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The Role of Financial Performance in Mediating the Economic Effects of Diversification on Sustainability Outcomes

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Abstract:

This study aims to examine and analyze the effect of diversification on sustainability performance, with financial performance acting as a mediating variable. The research was conducted on Islamic Commercial Banks (BUS) in Indonesia that were registered with the Financial Services Authority (OJK) during the period 2020–2022. The sampling method employed was purposive sampling. This study is motivated by previous research on the performance of Islamic banks in Indonesia, which has predominantly focused on financial or business outcomes. In response, several international scholars in Islamic banking have proposed a more comprehensive approach to measuring performance through the Islamicity Performance Index. The data were analyzed using Structural Equation Modeling–Partial Least Squares (SEM-PLS) with the assistance of WarpPLS 7.0 software. The findings reveal that diversification has a direct effect on sustainability performance and also exerts an indirect effect through financial performance as a mediating variable. Sustainability performance represents a crucial first step toward proactive innovation for Islamic banks, enabling them to enhance their competitiveness in an increasingly dynamic banking sector. Diversification serves as a strategic effort to improve the sustainability performance of Islamic banks in Indonesia. The main limitation of this study is the relatively short observation period and the narrow focus on Islamic banks, which still represent a small segment of the financial industry. Future research is recommended to expand the sample to include other Sharia-based companies across various sectors.

Keywords: Diversification, Financial Performance, Sustainability Performance

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1. Introduction

The growth of Islamic banking is not solely aimed at maximizing profits, but also carries social responsibility and sustainability as part of the implementation of Islamic economic principles. As stated in POJK No. 51/POJK.03/2017, sustainability performance represents a bank's commitment to fostering a sustainability-oriented

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culture and transparently reporting its economic, social, and environmental performance to all stakeholders. In this context, Islamic banks are expected to play an active role in improving the quality of life of the community through corporate social responsibility (CSR) programs and other activities aligned with Sharia principles (Han & Chen, 2025; Malik & Qureshi, 2024; Malini, 2021).

From the perspective of Sharia Enterprise Theory (SET), a company is not only accountable to shareholders but also to Allah, humanity, and nature as primary stakeholders (Triyuwono, 2015). Therefore, the performance of Islamic institutions should reflect a balance between economic, social, and environmental interests. Unfortunately, many prior studies have mainly focused on conventional financial indicators such as ROA, ROE, or ROI, which do not fully capture Islamic values (Fitriani et al., 2018; Platonova et al., 2016; Kabir & Qayum, 2016; Almaqtari & Ahmad, 2024).

A research gap arises due to the limited number of studies examining how business diversification strategies contribute to the sustainability performance of Islamic banks, particularly through the mediation of financial performance aligned with Islamic values. Some studies, such as those by Jeandry and Fajriyanti (2023) and Febriyane et al. (2023), have explored mediation aspects; however, they have not specifically investigated the role of financing diversification within the context of Islamic banks and the SET framework. Furthermore, there is a lack of literature linking diversification, Sharia financial performance, and sustainability simultaneously.

The novelty of this study lies in the integration of diversification strategies, financial performance, and sustainability performance of Islamic banks within the framework of Sharia Enterprise Theory. This research also utilizes sustainability indicators relevant to the Sustainable Development Goals (SDGs) and ESG (Environmental, Social, and Governance) criteria, as emphasized by Sundari & Nurohman (2024), Qoyum et al. (2022), and Sendi et al. (2024). The study goes beyond profitability by highlighting the social and environmental commitments of Islamic banks, which are integral to their mission as khalifatullah fil ardh (vicegerents of God on Earth).

The urgency of this research is reinforced by growing demands for sustainability transparency from financial institutions, including Islamic banks, by regulators, investors, and the wider public (Tommaso & Thornton, 2020; Lin & Qamruzzaman, 2023). Considering macroeconomic conditions and intense industry competition, Islamic banks require adaptive and sustainable strategies, such as financing diversification, to strengthen resilience and expand their positive impact on society (Aini & Suripto, 2024; Mendonca & Luzzi, 2013; Masruroh, 2018).

In addition, Islamic bank financial reports that reflect successful CSR implementation and green banking practices serve as important indicators of corporate sustainability (Andraeny & Putri, 2017; Candra Ningluthfi & Nurohman, 2024). Commitment to environmental preservation and sustainable development not only enhances corporate

image but also contributes positively to long-term stability and performance (Muneer et al., 2025; Salem et al., 2024; Jan et al., 2019).

The objective of this study is to examine and analyze both the direct and indirect effects of diversification on the sustainability performance of Islamic banks, mediated by financial performance. Thus, this research aims to provide empirical insights into the strategic role of diversification in supporting Islamic value-based business sustainability, while also contributing to academic literature and managerial practices within the Islamic banking sector.

Overall, the findings of this study are expected to serve as a valuable reference for Islamic bank management in developing more inclusive and Sharia-compliant business strategies and CSR policies. Moreover, this study may offer useful input for regulators and other stakeholders in formulating policies that encourage Islamic banking to actively contribute to national sustainable development efforts.

2. Theoretical Background

Sharia Enterprise Theory (SET)

Sharia Enterprise Theory (SET) is an extension of conventional accounting theory that emphasizes spiritual, social, and environmental dimensions in business practices, particularly within Sharia-based institutions. SET places God (Allah SWT) as the absolute owner of all things, while humans act merely as stewards (khalifah) responsible for managing resources based on the principles of justice, sustainability, and multidimensional accountability. In this context, accountability is not only horizontal (toward fellow humans) but also vertical—toward God and nature as part of His creation (Triyuwono, 2015).

According to Fitriani, Sutrisno, and Rahman (2018), this theory highlights the importance of accountability in three dimensions: spiritual accountability (to God), individual accountability (to internal stakeholders), and social accountability (to society and the environment). Therefore, from the SET perspective, diversification practices in Islamic financial institutions, such as Islamic banks, are not merely intended to pursue profit but also to ensure broader societal benefit and environmental preservation.

A study by Aini and Suripto (2024) supports this view, showing that business diversification implemented alongside principles of good corporate governance significantly enhances sustainable financial performance. Similarly, Almaqtari and Ahmad (2024) state that the adoption of Sustainable Development Goals (SDGs) principles within Islamic banks can improve financial performance and strengthen the institution's role in supporting comprehensive sustainable development.

Furthermore, Fitriani et al. (2018) emphasize that within the SET framework, Islamic financial performance cannot be separated from spiritual values and blessings (barakah), thus any strategy adopted, including diversification, must reflect the

principle of public benefit (maslahah). This aligns with findings from Malik and Qureshi (2024), who explain that sustainability practices in Islamic banks, coupled with enhanced financial performance, are key to achieving long-term excellence.

Thus, SET provides a strong theoretical foundation for assessing the relationship between diversification, financial performance, and sustainability in Islamic banks. Diversification is not only aimed at increasing profit but also serves as a means of distributing blessings and welfare to the wider society while protecting the environment.

Sustainability Performance in the Context of Islamic Banks

Sustainability performance reflects a company's long-term commitment to environmental preservation, social responsibility, and economic viability. In the context of Islamic banking, sustainability is not merely an economic pursuit but is deeply embedded in ethical, social, and spiritual values. Islamic banks are required to promote *maslahah* (public interest), social justice, and environmental stewardship as part of their operational mandate (Han & Chen, 2025).

According to the Indonesian Financial Services Authority (OJK) Regulation No. 51/POJK.03/2017, banks are required to integrate environmental, social, and governance (ESG) considerations into their strategies and to publish sustainability reports. Islamic banks are thus expected to go beyond profit-making by contributing to societal development and ecological balance, in line with the principles of Islamic economics (Malini, 2021).

Furthermore, the Sharia Enterprise Theory (SET) emphasizes three dimensions of accountability: to Allah (vertical accountability), to humans, and to the natural environment (horizontal accountability). Under this framework, Islamic banks are considered trustees (*khalifah*) of resources, entrusted to manage them justly and ethically (Triyuwono, 2015; Fitriani et al., 2018).

Diversification and Sustainability Performance

Diversification refers to a strategic move by institutions to spread their operations across different sectors, asset classes, or geographic locations in order to reduce risk, enhance income streams, and improve organizational resilience (Mendonca & Luzzi, 2013). In Islamic banking, diversification is manifested through a variety of Sharia-compliant financial instruments, investment portfolios, and financing segments.

A broader diversification of assets and operations can allow Islamic banks to better absorb financial shocks and allocate resources toward sustainability-oriented initiatives (Masruroh, 2018). For example, banks that diversify into green financing or socially responsible investments are more likely to achieve a higher level of sustainability performance (Aini & Suripto, 2024).

Empirical studies support this view. Jeandry and Fajriyanti (2023) found that diversification has a significant positive impact on the sustainability performance of Islamic banks. Similarly, Aini and Suripto (2024) concluded that strategic

diversification contributes to long-term resilience, innovation, and the capacity of banks to address environmental and social goals effectively.
Hypothesis 1 (H1): Diversification has a positive effect on sustainability performance.

The Mediating Role of Financial Performance
Financial performance represents the financial health, efficiency, and profitability of a firm. For Islamic banks, financial performance is not only measured by conventional indicators such as Return on Assets (ROA), Return on Equity (ROE), and Net Profit Margin (NPM), but also by compliance with Sharia principles and the realization of *maqasid al-shariah*(Andraeny & Putri, 2017; Almaqtari & Ahmad, 2024).

Diversification, when properly managed, can improve a bank's financial performance by reducing dependency on a limited set of income sources, enhancing operational efficiency, and spreading risk (Malik & Qureshi, 2024). Increased financial strength enables Islamic banks to allocate more resources to their Corporate Social Responsibility (CSR) initiatives and ESG commitments, thereby enhancing sustainability performance (Candra Ningluthfi & Nurohman, 2024).

Recent studies support the mediating role of financial performance in the diversification–sustainability nexus. Febriyane et al. (2023) show that green disclosure mediates the relationship between governance and financial performance in Islamic banks, suggesting that financial performance acts as a conduit through which governance and sustainability-related strategies are executed.

This aligns with the Resource-Based View (RBV), which posits that firm-specific resources, such as financial strength and strategic capabilities, are critical in achieving sustainable competitive advantages (Muneer et al., 2025). Therefore, financial performance may serve as an intermediary mechanism by which diversification leads to improved sustainability outcomes.
Hypothesis 2 (H2): Diversification has an indirect effect on sustainability performance through financial performance.

3. Methodology

This study employs a quantitative research approach, aiming to empirically examine the relationship between diversification, financial performance, and sustainability performance in Islamic commercial banks. The population of this study includes all Islamic commercial banks registered with the Financial Services Authority (OJK) of Indonesia from 2020 to 2022. According to the 2022 Islamic Banking Statistics published by OJK, there are 14 Islamic Commercial Banks operating in Indonesia. The sample selection was carried out using purposive sampling, with the following inclusion criteria: (1) Islamic commercial banks that operated nationally throughout the 2020–2022 period; and (2) banks that consistently published annual reports with complete data during this period, which were accessible through their official websites.

For data analysis, this study utilizes the Structural Equation Modeling – Partial Least Squares (SEM-PLS) technique, employing the WarpPLS software. This analytical method is suitable because the model involves latent variables formed by indicators and does not rely on strict distributional assumptions. SEM-PLS is particularly useful for theory confirmation and to assess the strength and significance of relationships among latent constructs. The measurement model (Model 1) assesses three latent variables: (a) Diversification (X1) as a formative construct, measured by three indicators (DIV1, DIV2, DIV3); (b) Financial Performance (Y1) as a reflective construct, measured by four indicators (FP1 to FP4); and (c) Sustainability Performance (Y2) also as a reflective construct, measured by five indicators (SP1 to SP5). The structural model (Model 2) tests the causal relationships between the variables using the following equations:

$FP = \beta 1DIV + \varepsilon 1$

$SP = \beta 1DIV + \beta 4FP + \varepsilon 2$

This model allows the researcher to analyze both the direct effect of diversification on sustainability performance and the indirect effect through the mediating role of financial performance.

4. Empirical Findings/Result

Statistic Descriptive

Descriptive analysis is intended to determine the characteristics of the variables studied, including determining the minimum, maximum, average and standard deviation values.

Table 1. Statistic Descriptive

Variabel	Indikator	Minimum	Maximum	Mean	Std Deviasi
Diversification	DIV1	0.000	0.018	0.002	0.004
	DIV2	0.000	0.007	0.001	0.001
	DIV3	0.000	0.281	0.013	0.046
Sustainability Performance	SP1	0.779	0.941	0.875	0.038
	SP2	0.846	1.000	0.918	0.049
	SP3	0.290	0.839	0.463	0.093
	SP4	0.075	0.113	0.078	0.010
	SP5	3.704	9.113	6.002	1.086
Financial Performance	FP1	0.008	1.207	0.886	0.292
	FP2	0.000	1.933	0.192	0.341
	FP3	0.192	19.423	4.082	4.452
	FP4	0.978	1.000	0.999	0.004

The results of the descriptive analysis inform that the lowest value of the contract type indicator (DIV1) is 0.000 and the highest is 0.018. The average value of the contract type indicator (DIV1) is 0.002, with a standard deviation of 0.004. This means that the value of the contract type indicator (DIV1) is centered at 0.002 ± 0.004.

The lowest value of the economic sector indicator (DIV2) is 0.000 and the highest is 0.007. The average value of the economic sector indicator (DIV2) is 0.001 with a standard deviation of 0.001. This means that the economic sector indicator (DIV2) is centered at 0.001 ± 0.001.

The lowest value of the fund use indicator (DIV3) is 0.000 and the highest is 0.281. The average value of the fund utilization indicator (DIV3) is 0.013 with a standard deviation of 0.046. This means that the fund utilization indicator (DIV3) is centered at 0.013 ± 0.046.

The results of the descriptive analysis indicate that the lowest value of the general disclosure indicator (SP1) is 0.779 and the highest is 0.941. The average value of the general disclosure indicator (SP1) is 0.875, with a standard deviation of 0.038. This means that the general disclosure indicator (SP1) is centered at 0.875 ± 0.038.

The lowest value of the management approach indicator (SP2) is 0.846 and the highest is 1,000. The average value of the management approach indicator (SP2) is 0.918 with a standard deviation of 0.049. This is the indicator of the management approach (SP2) centered at 0.918 ± 0.049.

The lowest value of the economic indicator (SP3) is 0.290 and the highest is 0.839. The average value of the economic indicator (SP3) is 0.463 with a standard deviation of 0.093. This is an economic indicator (SP3) centered at 0.463 ± 0.093.

The lowest environmental indicator value (SP4) is 0.075 and the highest is 0.113. The average environmental indicator value (SP4) is 0.078 with a standard deviation of 0.010. This is an environmental indicator (SP4) centered at 0.078 ± 0.010.

The lowest social indicator value (SP5) is 3.704 and the highest is 9.113. The average social indicator value (SP5) is 6.002 with a standard deviation of 1.086. This is a social indicator (SP5) centered at 6.002 ± 1.086.

The results of the descriptive analysis inform that the value of the general disclosure indicator (SP1) is the lowest at 0.008 and the highest at 1.207. The average value of the general disclosure indicator (SP1) is 0.886, with a standard deviation of 0.292. This means that the value of the general disclosure indicator (SP1) is centered at 0.886 ± 0.292.

The lowest value of the management approach indicator (SP2) is 0.000 and the highest is 0.933. The average value of the management approach indicator (SP2) is 0.192 with a standard deviation of 0.341. This means that the management approach indicator (SP2) is centered at 0.192 ± 0.341.

The lowest value of the economic indicator (SP3) is 0.192 and the highest is 19.423. The average value of the economic indicator (SP3) is 4.082 with a standard deviation of 4.452. This means that the economic indicator (SP3) is centered at 4.082 ± 4.452.

The lowest environmental indicator value (SP4) is 0.978 and the highest is 1.000. The average environmental indicator value (SP4) is 0.999 with a standard deviation of 0.004. This environmental indicator (SP4) is centered at 0.999 ± 0.004.

Hypothesis Testing Results

The coefficient of determination (R^2) for the sustainability performance construct is 0.11, indicating that 11% of the variance in sustainability performance can be explained jointly by diversification, corporate governance, intellectual capital, and financial performance. The remaining 89% is influenced by other factors not included in this research model. Furthermore, the Q^2 predictive relevance value is calculated using the formula:

$Q^2 = 1 – (1 – R^2_1)(1 – R^2_2)$
$Q^2 = 1 – (1 – 0.05)(1 – 0.11)$
$Q^2 = 1 – (0.95 \times 0.89) = 0.15$ or 15%

This value suggests that the model has a moderate predictive relevance for explaining the endogenous variables, particularly sustainability performance.

Table 2. Hypothesis Testing Results

Direct Testing	**Path Coefficient**	**Hypothesis**	**P Value**	**Description**
DIV → FP	0.234		0.014	Accepted
DIV → SP	0.259	Hypothesis 1	<0.001	Accepted
FP → SP	0.177		0.049	Accepted
Indirect Testing	**Total effect**			
DIV → FP → SP	0.298	Hypothesis 2	<0.001	Accepted

Table 3. Mediation Effect Test

Calculation of Variance Accounted For (VAF) (VAF)			
Indirect Effect			
DIV → FP → SP	0,23	0,18	0,30
Total Indirect Effect			**0,30**
Direct Effect			
DIV → SP			0,25
Total Direct Effect			**0,25**
Total Effect			**0,55**
VAF= Indirect Effect/Total Effect			0,54
Percentage			54%

Description: Value VAF > 80%: Full Mediation, 20% < VAF 80%: Partial Mediation, VAF < 20%: There is no mediating effect.

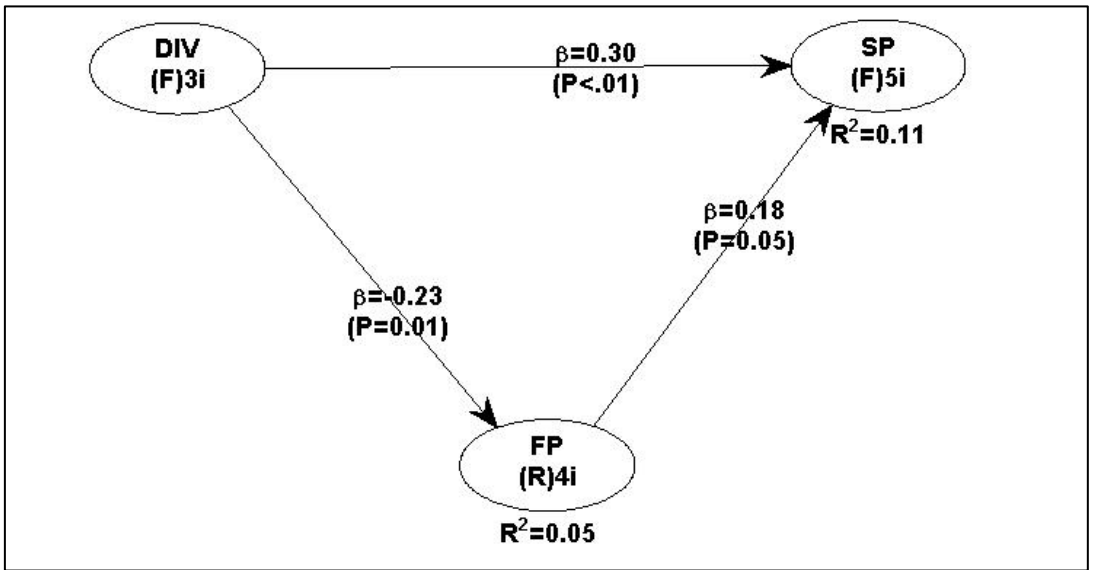

Figure 1. Structural Research Model Output
Source: WarpPLS Processed Data

As shown in Table 2, the direct path coefficient from diversification to financial performance (DIV → FP) is 0.234 with a p-value of 0.014, indicating a significant positive relationship. Similarly, the direct effect of diversification on sustainability performance (DIV → SP) is 0.259 with a p-value of <0.001, thus supporting Hypothesis 1. The path from financial performance to sustainability performance (FP → SP) also shows a significant positive relationship, with a coefficient of 0.177 and a p-value of 0.049. For the indirect effect (DIV → FP → SP), the total effect is 0.298 with a p-value of <0.001, supporting Hypothesis 2 that financial performance partially mediates the relationship between diversification and sustainability performance.

To further test the mediation effect, the Variance Accounted For (VAF) value was calculated. The VAF is derived from dividing the indirect effect (0.30) by the total effect (0.55), resulting in a value of 0.54 or 54%. According to Hair et al. (2017), a VAF between 20% and 80% indicates partial mediation. Therefore, financial performance partially mediatesthe influence of diversification on sustainability performance in Islamic commercial banks. This finding highlights that while diversification directly contributes to sustainability performance, part of its influence is channeled through improved financial performance.

5. Discussion

The Effect of Diversification on Sustainability Performance

The hypothesis testing results indicate that diversification has a significant effect on sustainability performance. This finding reinforces the Sharia Enterprise Theory

(SET) proposed by Triyuwono (2015), which emphasizes the fair distribution of wealth to all stakeholders—God, humans, and nature. Diversification, in this context, is not solely aimed at achieving financial profit but also serves as a form of vertical accountability to God and horizontal accountability to society and the environment.

This study is also consistent with Masruroh (2018), who stated that financing diversification is a risk management strategy that can enhance the stability and sustainability of Islamic banks. Additionally, Aini and Suripto (2024) found that business diversification positively influences the financial performance of banks, which in turn supports long-term sustainability.

More broadly, this research is also supported by findings from Han and Chen (2025) as well as Sundari and Nurohman (2024), who demonstrated that Islamic business practices focused on sustainability have positive implications for the Sustainable Development Goals (SDGs)—a key objective of Islamic banks as ethical financial institutions.

The Effect of Diversification on Sustainability Performance through Financial Performance

The second hypothesis testing result shows that financial performance mediates the effect of diversification on sustainability performance, with a Variance Accounted For (VAF) value of 54%, indicating partial mediation. This means that diversification impacts sustainability not only directly but also indirectly through improvements in financial performance.

These findings align with Sharia Enterprise Theory, which highlights that blessings (barakah) and economic sustainability are not solely measured by profit, but by the extent of benefits that can be distributed to the broader community. Diversification, in this case, serves as a benefit-distribution strategy that ultimately enhances sustainability performance.

Empirically, this result is consistent with studies by Jeandry and Fajriyanti (2023) and Almaqtari and Ahmad (2024), who stated that well-implemented diversification strategies can improve the financial performance of Islamic banks, thereby strengthening their sustainability performance. Likewise, Malik and Qureshi (2024) found that sustainability practices supported by a sound financial foundation are more effective in achieving long-term outcomes.

However, these results contrast with the findings of Sumail and Mappamiring (2015), who stated that financial performance does not mediate the relationship between diversification and sustainability. This discrepancy may be due to differences in managerial approaches, ownership structures, sustainability indicators used, as well as contextual differences in time and space across studies.

This study is further reinforced by the findings of Febriyane et al. (2023), who emphasized the role of green banking disclosure and good corporate governance (GCG) in strengthening the relationship between financial performance and

sustainability. This indicates that integrating financial strategies with social and environmental aspects will further enhance contributions to sustainability.

6. Conclusions

This study concludes that diversification has a significant impact on the sustainability performance of Islamic banks, both directly and indirectly through financial performance. The results affirm the relevance of Sharia Enterprise Theory (SET), which emphasizes not only profit generation but also the spiritual, social, and environmental responsibilities of Islamic financial institutions. Diversification, in this context, becomes a strategy for distributing benefits, promoting justice, and fulfilling multidimensional accountability to God, society, and the environment.

Future research may further explore how other factors—such as corporate governance quality, Sharia compliance, or environmental disclosure—moderate or strengthen the relationship between diversification and sustainability. Additionally, comparative studies across countries or institutional types, and the use of ESG (Environmental, Social, Governance) indicators, could offer deeper insights. Longitudinal approaches may also reveal how the long-term application of diversification strategies contributes to sustainable development in the Islamic banking sector.

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