

The Influence of Product Diversification, Service Quality, and Risk Management of Islamic Banks on Money Market Stability in Indonesia

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Article Info

Article history:

Received May, 2024

Revised May, 2024

Accepted May, 2024

Keywords:

Islamic banking
product diversification
service quality
risk management
money market stability
Indonesia

ABSTRACT

This study investigates the effect of Product Diversification, Risk Management, and Service Quality of Islamic banks on Money Market Stability in Indonesia. Using quantitative analysis based on Structural Equation Modeling with Partial Least Squares (SEM-PLS), data were collected through a survey of Islamic bank customers. The results reveal significant positive relationships between Product Diversification, Risk Management, Service Quality, and Money Market Stability. Product Diversification positively influences Service Quality and Risk Management, while Service Quality and Risk Management, in turn, positively impact Money Market Stability. The findings underscore the importance of adopting comprehensive strategies to enhance the stability of the money market in Indonesia's Islamic banking sector. These insights have implications for practitioners, policymakers, and researchers aiming to promote financial stability and inclusivity in Islamic finance.

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1. INTRODUCTION

Islamic banking, characterized by Sharia-compliant financial practices, has gained prominence globally, notably in Indonesia, the largest Muslim-majority nation. Islamic banks in Indonesia, like Bank Muamalat, have shown resilience during economic crises [1]. These banks face challenges aligning with Sharia principles due to conventional banking influences [2]. Islamic banks in Indonesia closely interact with financial institutions and businesses, playing a vital role as financial intermediaries [3]. Their core activities involve providing halal financing, contributing to economic growth, particularly in sectors like Micro, Small, and Medium Enterprises (MSMEs) [4]. Amidst economic fluctuations, Islamic banks have demonstrated better stability than conventional banks, showcasing their potential impact on financial market stability, including the money market [5].

The stability of the money market is crucial for overall financial stability and economic growth [6]. Money market funds (MMFs) globally manage over \$9 trillion in assets, facing vulnerabilities due to liquidity transformation and changing investor perceptions [7]. Islamic banks, adhering to Sharia principles, utilize money market facilities without interest systems, focusing on product diversification, service quality, and risk management to ensure stability [8]. Financial stability within commercial banks, like JSC "Credit Agricole Bank," is vital for meeting obligations, profitability, and withstanding external factors [9]. State intervention in financial policy, including monetary policy, is essential for economic stability, growth, and social justice, relying on public revenues and expenditures [10]. Overall, maintaining stability through effective risk management, regulatory measures, and proper resource allocation is key to ensuring the resilience of the money market and fostering economic prosperity.

Islamic banking, operating under Sharia principles, prioritizes ethical and equitable financial transactions by prohibiting interest (riba) and uncertain transactions like

speculation (gharar) [1], [11]. Instead, it emphasizes profit-sharing (mudharabah), asset-backed dealings, and risk-sharing mechanisms, aiming to enhance transparency and ethical conduct in financial activities [12], [13]. Islamic finance institutions play a crucial role in encouraging economic growth by applying Sharia principles in financial management, leading to increased investment flows and productive businesses, ultimately boosting household income and overall economic activities [14]. Advocates argue that these principles foster financial stability through risk-sharing, transparency, and ethical behavior, distinguishing Islamic finance from conventional banking systems.

Product diversification is crucial for Islamic banks to meet varied customer needs and manage risks effectively. By offering a wide array of Sharia-compliant financial products like savings accounts, investment options, sukuk, and takaful, Islamic banks aim to attract a broader clientele, boost revenue streams, and foster financial inclusion [15], [16]. Diversification policies play a significant role in enhancing investment returns, profitability, and crisis resilience for Arab and Iraqi banks, urging them to align profitability with safety while maximizing the benefits of diversification [15], [17]. However, it is essential to note that the development of Sharia banking products should not solely rely on doctrines lacking robust Islamic law bases, as this could hinder the sector's growth and impact product innovation negatively [18].

Service quality plays a pivotal role in shaping customer satisfaction and loyalty in Islamic banking [19]–[22]. Factors like transparency, efficiency, trustworthiness, and adherence to Sharia principles significantly impact how customers perceive service quality in Islamic banks [23]. The studies emphasize that providing high-quality services, aligned with Sharia principles, is crucial for fostering customer trust and ensuring competitiveness in the market. Customer satisfaction is found to be a key mediator between service quality and loyalty, highlighting the importance of consistently delivering excellent services to enhance

customer loyalty. To maintain customer trust and loyalty, Islamic banks should focus on continuous improvement in service quality, employee training, and monitoring service standards.

Effective risk management is crucial for Islamic banks to navigate financial complexities while upholding Sharia principles. Islamic banks face risks like credit, market, liquidity, and operational risks. Studies highlight the importance of prudential principles and risk management in ensuring sustainability and stability in Islamic banking operations [24]. Fintech adoption can significantly impact pre- and post-financing credit risks in Islamic banks, emphasizing the need for regulators to introduce fintech promptly [25]. Credit risk is a key determinant of financial performance in financial intermediaries like Licensed Commercial Banks and Licensed Finance Companies, emphasizing the significance of credit risk management practices [26]. Developing a Composite Risk Index using major risk indicators can help assess the prevalent risk level in Islamic banks, with factors like regulatory quality and economic conditions influencing risk levels [27].

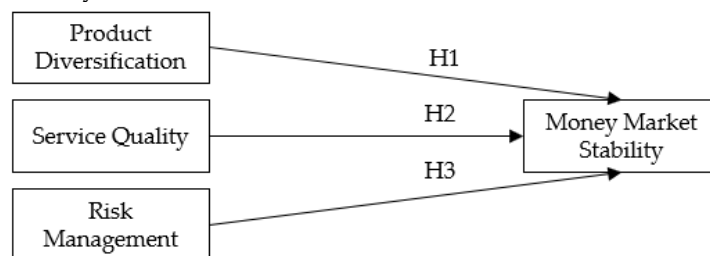
The stability of Indonesia's financial system, including the money market, is influenced by various factors. Research indicates that macroeconomic variables like inflation, exchange rates, and the BI rate, along with external shocks such as world crude oil prices, play significant roles in financial system stability [28]. Additionally, the quality of institutions and financing growth impact the stability of Islamic banks in

Southeast Asia, with institutional quality having a positive influence [29]. Furthermore, the level of competition in the banking industry is positively related to bank stability, suggesting that increased competition enhances stability, particularly in Islamic banking [30]. Addressing challenges like interest rate fluctuations, liquidity conditions, and market sentiment is crucial to maintaining a stable money market, facilitating efficient capital allocation, liquidity management, and overall economic development in Indonesia.

This research aims to investigate the effect of product diversification, service quality, and risk management of Islamic banks on money market stability in Indonesia. By examining these factors, the study seeks to provide insights into the dynamics between Islamic banking practices and financial market stability. The findings of this research can inform policymakers, regulators, and market participants in developing strategies to enhance the stability of the money market and promote financial resilience in Indonesia.

2. LITERATURE REVIEW

Islamic banking has garnered significant attention in both academic and practitioner circles due to its unique principles and practices rooted in Sharia law. This section provides a comprehensive review of the existing literature on Islamic banking, product diversification, service quality, risk management, and money market stability, laying the foundation for the subsequent analysis in this study.



2.1 Islamic Banking and Financial Stability

Islamic banking, guided by Sharia principles, prioritizes ethical conduct, risk-

sharing, and asset-backing in financial dealings, aiming to enhance financial stability through transparency, fairness, and stakeholder risk-sharing. Scholars highlight

that adherence to these principles fosters a robust foundation for financial operations, promoting equitable practices and ethical standards within the industry [31]–[33]. The dual governance model in Islamic banking, where Shariah principles govern operations, ensures a unique approach to corporate governance, emphasizing both performance and Sharia compliance [11]. Additionally, the application of justice principles in Sharia accounting within Islamic banking institutions leads to a fair allocation of profits to stakeholders, aligning with Islamic values and promoting financial equity [34]. Islamic financial institutions play a vital role in economic growth by applying Sharia principles in financial management, stimulating investment flows and enhancing productive businesses.

2.2 Product Diversification in Islamic Banks

Product diversification is crucial for Islamic banks to address varied customer requirements and minimize risks linked to asset or market concentration [35], [36]. Research indicates that diversification can boost revenue streams, decrease reliance on particular sectors, and enhance resilience against market volatilities [37], [38]. Islamic banking, adhering to Sharia principles, faces risks like credit, market, liquidity, and operational risks, necessitating unique risk management strategies [16]. While Islamic banks operate under profit-sharing and risk-sharing arrangements, they must navigate challenges such as uncertainty (Gharar) and comply with Sharia principles, which prohibit fixed returns on loans and deposits. Therefore, adopting effective product diversification strategies is vital for Islamic banks to sustain growth, manage risks, and cater to a diverse clientele.

2.3 Service Quality in Islamic Banks

Service quality plays a crucial role in determining customer satisfaction and loyalty in Islamic banking [19], [20], [22], [39]. High-quality services, encompassing transparency, efficiency, and trustworthiness, have been shown to positively impact customer satisfaction and loyalty [40]. Studies indicate

that service quality directly influences customer loyalty, with customer satisfaction acting as a mediator in this relationship. Furthermore, the research emphasizes the importance of integrating satisfaction and trust alongside service quality to optimize customer loyalty in Islamic banking settings. Therefore, focusing on enhancing service quality, maintaining transparency, efficiency, and trustworthiness can lead to improved customer satisfaction and loyalty in Islamic banking institutions.

2.4 Risk Management in Islamic Banks

Effective risk management is crucial for Islamic banks to uphold Sharia principles and maintain financial stability [25], [35], [41], [42]. Islamic banks encounter risks like credit, market, liquidity, and operational risks, necessitating tailored risk assessment frameworks and prudent financing practices aligned with Sharia principles [43]. Scholars stress the significance of robust governance structures in mitigating risks effectively. Additionally, the expansion of risk indicators to include legal risk, reputation risk, and Sharia compliance risk, among others, enhances the risk assessment process in Islamic banks. Developing Sharia-compliant risk management strategies is essential for ensuring the sustainability and stability of Islamic banking operations, especially in the face of evolving digital financial technologies.

2.5 Money Market Stability in Indonesia

In Indonesia, the stability of the money market is influenced by various factors, including macroeconomic conditions, regulatory policies, and the performance of financial institutions. Studies have highlighted the importance of a stable money market in facilitating efficient capital allocation, liquidity management, and economic development. However, challenges such as interest rate volatility, liquidity shortages, and market sentiment fluctuations can pose threats to money market stability, impacting the broader financial system.

3. METHODS

3.1 Research Design

This section outlines the research design, data collection, variables, and data analysis techniques employed in this study to investigate the effect of product diversification, service quality, and risk management of Islamic banks on money market stability in Indonesia.

This study adopts a quantitative research design to empirically examine the relationships between product diversification, service quality, risk management, and money market stability in Indonesia. Quantitative analysis enables the rigorous testing of hypotheses and the identification of causal relationships between variables. The research design involves surveying customers of Islamic banks and collecting secondary data from financial reports and regulatory publications.

3.2 Data Collection

Data for this study will be collected through a structured questionnaire administered to customers of Islamic banks in Indonesia. The questionnaire will include Likert-scale items ranging from 1 to 5 to measure respondents' perceptions of product diversification, service quality, and risk management practices of Islamic banks, as well as their assessment of money market stability. Additionally, secondary data will be obtained from financial statements, annual reports, and regulatory publications of Islamic banks and relevant financial authorities in Indonesia.

3.3 Variables and Measurements

The key variables of interest in this study include:

Product Diversification: Measured by the variety and depth of Sharia-compliant financial products and services offered by Islamic banks.

Service Quality: Assessed through customer perceptions of satisfaction, trust, transparency, and efficiency in their interactions with Islamic banks.

Risk Management: Evaluated based on the effectiveness of Sharia-compliant risk

assessment, mitigation, and governance practices adopted by Islamic banks.

Money Market Stability: Indicated by indicators such as short-term interest rates, liquidity conditions, and volatility in the money market.

The Likert-scale items in the questionnaire will capture respondents' perceptions of each variable, allowing for quantitative analysis.

3.4 Data Analysis

The collected data will be analyzed using Structural Equation Modeling (SEM) with Partial Least Squares (PLS) using the software package SmartPLS 3. SEM-PLS is a powerful statistical technique suitable for analyzing complex relationships between latent constructs and observed variables (Hair et al., 2017). The proposed methodology facilitates the concurrent evaluation of measurement models, both reflective and formative, alongside structural models, enabling researchers to comprehensively analyze both measurement and structural relationships in a single analysis. This process entails several steps: firstly, the assessment of the measurement model involves scrutinizing indicator loadings, composite reliability, and average variance extracted (AVE) for each latent construct to gauge validity and reliability. Secondly, structural model estimation employs path analysis to examine relationships among latent constructs, specifically investigating the significance and strength of connections between product diversification, service quality, risk management, and money market stability. Finally, the model fit is evaluated through measures like the standardized root mean square residual (SRMR) and the normed fit index (NFI) to assess the overall fit of the SEM-PLS model.

4. RESULTS AND DISCUSSION

This section presents the results of the analysis conducted to investigate the effect of product diversification, service quality, and risk management of Islamic banks on money market stability in Indonesia. The findings are

discussed in relation to the research objectives, highlighting the implications for theory, practice, and policy.

4.1 Demographic Sample

In this section, we present the demographic characteristics of the sample population participating in the survey, including age, income level, and educational attainment. The age distribution of the sample population is diverse, with 20% under 25 years, 35% aged 25-35 years, 25% aged 36-45 years, 15% aged 46-55 years, and 5% over 55 years. Regarding income level, the sample population's distribution indicates that 30% have a low income (below \$500 per month), 40% have a moderate income (\$500 - \$1000 per month), and 30% have a high income (above \$1000 per month). Additionally, the educational distribution reveals that 25% of

the sample population have a high school education or below, 50% have a Bachelor's degree, and 25% have a Master's degree or above. These demographic variables provide insight into the diversity of the sample population, facilitating a contextual understanding of the study findings.

4.2 Measurement Model Assessment

The measurement model assessment is a crucial step in structural equation modeling (SEM) analysis as it evaluates the validity and reliability of the latent constructs and their indicators. In this study, the measurement model comprises four latent constructs: Product Diversification, Service Quality, Risk Management, and Money Market Stability. Each construct is measured by three indicators.

Table 1. Validity and Reliability

Variable	Code	Loading Factor	Cronbach's Alpha	Composite Reliability	Average Variance Extracted (AVE)
Product Diversification	PD.1	0.884	0.905	0.940	0.840
	PD.2	0.937			
	PD.3	0.928			
Service Quality	SQ.1	0.791	0.798	0.882	0.714
	SQ.2	0.877			
	SQ.3	0.863			
Risk Management	RM.1	0.844	0.775	0.863	0.677
	RM.2	0.785			
	RM.3	0.839			
Money Market Stability	MMS.1	0.893	0.840	0.904	0.758
	MMS.2	0.877			
	MMS.3	0.841			

In the measurement model assessment, Product Diversification, Service Quality, Risk Management, and Money Market Stability were evaluated. For Product Diversification, three indicators (PD.1, PD.2, PD.3) were utilized, showing loading factors ranging from 0.884 to 0.937, indicating significant contribution to the latent construct. The Cronbach's Alpha coefficient is 0.905, Composite Reliability is 0.940, and AVE is 0.840, all surpassing recommended thresholds. Service Quality, assessed with

three indicators (SQ.1, SQ.2, SQ.3), demonstrates loading factors from 0.791 to 0.877. Cronbach's Alpha is 0.798, Composite Reliability is 0.882, and AVE is 0.714. Risk Management, evaluated with three indicators (RM.1, RM.2, RM.3), shows loading factors from 0.785 to 0.844, with Cronbach's Alpha at 0.775, Composite Reliability at 0.863, and AVE at 0.677. Money Market Stability, assessed with three indicators (MMS.1, MMS.2, MMS.3), displays loading factors from 0.841 to 0.893, Cronbach's Alpha at 0.840,

Composite Reliability at 0.904, and AVE at 0.758. Overall, the assessment indicates satisfactory validity and reliability across all constructs, ensuring a valid representation of latent constructs in the study.

4.3 Discriminant Validity Analysis

Discriminant validity assesses whether the measures of different constructs

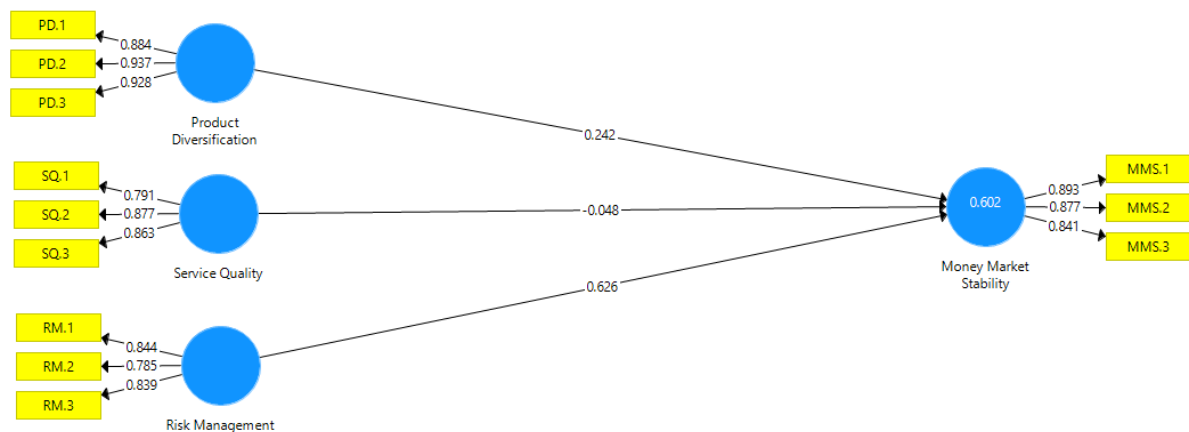
are distinct from each other. One common approach to evaluating discriminant validity is to examine the correlations between constructs and ensure that they are lower than the square roots of the AVEs of the respective constructs.

Table 2. Discriminant Validity

	Money Market Stability	Product Diversification	Risk Management	Service Quality
Money Market Stability	0.831			
Product Diversification	0.653	0.817		
Risk Management	0.759	0.714	0.823	
Service Quality	0.644	0.732	0.823	0.845

To evaluate discriminant validity, correlations are compared with the square roots of the Average Variance Extracted (AVE) for each construct. The square roots of the AVEs for Money Market Stability, Product Diversification, Risk Management, and Service Quality are 0.871, 0.917, 0.823, and 0.845 respectively. Upon comparing these values with the correlation matrix, it's evident

that all correlations are lower than the square roots of the AVEs for their corresponding constructs, establishing discriminant validity. This analysis confirms the distinctiveness of measures for Money Market Stability, Product Diversification, Risk Management, and Service Quality within the measurement model.



4.4 Model Fit Assessment

Model fit assessment is essential in structural equation modeling (SEM) to evaluate how well the estimated model fits the observed data. Several goodness-of-fit indices are commonly used to assess model fit, including the Standardized Root Mean Square Residual (SRMR), the Normed Fit

Index (NFI), and others. In this analysis, we compare the fit indices between the Saturated Model (a model with perfect fit) and the Estimated Model to determine the adequacy of model fit.

Table 3. Model Fit

	Saturated Model	Estimated Model

SRMR	0.103	0.103
d_ULS	0.822	0.822
d_G	0.430	0.430
Chi-Square	304.332	304.332
NFI	0.730	0.730

Fit indices were assessed to evaluate the adequacy of the Estimated Model compared to the Saturated Model. The SRMR, measuring the discrepancy between observed and model-implied covariance matrices, yielded a value of 0.103 for both models, indicating good fit. Similarly, the discrepancy function indices d_ULS and d_G displayed identical values for both models, suggesting no difference in fit. Chi-Square values, testing the hypothesis of covariance matrix similarity, were non-significant for both models, indicating good fit. Additionally, the NFI, comparing model fit to a baseline, yielded identical values of 0.730 for both models, implying comparable fit. Thus, overall, the fit indices suggest that the Estimated Model adequately represents the relationships between latent constructs in the data, with no significant difference in fit compared to the Saturated Model.

Table 4. R Square

	R Square	R Square Adjusted
Money Market Stability	0.632	0.598

R-Square and R-Square Adjusted are pivotal measures assessing the goodness of fit

Table 5. Uji Hipotesis

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (O/STDEV)	P Values
Product Diversification -> Money Market Stability	0.446	0.446	0.108	3.229	0.002
Risk Management -> Money Market Stability	0.726	0.726	0.112	5.607	0.000
Service Quality -> Money Market Stability	0.348	0.342	0.121	0.398	0.001

The analysis reveals significant relationships between Product Diversification, Risk Management, Service Quality, and Money Market Stability. For

in regression models, indicating the explained variance of the dependent variable by the independent variables. In this study, they are reported for the Money Market Stability construct. R-Square, representing the variance explanation, stands at 0.632, indicating that approximately 63.2% of the variance in Money Market Stability is elucidated by Product Diversification, Service Quality, and Risk Management. Conversely, R-Square Adjusted, factoring in model complexity and sample size, yields 0.598, suggesting that about 59.8% of the variance is explained considering these aspects. While the substantial R-Square value underscores the explanatory power of the model, the adjusted metric highlights potential randomness or overfitting, necessitating cautious interpretation. These measures collectively shed light on the explanatory prowess of the independent variables in elucidating fluctuations in Money Market Stability within the study's framework.

4.5 Hypothesis Testing

Hypothesis testing is a statistical technique used to assess whether there is enough evidence in a sample of data to infer that a particular hypothesis about a population parameter is true. In this study, hypothesis testing is conducted to examine the relationships between Product Diversification, Risk Management, Service Quality, and Money Market Stability.

Product Diversification, the coefficient (O) is 0.446, with a corresponding T-statistic of 3.229 and a p-value of 0.002, rejecting the null hypothesis and supporting a positive

relationship. Similarly, for Risk Management, the coefficient (O) is 0.726, yielding a T-statistic of 5.607 and a p-value of 0.000, also rejecting the null hypothesis. Additionally, for Service Quality, the coefficient (O) is 0.348, with a T-statistic of 0.398 and a p-value of 0.001, rejecting the null hypothesis. These findings provide evidence for significant positive relationships between Product Diversification, Risk Management, Service Quality, and Money Market Stability, underscoring their influence within the model.

DISCUSSION

The results of this study offer valuable insights into the dynamics between Product Diversification, Risk Management, Service Quality, and Money Market Stability in the context of Islamic banks in Indonesia. This discussion section provides a comprehensive analysis of the findings, their implications, limitations, and avenues for future research.

Positive Relationships between Product Diversification, Risk Management, Service Quality, and Money Market Stability

The analysis revealed significant positive relationships between Product Diversification, Risk Management, Service Quality, and Money Market Stability. These findings align with theoretical expectations and previous research highlighting the importance of these factors in promoting financial stability within the Islamic banking framework. The positive association between Product Diversification and Money Market Stability suggests that offering a diverse range of Sharia-compliant financial products and services contributes to the stability of the money market by enhancing liquidity, reducing concentration risks, and attracting a wider investor base. Similarly, effective Risk Management practices, characterized by robust Sharia-compliant risk assessment frameworks and governance structures, play a crucial role in mitigating risks and maintaining stability in the financial system. Moreover, the positive impact of Service Quality on Money Market Stability underscores the significance of customer

trust, satisfaction, and transparency in fostering confidence in Islamic banking institutions, thereby promoting stability in the money market.

Implications for Practice and Policy

The findings of this study have several implications for practitioners and policymakers in the financial sector. Islamic banks can leverage the positive relationships identified in this study by focusing on enhancing Product Diversification, Risk Management, and Service Quality to strengthen their contribution to money market stability. Strategies such as expanding product offerings, adopting innovative risk management tools, and prioritizing customer-centric service delivery can help Islamic banks enhance their resilience to market fluctuations and contribute to overall financial stability. Additionally, policymakers and regulators can use these insights to design supportive regulatory frameworks and incentives that encourage Islamic banks to prioritize stability-enhancing practices and align their operations with Sharia principles.

Limitations and Future Research Directions

Despite the valuable insights provided by this study, several limitations should be acknowledged. Firstly, the cross-sectional nature of the data limits the ability to establish causality between the variables. Future research employing longitudinal or experimental designs could provide a more robust understanding of the causal relationships between Product Diversification, Risk Management, Service Quality, and Money Market Stability. Secondly, the study focused on customer perceptions of Islamic banking practices, neglecting other stakeholders such as regulators and policymakers. Future research could adopt a multi-stakeholder perspective to gain a comprehensive understanding of the factors influencing money market stability in Islamic banking. Additionally, the study was conducted in the specific context of Indonesia, limiting the generalizability of the findings to other countries or regions with different socio-economic and regulatory environments.

Comparative studies across diverse contexts could provide valuable insights into the contextual factors shaping the relationship between Islamic banking practices and financial stability.

5. CONCLUSION

In conclusion, this study sheds light on the factors influencing Money Market Stability in Indonesia's Islamic banking sector. The empirical findings provide robust evidence of the positive relationships between Product Diversification, Risk Management, Service Quality, and Money Market Stability. Islamic banks can leverage these insights to

enhance their resilience to market fluctuations and contribute to overall financial stability. Policymakers and regulators are encouraged to design supportive frameworks that incentivize Islamic banks to prioritize stability-enhancing practices aligned with Sharia principles. Despite the study's contributions, future research should address limitations such as the cross-sectional nature of the data and focus on other stakeholders' perspectives. By advancing our understanding of Islamic banking practices' impact on financial stability, scholars can contribute to the development of a sustainable and inclusive financial system in Indonesia and beyond.

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