# THE INFLUENCE OF FINANCING POLICY, ASSET QUALITY, AND CAPITAL STRUCTURE ON EARNINGS RESPONSE AND FINANCIAL RISK MANAGEMENT

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**Abstract:**
**Purpose -** This study examines the effects of Financing Policy, Asset Quality, and Capital Structure on Financial Risk Management (FRM) in Indonesian commercial banks, with Earnings Response as a mediating variable, and evaluates how market-based earnings reactions transmit these effects to banking risk management.
**Methods -** Using secondary data from commercial banks listed on the Indonesia Stock Exchange (IDX) during 2010–2024, the study applies Structural Equation Modeling (SEM) and Sobel mediation tests to examine direct and indirect relationships among the study variables.
**Findings -** Financing Policy has a negative, insignificant effect on Earnings Response, whereas Asset Quality and Capital Structure show positive, significant effects. Financing Policy and Capital Structure negatively and significantly affect FRM, while Asset Quality's effect is positive but insignificant; Earnings Response positively and significantly affects FRM. Earnings Response significantly mediates the effects of Asset Quality and Capital Structure on FRM, but not of Financing Policy.
**Research Implications -** Bank managers should prioritize asset quality improvement and prudent capital structure management, while regulators and policymakers can use these insights to strengthen supervisory frameworks that support banking stability and market confidence.
**Originality -** This study offers empirical evidence on the mediating role of market-based earnings reactions in transmitting internal financial-policy effects to banking risk management, an underexplored mechanism in emerging-market banking research.

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## INTRODUCTION

Financial stability remains a crucial foundation for long-term corporate sustainability, particularly in the banking industry, where fluctuations in exchange rates, inflation, and interest rates can disrupt liquidity and elevate the likelihood of financial distress (Bhat & Bhat, 2022; Halim, 2020). A comprehensive Financial Risk Management (FRM) framework is therefore essential to sustain operational continuity and mitigate potential losses. The effectiveness of FRM is largely determined by a bank's internal financial policies, particularly Financing Policy, Asset Quality, and Capital Structure, which collectively shape financial resilience and performance (Sarens & Beelde, 2006).

Although interrelated, these three constructs address distinct dimensions of a bank's financial policy, and this distinction is maintained throughout the study. Financing Policy refers to the quality and prudence of the financing that a bank extends to its customers, reflected empirically in the ratio of non-performing financing to total financing; disciplined financing decisions translate into sustainable liquidity and reduced credit risk exposure (Brigham & Ehrhardt, 2017; Van Horne, 1977). Capital Structure, by contrast, concerns the composition of the bank's own funding, the balance between debt and equity used to finance its operations, commonly measured through the debt-to-equity ratio (Myers, 2001). The Pecking Order Theory and Trade-Off Theory offer competing explanations of how firms sequence and balance these two forms of capital (Frank & Goyal, 2003. Determining the optimal debt–equity mix and aligning debt maturities with asset durations are central to sustaining long-term solvency, while extending prudent financing similarly preserves asset quality and reduces default risk (Pindado et al., 2006); (Cortellini & Panetta, 2021).

Asset Quality further contributes to financial stability by shaping income generation and risk exposure: productive assets enhance liquidity and profitability, whereas deteriorating asset quality raises default probability and capital impairment (Mustetsa et al., 2022; Rompotis, 2024). High-quality assets strengthen solvency and build investor and creditor confidence, thereby supporting the effectiveness of Financial Risk Management in the banking industry (Faradynawati & Söderberg, 2022).

A central premise of this study is that the influence of these internal financial policies on Financial Risk Management is not purely mechanical but is transmitted through the capital market's evaluation of the bank's reported earnings. Earnings Response, the extent to which investors react to a firm's reported earnings—functions as a signal of information quality and managerial credibility (Awawdeh et al., 2020). When financing decisions, asset quality, and capital structure are managed prudently, investors are more likely to interpret reported earnings as sustainable, producing a stronger market reaction; this favorable reaction, in turn, creates reputational and disciplinary pressure that incentivizes bank management to sustain rigorous risk oversight, since a weakening of that oversight would undermine the earnings credibility the market has come to trust (Zattila, 2018). Earnings Response can therefore be understood as a market-based transmission mechanism linking internal financial policy decisions to Financial Risk Management outcomes, rather than merely a parallel outcome of those policies.

Despite this growing body of literature, empirical evidence remains fragmented regarding how Financing Policy, Asset Quality, and Capital Structure jointly influence Financial Risk Management through market-based Earnings Response, particularly in emerging banking markets such as Indonesia (Li et al., 2019; Ngatno et al., 2021). This gap raises three research questions: (1) Do Financing Policy, Asset Quality, and Capital Structure significantly affect Earnings Response? (2) Do these variables influence Financial Risk Management directly? and (3) Does Earnings Response mediate the relationship between these internal financial policies and Financial Risk Management? This study therefore examines the direct and indirect effects of Financing Policy, Asset Quality, and Capital Structure on Financial Risk Management via the mediating role of Earnings Response, using data from Indonesian commercial banks listed on the Indonesia Stock Exchange during 2010–2024, contributing an integrated model linking these internal financial policies to Financial Risk Management through market-based Earnings Response.

## THEORETICAL REVIEW

Corporate financial theory provides the conceptual foundation for understanding how firms make strategic decisions in financing, investment, and dividend policies to maximize firm value (Elston, 1996; Pattiruhu & Paais, 2020). According to Modigliani & Miller (1963), under perfect capital market assumptions, with no taxes, bankruptcy costs, or information asymmetry, the capital structure is irrelevant to firm value. However, real-world conditions such as taxation, bankruptcy risk, and information asymmetry invalidate these assumptions, making capital structure a critical determinant of firm value (Agnello & Sousa, 2013; Overesch & Voeller,2008). The Trade-Off Theory emerged to reconcile this limitation by emphasizing the balance between the tax benefits of debt and the potential cost of financial distress (Brusov et al., 2022). Conversely, the Pecking Order Theory argues that firms prefer internal financing, then debt, and lastly equity, due to asymmetric information and issuance costs (Serrasqueiro & Caetano, 2015; Leary & Roberts, 2005). In banking institutions, these theories are particularly relevant because financing decisions, asset quality management, and capital structure policies jointly influence market perceptions and risk-bearing capacity, thereby affecting both Earnings Response and Financial Risk Management effectiveness.

### Signaling Theory

Because Earnings Response is retained as the mediating variable in this study, Signaling Theory is developed explicitly as the theoretical mechanism linking internal financial policies to capital-market reactions. Signaling Theory posits that, under conditions of information asymmetry, firm insiders convey private information to outside investors through observable financial choices and disclosures, and that investors update their valuation of the firm based on the credibility of those signals (Jensen & Meckling, 1976). Applied to this study, a bank's Financing Policy, Asset Quality, and Capital Structure function as observable signals of managerial discipline and underlying credit risk: prudent financing and capital decisions signal lower risk and higher earnings sustainability, while deteriorating asset quality or excessive leverage signal elevated risk. Because these signals are difficult for outsiders to verify directly, the capital market's reaction to reported earnings, captured by the Earnings

Response Coefficient, serves as the empirical channel through which the credibility of these signals is revealed and priced. This positions Earnings Response not merely as an outcome of financial policy, but as the theoretical transmission mechanism through which Financing Policy, Asset Quality, and Capital Structure are hypothesized to influence Financial Risk Management.

***1. Financing Policy***

In this study, Financing Policy denotes the quality and prudence of the financing that a bank extends to its customers, operationalized as the ratio of non-performing financing to total financing (NPF); it is therefore conceptually distinct from Capital Structure, which concerns how the bank itself is funded through the mix of debt and equity on its own balance sheet. A lower NPF signals disciplined credit-granting decisions, which is expected to sustain profitability and reduce exposure to default risk (Carpenter & Petersen, 2002; Pil Yu & Eun Kim, 2023). Under the logic of Signaling Theory, prudent financing decisions signal managerial discipline to the capital market, strengthening investor confidence and generating a more favorable Earnings Response, whereas a rising share of non-performing financing signals weakening credit discipline and is expected to dampen that response (Romanovskaya et al., 2022). Moreover, sound financing decisions directly affect a bank's risk exposure by reducing the volume of problematic credit that must later be absorbed as losses; conversely, an expanding share of non-performing financing raises liquidity pressure and undermines Financial Risk Management practice, regardless of any short-term growth the expansion may generate (Debrun & Kinda, 2016); (Alnaa & Matey, 2023)..

H1: Financing Policy has a positive and significant effect on Earnings Response, reflecting that effective debt management enhances investor confidence in earnings quality.

***2. Asset Quality***

Asset Quality is expected to influence Earnings Response through the same signaling logic: because productive assets generate stable income and minimize exposure to non-performing or unproductive resources (Saiz et al., 2024), stronger Asset Quality signals lower credit risk and more sustainable earnings, which investors are expected to reward with a more favorable market reaction. Within the Agency Theory framework, deteriorating asset quality often results from misaligned incentives between managers and owners, leading to inefficient investment decisions and higher credit risk (Salike & Ao, 2018; Tosi et al., 2003); indicators such as the Non-Performing Loan ratio and asset turnover ratio capture the extent of this exposure (Hamdillah et al., 2021). High-quality assets are further expected to enhance solvency and cash flow stability, reinforcing investor perceptions of earnings sustainability (Brigham & Ehrhardt, 2020), and to support Financial Risk Management directly by lowering the pool of credit exposed to default, provided that monitoring mechanisms and incentive alignment remain effective (Khan & Mather, 2013; Teshima & Shuto, 2008).

H2: Asset Quality has a positive and significant effect on Earnings Response, implying that improved asset performance enhances investor reaction to earnings disclosures.

***3. Capital Structure***

Capital Structure, in contrast to Financing Policy, refers to how the bank itself is funded—the proportion of debt to equity used to finance its own operations, commonly measured through the debt-to-equity ratio, and pursued to optimize the Weighted Average Cost of Capital (Brigham & Ehrhardt, 2020). Moderate leverage can magnify returns through the leverage effect, but excessive debt raises bankruptcy risk and earnings volatility (Jaworski & Czerwonka, 2018; Modigliani & Miller, 1963).. The Trade-Off Theory frames this as a balance between the tax benefits of debt and the costs of financial distress (Myers, 1984), while the Pecking Order Theory highlights a financing hierarchy that prioritizes internal funds to minimize information asymmetry (Myers, 2001). Following Signaling Theory, a capital structure that signals restraint and financial discipline is expected to be rewarded by the market through a stronger Earnings Response, whereas a structure signaling over-reliance on debt is expected to depress that response. At the same time, an inappropriate capital structure is expected to raise liquidity and solvency risk directly, independent of how the market reacts to earnings, underscoring the need for capital structure decisions to be calibrated to firm-specific risk tolerance, industry dynamics, and macroeconomic cycles.

H3: Capital Structure has a positive and significant effect on Earnings Response, indicating that an optimal leverage strategy enhances earnings credibility and market valuation.

***4. Earnings Response***

Earnings Response denotes the extent to which capital market participants react to a firm's reported earnings, serving as a signal of information quality and managerial credibility (Ali, 2022). Consistent with Signaling Theory and the Asymmetric Information Theory (Jensen & Meckling, 1976), earnings announcements help reduce information gaps between management and investors, revealing the firm's true economic prospects (Gan et al., 2022; Zhu et al., 2023). As established above, market reactions to reported earnings are shaped not only by profit figures themselves but also by the internal financial-policy signals, Financing Policy, Asset Quality, and Capital Structure—that determine the credibility of those earnings (Gbenga et al., 2023); balanced financing and capital strategies tend to generate more favorable Earnings Responses, while excessive leverage or deteriorating financing quality depresses them (Indrayati et al., 2020; Okyere et al., 2021). Earnings Response thus functions as the market-based evaluation of a bank's financial policies and managerial performance, and, as developed further below, as the mechanism through which these policies are hypothesized to transmit their effect to Financial Risk Management (Fah & Huei, 2016).

***5. Financial Risk Management***

Financial Risk Management (FRM) refers to a structured process of identifying, measuring, and mitigating financial exposures that may jeopardize corporate stability (Fraser et al., 2013; Jorion, 2003; Lam, 2014), encompassing liquidity, interest rate, credit, and market risks that collectively affect firm performance and long-term solvency (Fabozzi & Drake, 2011). In the banking sector, FRM is commonly evaluated through indicators of credit risk and financial stability, most notably the Non-Performing Loan (NPL) ratio, which this study adopts as the empirical measure of

Financial Risk Management. It is important to state explicitly how this indicator is interpreted throughout the study: because the NPL ratio measures the proportion of problematic credit relative to total loans, a higher NPL ratio reflects greater credit risk exposure and weaker risk management outcomes, while a lower NPL ratio reflects more effective FRM. All coefficients reported for paths leading to Financial Risk Management in this study are interpreted according to this convention.

Within an Enterprise Risk Management perspective, Financing Policy, Asset Quality, and Capital Structure jointly shape a bank's risk exposure (Dwonczyk, 2013; Lam, 2014): excessive leverage elevates liquidity and interest rate risk, whereas sound asset quality enhances cash flow stability and reduces uncertainty (Dinh & Pham, 2020; Margaritis & Psillaki, 2010), while an expanding share of non-performing financing raises credit concentration and default risk when monitoring mechanisms are inadequate (Brigham & Ehrhardt, 2020). From a Trade-Off Theory perspective, optimal capital structure decisions require balancing the tax advantages of debt against the risk of financial distress of bankruptcy (Myers, 2001); excessive reliance on external financing, particularly when loan quality deteriorates, is expected to increase financial fragility. FRM, Financing Policy, and Asset Quality therefore function as interdependent pillars of corporate resilience (García-Gómez et al., 2021), while Earnings Response is hypothesized to condition how strongly these policies translate into realized risk outcomes, consistent with the signaling and market-discipline logic developed above.

**H4:** Financing Policy (NPF) has a positive and significant effect on Financial Risk Management (NPL), reflecting that a deterioration in financing quality is associated with a higher incidence of non-performing loans.

**H5:** Asset Quality has a negative and significant effect on Financial Risk Management, reflecting that a higher proportion of productive assets is associated with a lower incidence of non-performing loans.

**H6:** Capital Structure has a negative and significant effect on Financial Risk Management, reflecting an empirical pattern in which higher leverage among the sampled banks is associated with a lower incidence of non-performing loans, a direction that runs counter to the conventional Trade-Off Theory expectation and is examined further in the Discussion.

**H7:** Earnings Response has a positive and significant effect on Financial Risk Management, reflecting an empirical pattern in which a stronger market reaction to reported earnings is associated with a higher incidence of non-performing loans, a counterintuitive direction that is examined further, with appropriate caution, in the Discussion.

Taken together, Financing Policy, Asset Quality, and Capital Structure are hypothesized to affect Financial Risk Management both directly, through their mechanical influence on credit exposure and liquidity, and indirectly, through the market-discipline channel captured by Earnings Response. Because the direction of the Earnings Response \u2013 Financial Risk Management path is itself an open empirical question in the banking context of this study rather than a settled theoretical prediction, the mediation hypotheses below are stated in terms of the existence of a mediating pathway, consistent with Signaling Theory\u2019s premise that credible

market signals alter the risk-taking behavior of bank management, without presupposing in advance whether that alteration lowers or raises realized credit risk.

H8: Earnings Response mediates the relationship between Financing Policy and Financial Risk Management.

H9: Earnings Response mediates the relationship between Asset Quality and Financial Risk Management.

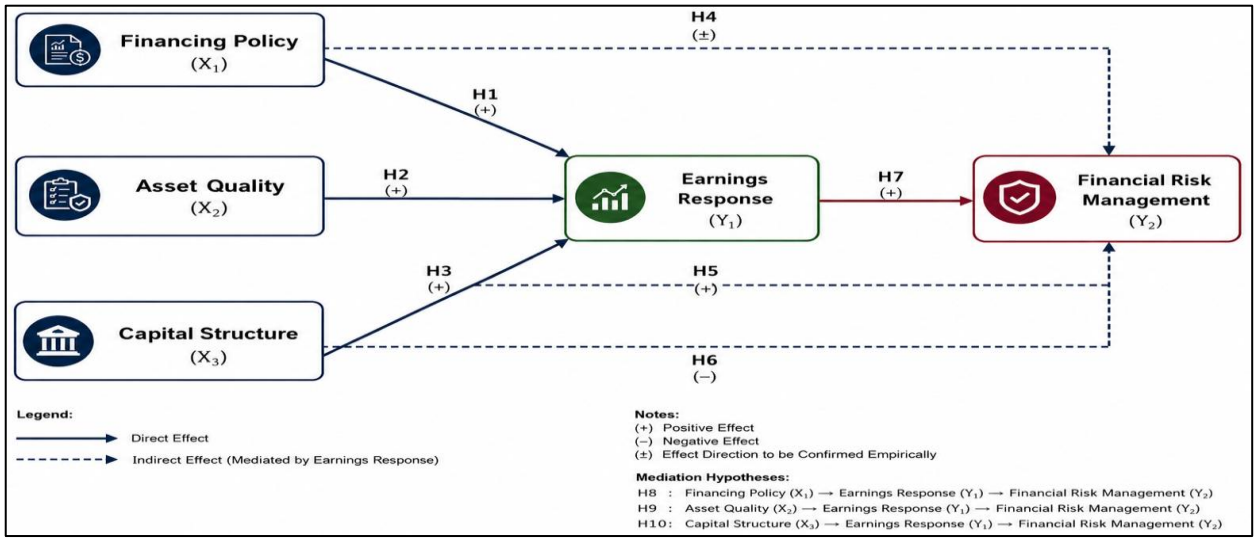
H10: Earnings Response mediates the relationship between Capital Structure and Financial Risk Management.

## RESEARCH METHODS

This study employs an explanatory (associative) research design to examine the statistical relationships among the study variables using Structural Equation Modeling (SEM). Because the data are observational, secondary, and drawn from a single point-in-time set of firms rather than an experimental or instrumented design, path coefficients are interpreted as statistical associations consistent with the hypothesized theoretical direction. Accordingly, causal language (e.g., "effect" and "influence") is adopted following the conventional reporting practice in SEM studies, while acknowledging that strict causal identification cannot be established. This limitation is further discussed in the *Limitations* section. Secondary data were collected from the audited annual financial statements of commercial banks listed on the Indonesia Stock Exchange (IDX) for the period 2010–2024. Banks were selected using purposive sampling based on the following criteria: (a) continuously listed on the IDX throughout 2010–2024; (b) publishing complete audited annual financial statements for the entire observation period; and (c) reporting all variables required for this study (NPF, productive-asset composition, DER, stock-return data for ERC estimation, and NPL) without missing values. Banks that were delisted, suspended, merged, or had incomplete financial reporting during the observation period were excluded from the sample. The initial population consisted of six commercial banks listed on the IDX that met the sectoral classification. Following the application of the sampling criteria, three banks were excluded due to incomplete financial reporting over the observation period, namely Bank Aladin Syariah Tbk (BAS), Bank BTPN Syariah Tbk (BTPNS), and Bank Pembangunan Daerah Banten Tbk (BPDS). Specifically, these banks did not consistently disclose one or more of the variables required for the analysis across the 2010–2024 period, resulting in an unbalanced dataset that did not satisfy the study's sample selection criteria. Consequently, the final sample comprised three commercial banks with complete and consistent data for all study variables throughout the observation period. Applying these criteria yielded three commercial banks, each observed over 15 annual periods (2010–2024), resulting in a balanced panel of 45 bank-year observations. Data analysis was performed using SEM with AMOS Version 29, which allows the simultaneous estimation of direct and mediated relationships among constructs. SEM was selected over PLS-SEM because of its superior capability for confirmatory factor analysis and comprehensive model-fit evaluation, including the Comparative Fit Index (CFI), Tucker–Lewis Index (TLI), and Root Mean Square Error of Approximation (RMSEA). Prior to model estimation, the assumptions of normality, multicollinearity, and overall model fit were assessed. Hypotheses were tested at the

5 percent significance level (α = 0.05) using critical ratios and standardized path coefficients. The conceptual framework of the study is presented in Figure 1.

**Figure 1. Conceptual Framework**




Conceptually, the study positions Financing Policy, Asset Quality, and Capital Structure as exogenous variables that are statistically associated with both Earnings Response and Financial Risk Management. To ensure conceptual–operational alignment, each construct is defined here exactly as it is operationalized in Table 1. Financing Policy is defined and measured as the ratio of non-performing financing to total financing (NPF), capturing the quality and prudence of credit extended by the bank, and is conceptually distinct from Capital Structure. Asset Quality is defined and measured as the proportion of productive assets to total assets, capturing the efficiency and income-generating capacity of the bank's asset base. Capital Structure is defined and measured as the debt-to-equity ratio (DER), capturing how the bank's own operations are funded through the relative mix of debt and equity, independent of financing quality. Earnings Response is defined and measured as the Earnings Response Coefficient (ERC), capturing the capital market's reaction to reported earnings. Financial Risk Management is defined and measured as the Non-Performing Loan (NPL) ratio, capturing the proportion of credit exposure classified as problematic; consistent with the interpretive convention stated in the Theoretical Review, a lower NPL ratio indicates more effective Financial Risk Management, while a higher NPL ratio indicates weaker risk management outcomes. Earnings Response is positioned as a mediating variable linking these financial-policy signals to Financial Risk Management outcomes. In this framework, the model simultaneously evaluates direct and indirect statistical pathways to test the robustness of the proposed theoretical relationships. Operational definitions and measurement scales for each construct are presented in Table 1 to ensure clarity and replicability. To evaluate the significance of mediation effects, the study applies the Sobel test based on the coefficients of the independent variable–mediator path and the mediator–dependent variable path.

$$Z = \frac{a\ x\ b}{\sqrt{b^2 - sa^2 + a^2\ x\ sb^2}}$$

The measurements on each variable can be seen in Table 1 below:

**Table 1. Measurement Methods of Research Variables**

| Variabel | Measurement |
|---|---|
| Financing Policy ($X_1$) | Financing Policy (X1) NPF = Non-Performing Financing / Total Financing |
| Asset Quality ($X_2$) | AQ: Total Productive Assets / Total Assets |
| Capital Structure ($X_3$) | Capital Structure (X3) Debt to Equity Ratio = Total Debt / Total Equity |
| Earnings Response ($Y_1$) | Earnings Response (Y1) Earnings Response Coefficient (ERC) was estimated using the relationship between abnormal return and unexpected earnings. Abnormal Return = α + β (Unexpected Earnings) + ε |
| Financial Risk Management ($Y_2$) | Financial Risk Management (Y2) NPL Ratio = Non-Performing Loans / Total Loans |

The calculation of Earnings Response was conducted through several stages. First, actual stock returns were calculated using the percentage change in stock prices. Second, expected returns were estimated using the market model approach. Third, abnormal returns were obtained from the difference between actual returns and expected returns. Finally, unexpected earnings were measured using annual changes in earnings per share (EPS). The Earnings Response Coefficient (ERC) was then estimated based on the relationship between abnormal returns and unexpected earnings. A higher ERC indicates a stronger market reaction to earnings information and reflects greater investor confidence in reported financial performance.

$$Y_1 = b_1X_1 + b_2X_2 + b_3X_3 + e_1$$
$$Y_2 = b_4X_1 + b_5X_2 + b_6X_3 + b_7Y_1 + e_2$$

Where: Y_1 = Earnings Response; Y_2 = Financial Risk Management; X_1 = Financing Policy; X_2 = Asset Quality; X_3 = Capital Structure.

Path Coefficients: b_1 = standardized path coefficient from Financing Policy (X_1) to Earnings Response (Y_1); b_2 = from Asset Quality (X_2) to Earnings Response (Y_1); b_3 = from Capital Structure (X_3) to Earnings Response (Y_1); b_4 = from Financing Policy (X_1) to Financial Risk Management (Y_2); b_5 = from Asset Quality (X_2) to Financial Risk Management (Y_2); b_6 = from Capital Structure (X_3) to Financial Risk Management (Y_2); b_7 = from Earnings Response (Y_1) to Financial Risk Management (Y_2).

Error Terms: e_1 and e_2 = disturbance terms (unexplained variance) for Equations (2) and (3), respectively.

These equations represent the hypothesized causal relationships among the exogenous and endogenous constructs analyzed using the Structural Equation Modeling (SEM) approach with AMOS Version 29. All coefficients are estimated using

the Maximum Likelihood Estimation (MLE) method, ensuring the model's statistical identification and theoretical consistency with prior empirical frameworks.

## RESULTS AND DISCUSSION

### *1. Measurement Model*

The analysis process began with assessing the overall Model Goodness-of-Fit to ensure that the Structural Equation Model (SEM) met empirical adequacy prior to hypothesis testing. The results of the model fit evaluation are presented in Table 2.

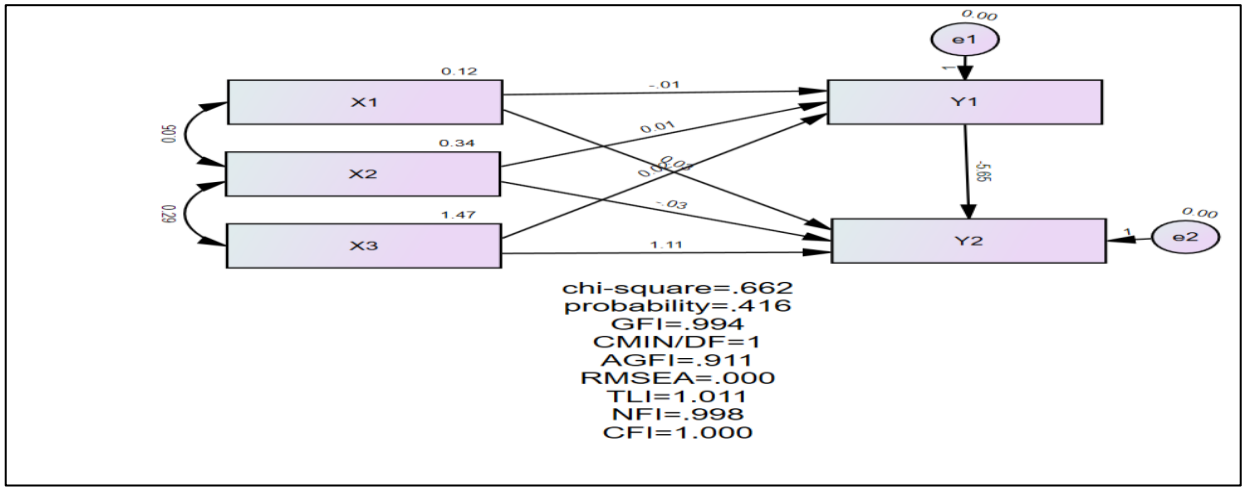
**Table 2. Model Goodness Testing**

| Goodness of Fit Index | Cut-off Value | Hasil | Evaluasi Model |
|---|---|---|---|
| *Chi-square* | Expected small | 0,662 | Good Fit |
| *Probability* | ≥0.05 | 0,416 | Good Fit |
| RMSEA | ≤0.08 | 0,000 | Good Fit |
| GFI | ≥0.90 | 0,994 | Good Fit |
| AGFI | ≥0.90 | 0,911 | Good Fit |
| CMIN/DF | ≤2.00 | 1 | Good Fit |
| TLI | ≥0.95 | 1.011 | Good Fit |
| CFI | ≥0.94 | 1 | Good fit |

Source: Data processed

The results in Table 2 confirm that all goodness-of-fit indices met the recommended cut-off values, indicating the model's excellent structural adequacy. Specifically, Chi-Square = 0.662 (p = 0.416 > 0.05), RMSEA = 0.000 (≤ 0.08), GFI = 0.994, AGFI = 0.911, CMIN/DF = 1.00, TLI = 1.011, and CFI = 1.000. Therefore, the measurement model is considered acceptable for subsequent structural analysis.

**Figure 2. Structural Equation Model**




Accordingly, the SEM model is deemed acceptable and robust for hypothesis testing, as all indicators fall within the acceptable threshold values suggested by Hair et al. (2019) and Kline (2016). Subsequently, path coefficient and significance testing (C.R. and p-values) were conducted to evaluate the direct and mediated effects

between variables, as shown in Table 3. A relationship is considered significant when C.R. > 1.96 and p < 0.05.

**Table 3. Hypotesis Testing**

| Variable Relationships | | | Estimate | S.E. | C.R. | P | R Square |
|---|---|---|---|---|---|---|---|
| Y1 | <--- | X1 | -0.009 | 0.009 | -0.938 | 0.348 | |
| Y1 | <--- | X2 | 0.013 | 0.006 | 2.155 | 0.031 | 0.613 |
| Y1 | <--- | X3 | 0.017 | 0.003 | 6.292 | *** | |
| Y2 | <--- | X1 | -5.651 | 0.413 | -13.698 | *** | |
| Y2 | <--- | X2 | 0.026 | 0.025 | 1.044 | 0.297 | 0.998 |
| Y2 | <--- | X3 | -0.034 | 0.017 | -2.043 | 0.041 | |
| Y2 | <--- | Y1 | 1.114 | 0.01 | 108.756 | *** | |

Source: Data processed

Based on the data in Table 3 above, an equation model can be made for the direct impact of Financing Policy, Asset Quality, and Capital Structure on Profit Response. The following equation model can be made.

***a. Direct Influence Model I***

Earnings Answers = -0.009 $x_1$ + 0.013$X_2$ + 0.017$X_3$

*The Influence of Financing Policy, Asset Quality, and Capital Structure on Earnings Response*

Based on SEM path estimates, the effects of Financing Policy (X1), Asset Quality (X2), and Capital Structure (X3) on Earnings Response (Y1) were examined and are summarized as follows:

***Statistical Results – Model I (Effects on Earnings Response)***

Based on the SEM path estimates reported in Table 3, Financing Policy showed a negative, non-significant relationship with Earnings Response (β = –0.009; C.R. = –0.938; p = 0.348 > 0.05); H1 is not supported. Asset Quality showed a positive, significant relationship with Earnings Response (β = 0.013; C.R. = 2.155; p = 0.031 < 0.05); H2 is supported. Capital Structure showed a positive, significant relationship with Earnings Response (β = 0.017; C.R. = 6.292; p < 0.001); H3 is supported. Together, these three paths explain 61.3 percent of the variance in Earnings Response ($R^2$ = 0.613).

***b. Direct Influence Model II***

Based on the SEM results, the structural equation for the endogenous variable Financial Risk Management (Y2) can be expressed as:

$Y_2 = –5.651X_1 + 0.026X_2 – 0.034X_3 + 1.114Y_1$

***Statistical Results – Model II (Effects on Financial Risk Management)***

Based on the SEM path estimates reported in Table 3, Financing Policy showed a negative, significant relationship with Financial Risk Management (β = –5.651; C.R. = –13.698; p < 0.001); because the hypothesized direction (H4) was positive, H4 is not supported. Asset Quality showed a positive, non-significant relationship with Financial Risk Management (β = 0.026; C.R. = 1.044; p = 0.297 > 0.05); because the hypothesized direction (H5) was negative, H5 is not supported. Capital Structure showed a negative, significant relationship with Financial Risk Management (β = –

0.034; C.R. = –2.043; p = 0.041 < 0.05); H6 is supported. Earnings Response showed a positive, significant relationship with Financial Risk Management (β = 1.114; C.R. = 108.756; p < 0.001); H7 is supported. Together, these four paths explain 99.8 percent of the variance in Financial Risk Management ($R^2$ = 0.998). Because Financial Risk Management is operationalized as the NPL ratio, coefficients here follow the sign convention already stated in the Theoretical Review (positive = higher NPL incidence; negative = lower NPL incidence).

***c. Indirect Influence***

The mediating role of Earnings Response in the relationship between Financing Policy, Asset Quality, and Capital Structure on Financial Risk Management was evaluated using the Sobel Test. Results are presented in Table 4.

**Table 4. Values of Indirect Influence Coefficients**

| Path | coefisien pengaruh tidak langsung | Significance of Indirect Influence Z (Sobel) | Sobel > 1.96 | Information |
|---|---|---|---|---|
| X1->Y1->Y2 | –0.010026 | 1.00 | > 1.96 | Insignificant |
| X2->Y1->Y2 | 0.014482 | 2.15 | > 1.96 | Signifikant |
| X3->Y1->Y2 | 0.018938 | 5.16 | > 1.96 | Very Significant |

Source: Data processed

The indirect effect coefficients were obtained by multiplying the path coefficient from the independent variable to Earnings Response (Y1) by the coefficient from Earnings Response (Y1) to Financial Risk Management (Y2). The resulting coefficients are reported in Table 4.

Coefficient Indirect Effect X1 → Y2 = –0.009 × 1.114 = –0.010026

Coefficient Indirect Effect X2 → Y2 = 0.013 × 1.114 = 0.014482

Coefficient Indirect Effect X3 → Y2 = 0.017 × 1.114 = 0.018938

Table 4 presents the indirect effect coefficients and Sobel test values for the mediation analysis. A Sobel Z-value greater than 1.96 indicates a significant mediation effect at the 5 percent level.

First, the indirect effect of Financing Policy (X1 → Y1 → Y2) is β = –0.010026; Z = 1.00 (< 1.96), indicating that Earnings Response does not significantly mediate the relationship between Financing Policy and Financial Risk Management. Therefore, H8 is not supported**.**

Second, Asset Quality (X2 → Y1 → Y2) demonstrates an indirect effect of β = 0.014482; Z = 2.15 (> 1.96), indicating that Earnings Response significantly mediates the relationship between Asset Quality and Financial Risk Management. Therefore, H9 is supported.

Third, Capital Structure (X3 → Y1 → Y2) exhibits a strong indirect effect of β = 0.018938; Z = 5.16 (> 1.96), indicating highly significant mediation through Earnings Response. Therefore, H10 is supported. The finding is consistent with signaling and leverage theories, which explain that balanced capital structure decisions strengthen investor confidence and improve banking financial stability.

***Efek Total***

The total effect represents the combined influence of direct and indirect relationships among variables. The results are summarized in Table 5.

**Table 5. Total Effect Estimation of Exogenous Variables on Financial Risk Management**

| Relationship between Variables | | | Direct Effect | Indirect Effect | Total Effect |
|---|---|---|---|---|---|
| Financial Risk Management ($Y_2$) | <--- | $X_1$ = Financing Policy | -5.651 | –0.010026 | 5.661026 |
| | <--- | $X_2$ = Asset Quality | 0.026 | 0.014482 | 0.040482 |
| | <--- | $X_3$ = Capital Structure | –0.034 | 0.018938 | 0.015062 |

Source: Data processed

The total effect of Financing Policy on Financial Risk Management is β = –5.651 (direct) + (–0.010026) (indirect) = –5.661026; since the indirect path is not significant (Z = 1.00 < 1.96), the total effect is driven almost entirely by the direct path, indicating that a deteriorating Financing Policy is associated with a lower incidence of non-performing loans in this sample.

Asset Quality shows a total effect of 0.040482 (direct = 0.026, non-significant; indirect = 0.014482, significant), driven mainly by the Earnings-Response-mediated channel; this indicates a marginally higher incidence of non-performing loans, the opposite of the conventional expectation that better asset quality lowers credit risk.

Capital Structure shows a total effect of –0.015062 (direct = –0.034; indirect = 0.018938), with the risk-reducing direct path outweighing the risk-increasing indirect path. Earnings Response and Capital Structure therefore pull in opposite directions with respect to realized credit risk in this sample, a nuance revisited in the Discussion below.

***Discussion***

Financing Policy has a negative and insignificant effect on Earnings Response (β = –0.009; p > 0.05), indicating that variations in financing structure did not substantially influence investors' reactions to earnings disclosures. Market participants appear to rely more on profitability and efficiency indicators than on financing composition, possibly reflecting limited transparency in financing disclosures. Thus, Financing Policy cannot be considered a primary determinant of Earnings Response in Indonesian commercial banks during the observation period.

**H2:** Asset Quality positively and significantly affects Earnings Response (β = 0.013; p < 0.05), consistent with Signaling Theory and Risk Management Theory. High-quality assets signal prudent lending and sound credit risk management, strengthening investor confidence in reported earnings and functioning as an important determinant of earnings reliability and banking financial soundness.

**H3:** Capital Structure positively and significantly influences Earnings Response (β = 0.017; p < 0.001), consistent with Trade-Off Theory and Signaling Theory. Prudent leverage and balanced debt-to-equity decisions enhance market perceptions of earnings sustainability and managerial discipline, underscoring strategic leverage

management as both a profitability enhancer and a positive market signal within Indonesia's banking sector.

**H4:** Financing Policy shows a negative and significant relationship with Financial Risk Management ($\beta = -5.651$; $p < 0.001$), opposite the hypothesized direction; H4 is not supported. Within these three banks, periods of deteriorating financing quality were not accompanied by a higher NPL ratio. This is reported as an association observed in the data rather than a general mechanism: a plausible explanation is that the sampled banks may resolve non-performing financing through write-offs, provisioning, or restructuring that decouple the NPF ratio from the reported NPL ratio within the same period.

**H5:** Asset Quality shows a positive but non-significant relationship with Financial Risk Management ($\beta = 0.026$; $p = 0.297$); since the hypothesized direction was negative, H5 is not supported. The most defensible reading is that asset composition shows no reliable direct association with the NPL ratio in this sample. A plausible explanation is that close, fairly uniform supervisory oversight by Otoritas Jasa Keuangan and Bank Indonesia may compress inter-bank variation in realized asset quality, leaving too little variation for a significant relationship to emerge in a three-bank panel.

**H6:** Capital Structure shows a negative and significant relationship with Financial Risk Management ($\beta = -0.034$; $p = 0.041$); H6 is statistically supported, indicating that banks with higher leverage in this sample tend to exhibit a lower NPL ratio, contrary to the conventional Trade-Off Theory expectation. Rather than confirming that leverage reduces risk in general, a plausible explanation is that the sampled banks with higher leverage are the larger, more established institutions in the panel, typically subject to closer creditor, market, and prudential monitoring that independently supports credit quality; distinguishing this from reverse causality is a direction for future research.

**H7:** Earnings Response shows a positive and significant relationship with Financial Risk Management ($\beta = 1.114$; $p < 0.001$); H7 is statistically supported, with the direction indicating that a stronger, more favorable market reaction to reported earnings is associated with a higher, not lower, NPL ratio in this sample. This counterintuitive result is reported explicitly rather than folded into a confident causal narrative. A plausible explanation is that investors may react more strongly to the earnings of banks carrying higher credit risk because those earnings are harder to predict and therefore more informative at the margin, though this cannot be confirmed by the present model.

**H8:** The indirect effect of Financing Policy on Financial Risk Management through Earnings Response is small and not statistically significant ($\beta = -0.010026$; Sobel $Z = 1.00 < 1.96$); H8 is not supported, consistent with the non-significant direct effect of Financing Policy on Earnings Response reported under H1.

**H9:** The indirect effect of Asset Quality on Financial Risk Management through Earnings Response is statistically significant ($\beta = 0.014482$; Sobel $Z = 2.15 > 1.96$); H9 is supported. Because both paths are positive, stronger Asset Quality is associated with a marginally higher NPL ratio through this channel, reinforcing the point under H5 that the relationship between Asset Quality and realized credit risk is more complex than a simple risk-reducing association.

**H10:** The indirect effect of Capital Structure on Financial Risk Management through Earnings Response is statistically significant (β = 0.018938; Sobel Z = 5.16 > 1.96); H10 is supported. This indirect channel works in the direction of higher, not lower, credit risk, the opposite of the direct effect reported under H6, partially offsetting it and helping explain why the total effect (β = –0.015062) is smaller in magnitude than the direct effect alone.

## CONCLUSION

This study examined the effects of Financing Policy, Asset Quality, and Capital Structure on Earnings Response and Financial Risk Management, and the mediating role of Earnings Response, using data from three Indonesian commercial banks during 2010–2024. Asset Quality and Capital Structure positively and significantly influence Earnings Response, while Financing Policy does not; together these paths explain 61.3 percent of the variance in Earnings Response, suggesting investors weigh asset quality and capital strength more heavily than financing composition when reacting to reported earnings. Financing Policy and Capital Structure negatively and significantly affect Financial Risk Management, while Asset Quality's effect is positive but non-significant, together explaining 99.8 percent of its variance. Because Financial Risk Management is measured as the NPL ratio, several of these directions run counter to conventional expectation, most notably that a deteriorating Financing Policy and higher leverage are both associated with a lower incidence of non-performing loans in this sample, and are interpreted cautiously as patterns specific to the three sampled banks rather than as generalizable causal mechanisms. Earnings Response significantly mediates the effects of Asset Quality and Capital Structure on Financial Risk Management, but not of Financing Policy, and itself shows a positive relationship with the NPL ratio, indicating that market reactions to earnings and realized credit outcomes are only loosely, and at times inversely, aligned in this sample.

Overall, the findings partially support Signaling Theory, Trade-Off Theory, and Pecking Order Theory, while transparently reporting several relationships that do not conform to conventional theoretical expectation rather than reframing them as confirmatory. Practically, bank managers and regulators are encouraged to monitor market reactions to earnings and realized NPL ratios as distinct signals rather than assuming they move together, and to prioritize disclosure quality and capital adequacy while further research clarifies the mechanisms behind the counterintuitive associations reported here.

### *Implications*

#### *a. Theoretical implications*

Contrary to the Modigliani–Miller Irrelevance Theorem, this study shows that Capital Structure significantly affects both Earnings Response and Financial Risk Management, reflecting market imperfections, information asymmetry, and regulatory intervention in emerging economies. The findings support the relevance of Trade-Off Theory, Pecking Order Theory, and Signaling Theory in explaining banking financial behavior in Indonesia, and contribute to the literature by integrating Earnings Response as a mediating mechanism linking financial policy decisions to Financial Risk Management outcomes.

***b. Management Implications***

Because Earnings Response is positively associated with the NPL ratio in this sample, banks should not treat a favorable market reaction to earnings as a signal that credit risk is under control, and should monitor Earnings Response alongside internal credit-risk indicators as complementary but potentially divergent signals. Since Financing Policy was unrelated to Earnings Response and moved counterintuitively relative to Financial Risk Management, improved transparency and standardization of financing-quality disclosure remain advisable, allowing more consistent evaluation of financing quality across banks and periods. Because higher leverage was associated with a lower NPL ratio directly but a higher NPL ratio through the Earnings-Response-mediated path, capital structure decisions should not be guided by leverage level alone; banks are encouraged to pair leverage decisions with close monitoring of market reactions to earnings, guided by transparent risk–return analysis and compliance with prudential capital adequacy regulations set by the Basel Committee on Banking Supervision and Otoritas Jasa Keuangan.

***Limitations Research***

This study is limited by its small sample (three banks, 45 bank-year observations), which constrains statistical power and generalizability to Indonesia's wider banking sector and may explain some of the counterintuitive findings; by its exclusive focus on the Indonesian banking industry; by its reliance on the NPL ratio as the sole proxy for Financial Risk Management, which does not capture liquidity, market, or interest-rate risk; and by its observational design, which does not support causal interpretation of the associations reported, including those running opposite to the hypothesized direction.

***Future Research***

Future studies are encouraged to expand sample coverage through additional institutions or cross-country comparisons, employ alternative risk indicators such as the Loan-to-Deposit Ratio, Altman Z-score, or composite risk indices, and consider alternative analytical approaches such as Partial Least Squares Structural Equation Modeling (PLS-SEM) or panel-data regression to address these limitations and improve model robustness.

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