

CHAPTER I

INTRODUCTION

1.1 Research Background

The development of Islamic banking in Indonesia has shown significant growth in recent decades. As a financial institution operating based on Islamic principles, Islamic banks have unique characteristics that distinguish them from conventional banks. One important aspect of Islamic bank operations is risk management, particularly in terms of financing.

According to Law Number 21 of 2008 concerning Islamic Banking, financing is defined as the provision of funds or claims based on an agreement between a bank and another party, which obligates the party receiving the funds to return those funds after a certain period with compensation or profit-sharing.¹ Article 35 explains that the applicable legal provisions regarding risk management in Islamic banking stipulate that Islamic banks and Islamic Business Units must use a prudential principle in conducting their commercial activities.

According to Bank Indonesia Regulation Number 13/23/PBI/2011 of 2011 on the Implementation of Risk Management for Islamic Commercial Banks and Islamic Business Units, and according to Financial Services Authority Circular Letter Number 25/SEOJK.03/2023 of 2023 on the Implementation of Risk Management for Islamic Commercial Banks and Islamic Business Units, there are ten types of risks for Islamic banks: credit risk, market risk, liquidity risk, operational risk, legal risk, reputation risk,

¹ UU, "Undang-Undang Republik Indonesia No 21 Tahun 2008 Tentang Perbankan Syariah," *Lembaran Negara Republik Indonesia No 4867*, vol. 76, 2008.

strategic risk, compliance risk, return risk, and investment risk.² The risk cannot be avoided, but it can be managed and controlled to minimize the risk that may lead to losses for the bank.

After assuming the responsibility of bank supervision, the Financial Services Authority Regulation Number 65/POJK.03/2016 on risk management for Islamic Commercial Banks (BUS) and Islamic Business Units (UUS). In the Islamic banking sector, risk management is not merely an operational necessity but also a legal obligation. Regulations on Islamic bank risk management provide comprehensive guidelines for identifying, measuring, managing, and communicating risks in accordance with sharia principles.

Compliance with these regulations enables Islamic banks to maintain alignment with sharia principles, minimize potential losses, and enhance public trust. Law also plays a crucial role in creating a transparent, accountable, and integrity-driven environment, supporting the growth and stability of the Islamic banking industry. Therefore, proper understanding and implementation of legal provisions on risk management are critical factors for the success and sustainability of Islamic banking in the global financial landscape.³

² Bank Indonesia, "Peraturan Bank Indonesia Nomor 13/23/PBI/2011 Tentang Penerapan Manajemen Risiko Bagi Bank Umum Syariah Dan Unit Usaha Syariah," 2011.

³ OJK, "Peraturan Otoritas Jasa Keuangan Nomor 65/POJK.03/2016 Tentang Manajemen Risiko Bagi Bank Umum Syariah Dan Unit Usaha Syariah," *Otoritas Jasa Keuangan*, 2016, <https://ojk.go.id/id/regulasi/Documents/Pages/POJK-tentang-Penerapan-Manajemen-Risiko-bagi-Bank-Umum-Syariah-dan-Unit-Usaha-Syariah/pojk-65-2016.pdf>.

Table 1 Main Islamic Banking Indicators 2023

BANKING INDUSTRY	Assets (Rp T)	Financing Provided (PDY) (Rp T)	Third-Party Funds (DPK) (Rp T)
Islamic Commercial Bank (BUS)	594,71	368,38	465,93
Sharia Business Unit (UUS)	274,28	200,06	203,32
Islamic Rural Bank (BPRS)	23,18	17,03	15,27
Total	892,17	585,46	684,52

Source 1 Islamic Financial Services Industry Stability Report. Islamic Financial Services Board (IFSB) 2023 (data processed)

The development of Islamic banking in Indonesia and globally has shown significant growth in recent years. According to the 2023 Islamic Financial Service Board (IFSB) report, global Islamic financial assets reached \$3.25 trillion in 2022, with a growth of 6.9% compared to the previous year.⁴ In Indonesia, the Financial Services Authority (OJK) reports that amid volatile economic conditions, the Islamic banking industry continues to show good development, with total assets reaching IDR 892.17 trillion, growing by 11.21% (year-on-year) in 2023. With this achievement, Islamic banking financing and Third-Party Funds (DPK) or public savings continue to record double-digit growth. Current Islamic banking financing stands at IDR 585.46 trillion, growing 15.72%, while DPK is IDR 684.52 trillion, growing 10.49% compared to 2022.⁵

⁴ "Islamic Financial Services Industry Stability Report. Islamic Financial Services Board (IFSB) 2023," 2023.

⁵ Otoritas Jasa Keuangan (OJK), "Laporan Perkembangan Keuangan Syariah Indonesia 2023," 2023.

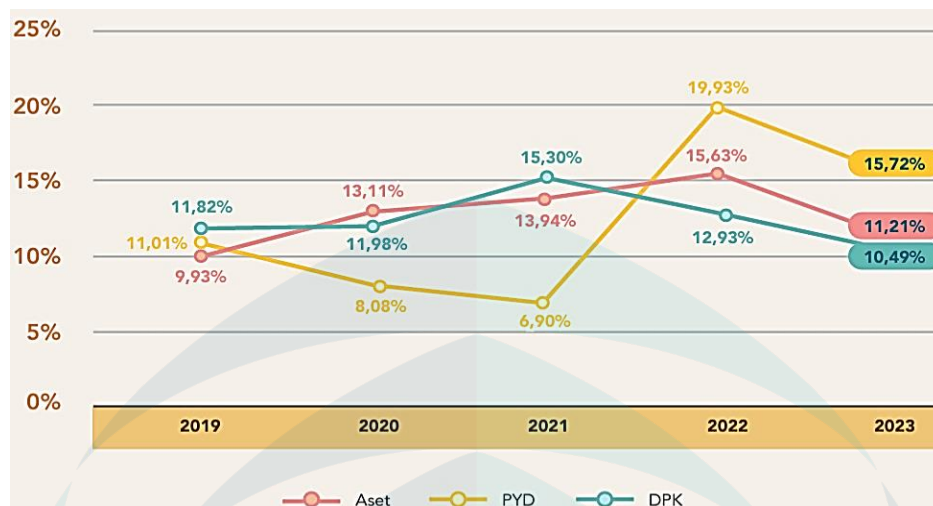


Figure 1 Islamic Banking Growth (2019-2023)

Source 2 Islamic Banking Statistics and Development 2023, Financial Services Authority (OJK)

With this growth, Islamic banking faces various risks in financing distribution. Financing risks can arise from various factors, such as customer failure to meet obligations, changes in economic conditions, or non-compliance with Islamic principles. Various financing issues in Islamic banks have occurred recently, such as the COVID-19 pandemic, that has further complicated the risk landscape, with many Islamic banks experiencing an increase in Non-Performing Financing (NPF) due to economic disruptions caused by the pandemic.⁶ This has forced Islamic banks to restructure financing while remaining aligned with Islamic principles.

⁶ Kasubaud IV BPK Perwakilan Provinsi DKI Jakarta Wahyudi, "Penyajian Informasi Beban Penanganan Pandemi Covid, Posisi Utang, Dan Keberlangsungan Fiskal Pada LK 2020," Warta Pemeriksa BPK, 2020, <https://wartapemeriksa.bpk.go.id/?p=25510>.

Table 2 Bank Performance Infographic for Quarter 2 2024

Performance	Assets	Third Party Funds (DPK)	Credit	Capital Adequacy Ratio (CAR)	Return on Assets (ROA)
Commercial Banks	7,21% (YoY)	5,79% (YoY)	7,76% (YoY)	27,16%	2,73%
	9,01% (YoY)	8,45% (YoY)	12,36% (YoY)	26,09%	2,66%
	Rp 12.048 T	Rp 8.722 T	Rp 7.478 T		
Conventional Commercial Bank	6,72% (YoY)	5,51% (YoY)	7,08% (YoY)	27,24%	2,76%
	8,85% (YoY)	8,24% (YoY)	12,29% (YoY)	26,13%	2,69%
	Rp 11.441 T	Rp 8.247 T	Rp 7.089 T		
Islamic Commercial Bank	17,88% (YoY)	10,92% (YoY)	21,87% (YoY)	25,35%	2,08%
	12,16% (YoY)	12,36% (YoY)	13,55% (YoY)	25,29%	2,06%
	Rp 607 T	Rp 475 T	Rp 390 T		

TW II-23

TW II-24

Source 3 Indonesia Banking Surveillance Report (LSPI) Quarter 2 2024, Financial Services Authority (OJK) (data processed)

Based on banking performance data, Islamic Commercial Banks (BUS) show significant growth across various aspects, including assets growing by 17.88% (year-on-year), Third-Party Funds (DPK) at 10.92% (year-on-year), and credit at 21.87% (year-on-year). However, Islamic Commercial Banks (BUS) have a Capital Adequacy Ratio (CAR) of 25.35% and Return on Assets (ROA) of 2.08%, which are lower than Conventional Commercial Banks (Capital Adequacy Ratio (CAR) 26.13% and Return on Assets (ROA) 2.69%). The high financing growth of 21.87% (year-on-year) for Islamic Commercial Banks (BUS) indicates both opportunities and challenges in financing risk mitigation, which is more critical compared to Conventional Commercial Banks. This underscores the need for special attention to risk management from both juridical and sharia perspectives.

On the other side, the development trend of Artificial Intelligence (AI) technology also brings a new dimension to Islamic banking digitalization by enhancing the accuracy of risk assessment in terms of sharia compliance while introducing new risks related to cybersecurity and

customer data privacy, simultaneously creating a need for regulations that can accommodate Islamic fintech innovation.⁷ The improper use of contracts inconsistent with transactions is also a key issue in this problem, involving elements of usury, gharar, or maysir in financial products, lack of comprehensive regulations to govern new Islamic financial products, and insufficient understanding of sharia principles among practitioners.⁸ Not only that, but competition with conventional banks is also becoming increasingly intense, pushing Islamic banks to improve efficiency and develop more innovative financing products while still adhering to Islamic principles.⁹

Research on risk mitigation in Islamic banking becomes relevant due to the unique nature of Islamic financing, such as contract-based financing like mudharabah and musyarakah, which inherently carries higher risks compared to interest-based conventional financing. Risks such as default and moral hazard become more significant because of profit-sharing aspects that depend on customer honesty and transparency, and every risk mitigation step must align with Islamic principles and fatwas issued by the National Sharia Board-Indonesian Ulama Council (DSN-MUI).

⁷ Mustafa Raza Rabbani, Shahnawaz Khan, and Eleftherios I Thalassinou, "FinTech, Blockchain and Islamic Finance: An Extensive Literature Review" VIII, no. 2 (2020): 65–86.

⁸ Mai Simahatie, Saparuddin Siregar, and Sugianto Sugianto, "Problems of Al-Sharf Implementation in Sharia Banking (Study Literature)," *International Journal of Economic, Business, Accounting, Agriculture Management and Sharia Administration (IJEBAAS)* 2, no. 2 (2022): 259–62, <https://doi.org/10.54443/ijeabas.v2i2.218>.

⁹ Zujajatul 'Ilmi, "The Application of Fiqh Principles in Contemporary Sharia Transactions in The Development of Innovative Products of Islamic Financial Institutions in Indonesia," *OECONOMICUS Journal of Economics* 7, no. 2 (2023): 142–56, <https://doi.org/10.15642/oje.2023.7.2.142-156>.

From a juridical perspective, islamic banks must comply with the prevailing regulations in Indonesia, including the Islamic Banking Law, Financial Services Authority Regulations (POJK), and Bank Indonesia Regulations (PBI). Islamic banking also faces challenges in implementing regulations that have not yet fully accommodated the complexity of sharia contracts. Therefore, an in-depth analysis is needed to strengthen the legal framework for assessing risk mitigation in islamic banking from both juridical and sharia perspectives.

The research gap lies in the lack of integrated research connecting juridical aspects and sharia principles in the context of financing risk mitigation. Previous research has primarily focused on general risk management analysis or juridical and sharia aspects separately, without exploring how these two approaches can complement each other to create a more effective risk mitigation system in Islamic banking. The balance between compliance with positive law and sharia principles in financing risk mitigation poses a unique challenge for islamic banks. On one side, Islamic banks are required to manage risks effectively to maintain the bank's health.

Therefore, this research aims to analyze the risk mitigation strategies applied by islamic banks in Indonesia, evaluate the effectiveness of financing risk mitigation in islamic banking based on the bank's health level, and analyze the relationship between laws and regulations in handling financing risk in islamic banking from both juridical and sharia perspectives. This analysis is important considering the limited comprehensive studies that integrate these two perspectives in the context of financing risk mitigation in Islamic banking.

1.2 Research Scope

This research will examine financing risk mitigation in Islamic banking. The research focuses on analyzing secondary data obtained from the Financial Services Authority (OJK) over the past five years (2019-2024). The processed data will be from Islamic Commercial Banks (BUS) and Islamic Business Units (UUS) in Indonesia, utilizing four primary financial ratios as measurement tools: Non-Performing Financing (NPF), Financing to Deposit Ratio (FDR), Capital Adequacy Ratio (CAR), and Return on Assets (ROA). The analysis will cover trends and developments of these ratios during the research period, as well as their relationship to financing risk mitigation efforts.

Based on the four indicators (NPF, FDR, CAR, and ROA), two main legal issues can be identified in the context of Islamic banking. There are several legal issues related to the four indicators. The analysis of these indicators is closely related to various legal aspects of Islamic banking. NPF is associated with the bank's compliance with risk management regulations, the implementation of prudential principles in financing distribution, and legal protection for both the bank and customers in handling problematic financing. FDR reflects the bank's fulfillment of legal obligations in liquidity management, the balance of rights and obligations between the bank, depositors, and financing recipients, as well as compliance with the maximum financing distribution limits set by regulators. CAR serves as an indicator of the bank's adherence to minimum capital requirements, compliance with legal obligations related to capitalization, and the overall protection of the banking system to maintain stability and health. Meanwhile, ROA represents the bank's responsibility in asset management,

the application of prudential principles in generating profits, and the relationship between profitability and the protection of stakeholders' interests. Thus, these four indicators not only reflect the financial performance of Islamic banks but also serve as a foundation for assessing compliance and legal protection aspects in Islamic banking operations.

Then, this research will evaluate the effectiveness of the risk mitigation strategies implemented by Islamic Commercial Bank (BUS) and Islamic Business Units (UUS) based on the performance of these ratios, taking into account juridical aspects such as compliance with the Financial Services Authority (OJK) and Bank Indonesia regulations, as well as sharia aspects, including adherence to the fatwas of the National Sharia Board-Indonesian Ulema Council (DSN-MUI).

This research analyzes various relevant indicators in Islamic banks to measure the effectiveness of financing risk mitigation from both juridical and sharia perspectives. It also aims to compare financing risk management in the form of Provisions for Impairment Losses (CKPN) between Islamic Commercial Banks (BUS) and Islamic Business Units (UUS).

This research also examines various secondary data sources derived from regulatory documents and legal provisions applicable in Indonesia in the practice of risk mitigation. These documents include the Financial Services Authority Regulation (POJK) as the operational foundation for financial institutions, the Financial Services Authority Circular Letter (SEOJK), which provides technical explanations of the Financial Services Authority Regulation (POJK), the Bank Indonesia Regulation (PBI) which governs the national financial and banking system, and Laws (UU) which serve as the highest legal foundation in the banking system. In addition, this

study also analyzes the Fatwa of the National Sharia Council-Indonesian Ulema Council (DSN-MUI) as the sharia foundation for the implementation of islamic financial principles in Indonesia and the practice of risk mitigation.

The regulations that will be discussed in this research include: Law Number 21 of 2008 concerning Islamic Banking; Bank Indonesia Regulation Number 13/23/PBI/2011 of 2011 concerning the Implementation of Risk Management for Islamic Commercial Banks and Islamic Business Units; Financial Services Authority Regulation Number 65/POJK.03/2016 of 2016 concerning the Implementation of Risk Management for Islamic Commercial Banks and Islamic Business Units; Financial Services Authority Regulation Number 8/POJK.03/2014 of 2014 concerning the Assessment of Soundness Levels for Islamic Commercial Banks and Islamic Business Units; Financial Services Authority Regulation Number 16/POJK.03/2014 of 2014 concerning the Assessment of Asset Quality for Islamic Commercial Banks and Islamic Business Units; Financial Services Authority Circular Letter Number 8/SEOJK.03/2015 of 2015 concerning the Assessment of Asset Quality for Islamic Commercial Banks and Islamic Business Units; Financial Services Authority Circular Letter Number 10/SEOJK.03/2014 of 2014 concerning the Assessment of Soundness Levels for Islamic Commercial Banks and Islamic Business Units; and Financial Services Authority Circular Letter Number 25/SEOJK.03/2023 of 2023 concerning the Implementation of Risk Management for Islamic Commercial Banks and Islamic Business Units, and several Fatwas of the National Sharia Council-Majelis Ulama Indonesia (DSN-MUI).

Through a comprehensive analysis, the researcher aims to identify best practices in risk mitigation for financing in Islamic banking in Indonesia, as well as to uncover the challenges and opportunities faced in balancing compliance with regulations and Sharia principles.

1.3 Problem Formulation

Based on the complexity and dynamics that occur in the risk mitigation practices of financing in Islamic banking, the research problem to be addressed by the researcher is as follows:

1. How does the risk mitigation analysis of financing relate to the health level of Islamic banking?
2. How is the interrelation between laws and regulations in handling financing risks in Islamic banking from both juridical and sharia perspectives?

1.4 Research Objectives

Based on the problem formulation above, the objectives of this research are as follows:

1. To analyze and evaluate the effectiveness of financing risk mitigation in Islamic banking based on the bank's health level.
2. To understand and explain the relationship between laws and regulations in handling financing risks in Islamic banking from both juridical and sharia perspectives

1.5 Benefits of Research

Based on the explanation in the background, title, problem formulation, and research objectives, it is expected that the research can provide several benefits, as follows:

1.5.1 Theoretical Benefits

Theoretically, this research provides a significant contribution to the understanding of risk mitigation in the context of Islamic banking, which remains a relatively new area in academic studies. By analyzing juridical and sharia aspects, this research can enrich existing literature and serve as a reference for other researchers who wish to further explore risk management in Islamic banks.

The findings of this research can also offer valuable insights for Islamic banks in enhancing their risk management practices. By understanding various effective risk mitigation strategies, Islamic banks can implement better practices in financing management, thereby not only improving their performance but also providing greater protection for customers and other stakeholders. Through this contribution, the research is expected to lay the foundation for the development of new theories in Islamic banking and better risk management practices.

1.5.2 Practical Benefits

Practically, this research can serve as a reference for future research, providing a strong foundation for researchers seeking to further explore aspects of risk mitigation in the context of Islamic banking. Additionally, this research offers a significant academic contribution to the field of Islamic financial risk management by presenting an in-depth analysis of relevant challenges and mitigation strategies. It is expected to enrich academic discourse and provide new insights for academics and practitioners alike.

This research also provides valuable guidance for policymakers in formulating regulations that support risk mitigation in Islamic banks. By

understanding the findings and recommendations of this research, policymakers can develop a more effective and responsive regulatory framework tailored to the needs of Islamic banks, thereby creating a safer and more stable environment for the Islamic banking sector as a whole.

1.6 Writing Systematics

To better understand this research, the researcher has designed the discussion in this research into five chapters, as follows:

The first chapter is the introduction, which covers several aspects to be discussed, including the background of the problem, problem formulation, research objectives, research benefits, and the systematic structure of the writing.

The second chapter is the theoretical framework, which includes previous research, the theoretical foundation of this research derived from various literature reviews in the field of research, and the conceptual framework.

The third chapter is the research methodology, which outlines the steps taken by the researcher in conducting the research. This includes the type of research chosen, sources and types of data, data collection instruments, and data analysis techniques.

The fourth chapter is the results and analysis. In this chapter, the researcher presents the descriptive analysis, data analysis, results, and discussion.

The fifth chapter is the conclusion, which contains an explanation of the conclusions drawn from the research findings and the implications of the research, along with recommendations related to matters relevant to this research.