam is not a patchy solution, but a fundamental, comprehensive solution to society's problems including labor problems. It is time for the Indonesian people to turn to Islam to solve various national problems including labor problems.

This study offers a comprehensive examination of the factors influencing the profitability of Islamic Commercial Banks in Indonesia, drawing on an integrative model that incorporates both macroeconomic and bank-specific variables. In response to the first research question, it was found that inflation, GDP growth, and exchange rate stability significantly impact bank profitability, with GDP growth exerting the most consistent positive influence. Inflation, on the other hand, demonstrates a dual effect—moderate levels support profitability while volatility undermines it. These results reinforce the necessity for Islamic banks to align their operations with broader economic trends to sustain profitability.

Addressing the second research question, internal variables such as capital adequacy ratio, cost-to-income ratio, non-performing financing, and liquidity ratio emerged as critical determinants of profitability. Banks with high capital reserves, efficient cost structures, and effective risk management systems consistently outperformed their peers. These findings emphasize the importance of internal resource optimization, in line with the Resource-Based View, and demonstrate the enduring relevance of bank-specific strategies in shaping outcomes.

The third research question revealed that the interaction between macroeconomic and internal variables is dynamic and context-dependent. Banks with robust internal capabilities were better positioned to leverage economic growth and mitigate external shocks such as inflation and currency volatility. This contingent relationship underscores the need for strategic alignment between institutional resources and environmental conditions.

The theoretical implication of these findings is the successful integration of the Resource-Based View and Financial Intermediation Theory into a unified framework for understanding Islamic bank performance. The model advances the literature by showing that profitability in sharia-compliant institutions is not merely a function of external conditions or internal strengths but the synergy between them. It challenges conventional profitability models by highlighting the contingent and context-sensitive nature of performance in Islamic banking.

Practically, the findings suggest that bank managers should focus on strengthening internal capabilities—such as capital structure, cost efficiency, and credit risk systems—while maintaining sensitivity to macroeconomic indicators. Policymakers, in turn, should ensure a stable economic environment and provide regulatory incentives for banks that invest in strategic capabilities. For stakeholders in Islamic finance, this study offers a roadmap for aligning institutional strategy with external realities to enhance sustainability and ethical performance.

CONCLUSION

This study has explored the multifaceted determinants of profitability in Indonesia's Islamic Commercial Banks by integrating both macroeconomic and bank-specific variables within a dual-theoretical framework. It confirmed that profitability is significantly shaped by inflation trends, GDP growth, and exchange rate dynamics, as well as by internal factors such as capital adequacy, cost management, asset quality, and liquidity efficiency. Each of the three research questions was addressed through a thematic synthesis that not only validated earlier empirical observations but also contributed new theoretical insights into the contingent nature of profitability.

The theoretical models employed—Resource-Based View and Financial Intermediation Theory—proved to be particularly effective in framing the complex interactions between internal institutional strategies and external economic pressures. The findings underscore that Islamic banks must go beyond compliance and cost containment to strategically manage their internal resources in response to evolving macroeconomic conditions. This dynamic alignment is crucial for sustaining profitability and resilience in a competitive, ethically constrained environment.

Drawing from these insights, the study recommends that Islamic Commercial Banks invest in capability-building initiatives such as human capital development, digital infrastructure, and risk management systems tailored to Islamic financial contracts. For policymakers, it highlights the importance of maintaining macroeconomic stability and enabling regulatory frameworks that support strategic investment in internal capabilities. Future research should expand this integrative model to cross-country comparative studies or incorporate longitudinal case analyses to test the stability of these relationships across time and institutional settings.

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