

Analysis of Islamic Banking Risk Management During Economic Disruptions: Evidence from the COVID-19 Pandemic

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ABSTRACT

This study aims to analyze the risks experienced by Islamic banking during the COVID-19 pandemic which has resulted in global economic uncertainty, making it vulnerable to risks that have quite an impact on the Islamic banking industry. Through a descriptive qualitative method, the author explores 4 risks in Islamic banking, including financing risk, liquidity risk, operational risk and systemic risk. The results of the study show that Islamic banks during the pandemic experienced a decline in profitability and an increase in NPF but were still quite stable in terms of financing so that they were not quite risky. Profit sharing contracts have quite an effect on reducing the impact of financing risk. While in terms of liquidity risk, the high FDR poses a fairly high liquidity risk to Islamic banks. In terms of operations, Islamic banks have a higher Operating Costs to Operating Income (BOPO) ratio, reflecting a lower level of operational efficiency. Islamic banks also have limited exposure to high-risk derivative instruments and focus on the real sector, thus reducing the potential for systemic linkages.

INTRODUCTION

The Islamic banking system plays an important role in the global economy, especially in countries with significant Muslim populations. Unlike conventional banks, Islamic banking operates based on sharia principles that prohibit usury (interest) and prioritize a profit-sharing system. In practice, Islamic banking faces its own challenges in managing risk, especially when major economic disruptions such as the COVID-19 pandemic occur (Hidayah et al., 2021). The COVID-19 pandemic has had a significant impact on the banking sector worldwide, including Islamic banking. Uncertainty in the global economic system reinforces the need for adaptive and resilient risk management in the financial industry. A study by Rizwan dkk (2022) identified that Islamic banks exhibited a different risk profile compared to conventional banks during the pandemic. Risk management has become increasingly crucial to maintain the stability and sustainability of Islamic banks' operations. During the pandemic, Islamic banks experienced a significant decline in their risk-based asset values and capital adequacy ratios, indicating that they are more vulnerable to economic fluctuations caused by this global health crisis (Miana et al., 2021). In addition, challenges such as increasing credit and operational risks also arise due to the decline in people's purchasing power and social restriction policies implemented by the government (Effendi & RS, 2020).

Risk management in Islamic banking is a key factor in maintaining financial stability amidst economic uncertainty. The approaches used in risk mitigation include liquidity management, portfolio diversification, and the application of the principle of prudence in financing. In addition, the regulatory role of financial authorities such as the Financial Services Authority (OJK) and Bank Indonesia (BI) is also an important element in ensuring the sustainability of the Islamic banking industry amidst existing challenges (Buwono et al., 2022). In facing these challenges, Islamic banks are required to adapt more effective risk management strategies. Research by Pratiwi & Kurniawan (2018) shows that the application of good risk management principles can help Islamic banks maintain their financial performance during times of crisis. These strategies include financing restructuring for affected customers, implementing strict health protocols, and utilizing technology to improve operational efficiency. Research on risk management in Islamic banks is very relevant considering that the pandemic has exacerbated credit, liquidity, and operational risk challenges. Several studies, such as those conducted by Shah dkk (2022) shows that the duration gap is increasing due to the business slowdown and restructuring policies introduced by central banks in various countries. This phenomenon highlights the importance of a strategic approach in risk management to ensure the sustainability of Islamic banks during the crisis period. This study emphasizes the importance of understanding how Islamic principles affect the ability of Islamic banks to face risks during the pandemic. The novelty of this study lies in its comprehensive approach based on literature review to analyze various risk management challenges and solutions applied in the context of Islamic banking.

The main objective of this study is to identify the risks faced by Islamic banks and the best strategies implemented in managing risks during the COVID-19 pandemic through a literature review. Using data from various recent studies, this study provides insights that contribute to the stability and sustainability of Islamic banks in facing global challenges. This study is expected to provide useful recommendations for policy makers, bank managers, and academics. Considering the increasingly dynamic economic conditions, it is important for Islamic banking to continue to innovate in risk mitigation strategies. This study not only provides an overview of the impact of the pandemic on the Islamic banking system but also offers strategic recommendations in order to strengthen the resilience of Islamic banking in an era of global economic uncertainty.

LITERATURE REVIEW

Risk Management

Risk management is a systematic approach to managing uncertainty related to threats to a bank. It includes steps to identify, measure, monitor and control risks arising from banking activities (Naura et al., 2024). Risk management includes a logical approach to identifying and measuring risks and establishing appropriate solutions to manage them (Idrus, 2008). In the banking context, risk management becomes very important because banks operate in an environment full of uncertainty and must protect their assets and reputation from potential losses that may arise due to various external and internal factors (Junkes et al., 2015). The main objective of risk management is to minimize negative impacts on the bank's operations, financial performance and reputation.

Financing Risk

Financing risk refers to the possibility of a customer failing to meet payment obligations in accordance with the financing agreement. This is one of the main risks for Islamic banks, especially when economic conditions worsen. When customers experience financial difficulties, banks may not be able to recover the principal installments or profit sharing from the financing that has been provided (Naura et al., 2024; Syafii & Siregar, 2023). In the context of Islamic banks, these risks become more complex due to the existence of Islamic principles that must be adhered to. If the customer fails to pay the financing, the Islamic bank not only faces financial losses but must also consider the ethical and reputational implications of the financing decision.

Liquidity Risk

Liquidity risk is the risk that arises when a bank is unable to meet its financial obligations on time without incurring significant losses. In the context of Islamic banks, this risk can occur due to difficulties in finding cash at a reasonable cost or due to the prohibition on selling debt securities beyond the nominal value (Syafii & Siregar, 2023). Islamic banks also face unique challenges in liquidity management because they cannot use interest-based instruments to obtain loans (Naura et al., 2024).

Operational Risk

Operational risk is the risk resulting from inadequacies or failures in internal processes, human error, or external events that affect the bank's operations (Syafii & Siregar, 2023). These risks cover various aspects, such as technological failures, internal fraud, and operational disruptions that can impact the bank's financial performance. In the context of Islamic banking, operational risks are also related to compliance with sharia principles, which can affect customer trust and bank stability (Putri & Filianti, 2021).

Systemic Risk

Systemic risk is a risk that affects the entire financial system and not just one institution. This risk is usually caused by macroeconomic factors such as financial crises, changes in government policies, or unstable market conditions. Islamic banks must pay attention to systemic risk because its impact can spread and affect the stability of the banking sector as a whole (Naura et al., 2024; Syafii & Siregar, 2023).

METHODOLOGY

This study uses a qualitative method based on literature studies to analyze risk management in Islamic banks during the COVID-19 pandemic. Qualitative research methods based on literature studies are research approaches that aim to understand phenomena through in-depth analysis of various written sources such as documents, articles, scientific journals, and books without involving direct interaction with research subjects. This method relies on the collection and reconstruction of information from relevant literature to gain a comprehensive understanding of the topic being studied. Analysis in literature studies is carried out descriptively with an inductive approach, which emphasizes the interpretation and meaning of data from diverse perspectives in the sources studied (Fadli, 2021). This research is non-empirical because it does not involve direct observation or experiments, but still provides academic contributions by presenting a synthesis of existing knowledge to answer research questions (Atmadja, 2013).

This approach aims to explore and understand various strategies and challenges in managing financing, liquidity, operational, and systemic risks through in-depth analysis of secondary data. The data used are sourced from academic journals, research articles, and publications relevant to the research topic. The data analysis technique used is content analysis, where information from various sources is critically evaluated to identify patterns, themes, and relationships relevant to Islamic bank risk management (Bowen, 2009).

RESULT AND DISCUSSION

Risk management is an essential element in maintaining the sustainability of Islamic banking operations, especially during the COVID-19 pandemic. This period of crisis presents unique challenges because Islamic principles limit flexibility in handling risks based on conventional instruments. Here are some of the risks faced by Islamic banks during the COVID-19 pandemic.

Financing Risk

Under normal conditions, financing risks in Islamic banks are managed through sharia-based contracts such as murabahah, mudharabah, and musyarakah. Islamic banks tend to be more careful in providing financing, especially because they focus on real asset-based financing. The level of credit risk is usually lower compared to conventional banks due to the risk-sharing approach. Before the COVID-19 pandemic, financing risks in Islamic banks in Indonesia tended to be under control, with a relatively stable Non-Performing Financing (NPF) level below Bank Indonesia's maximum limit of 5%. However, the profitability of Islamic banks is still limited, with an average Return on Assets (ROA) below 2% (Machmudin, 2013). This condition reflects that although the financing risk is relatively stable, the efficiency and competitiveness of Islamic banks still need to be improved. In addition, the difference in risk between Islamic and conventional banks at this time is not significant in terms of liquidity and credit (Luthfiyah, 2019).

The pandemic has caused a spike in non-performing financing (NPF) due to customers' inability to pay their obligations. A study by Safitri & Khasanah (2023) shows that Bank Syariah Indonesia recorded a decline in profitability due to increased operational costs and decreased income from financing. In addition, the COVID-19 pandemic also significantly increased financing risks, especially in sectors directly affected by restrictions on economic activity. Nevertheless, Islamic banks showed better resilience than conventional banks in managing risk, thanks to the risk-sharing mechanisms inherent in Islamic products such as mudharabah and musyarakah (Hidayah et al., 2021). However, lower operational efficiency in Islamic banks poses a challenge in maintaining profitability during the pandemic (Maidah et al., 2024).

In comparison to conventional banks, Islamic banks are more resilient in maintaining financial stability during the pandemic. This is evident from the lower credit risk in Islamic banks, even though they face slower credit growth compared to conventional banks (Maidah et al., 2024). Study by Shah dkk (2022) also shows that the implementation of mudharabah contracts with more flexible risk sharing has succeeded in reducing the impact of credit risk. On the other hand, conventional banks are able to maintain higher credit growth by utilizing larger capital structures and asset sizes. In addressing financing risks, Islamic banks adopt strategies such as financing restructuring and developing digital technology. In addition, increasing operational efficiency by cutting operational costs is a top priority (Bellinda, 2022).

Liquidity Risk

Before the COVID-19 pandemic, Islamic banks in Indonesia faced liquidity challenges due to short-term funding structures such as Third Party Funds (TPF), which limited flexibility to meet long-term financing needs. The high Financing to Deposit Ratio (FDR) in Islamic banks indicates an aggressive level of fund utilization, but also poses a higher potential liquidity risk compared to conventional banks. This condition is exacerbated by the limited access of Islamic banks to sharia-based liquidity instruments, so that their room for maneuver is narrower to deal with market shocks (Ramdhan, 2018). When the pandemic hit,

liquidity risks increased sharply as declining economic activity hampered fund raising, while non-performing loans (NPF) increased significantly as affected sectors such as MSMEs failed to meet their obligations. However, the profit-sharing mechanism in Islamic financing provides a slight advantage, as financial risks can be shared between the bank and the customer, reducing direct pressure on liquidity (Alawi, 2018).

In comparison with conventional banks, Islamic banks appear to be less superior in terms of liquidity stability. Conventional banks, which have wider access to money market instruments and long-term bonds, are able to maintain a more stable Loan to Deposit Ratio (LDR) compared to FDR in Islamic banks. In addition, regulatory support and liquidity instruments such as Bank Indonesia Certificates are more beneficial to conventional banks, while Islamic banks must rely on more limited mechanisms (Luthfiyah, 2019). To overcome these challenges, Islamic banks have begun to adopt strategic measures, such as utilizing Sukuk and Bank Indonesia Syariah Certificates (SBIS) to expand liquidity. Digitalization of banking services is also a priority, as it allows for more efficient fund management and facilitates public access to Islamic banking products (Ramdhan, 2018).

In addition, the development of green financing is a relevant initiative to ensure long-term liquidity sustainability. This step not only increases funding stability, but also supports sustainable development goals that are in line with sharia principles (Bapang, 2023). With this combination of strategies, Islamic banks are expected to increase their competitiveness while reducing the liquidity risk that has become their main challenge. In the future, closer collaboration with regulators and the government to create more diverse Islamic financial instruments is needed so that Islamic banks can be more resilient in facing future economic shocks.

Operational Risk

During the COVID-19 pandemic, operational risks in Islamic banks increased due to disruptions to business processes due to activity restrictions and the need to shift to digital services. While digitalization improves efficiency in some aspects, this sudden transition also increases risks related to data security and system failures. The frequency of Sharia Supervisory Board (SSB) meetings has been shown to contribute positively to reducing operational risks by increasing supervision of sharia compliance (Putri & Filianti, 2021). Compared to conventional banks, Islamic banks have a higher Operating Costs to Operating Income (BOPO) ratio, reflecting a lower level of operational efficiency. This is a major weakness that affects the profitability of Islamic banks compared to conventional banks (Sudiyatno & Fatmawati, 2013). However, the existence of the Sharia Supervisory Board provides an advantage in ensuring that risk management remains in accordance with sharia principles, which is an added value in attracting customers who care about sharia compliance. Strategic steps taken by sharia banks to address operational risks include strengthening information technology, improving employee training, and stricter supervision of internal processes. In addition, the implementation of the Advanced

Measurement Approach (AMA) has helped sharia banks manage capital more efficiently to cover operational risks (Rachmawati, 2018).

Systemic Risk

Before COVID-19, systemic risk in Indonesian Islamic banks was relatively lower compared to conventional banks. Islamic banks have limited exposure to high-risk derivative instruments and focus on the real sector, thus reducing the potential for systemic linkages. However, studies show that the contribution of Islamic banks to the stability of the Indonesian financial system remains small due to their lower market share compared to conventional banks (Fardila & Utama, 2021). Before the pandemic, interbank connectivity was more focused on conventional banks, while Islamic banks tended to be stand-alone with more limited systemic relationships.

The COVID-19 pandemic has increased systemic risk in banking, including Islamic banks. Studies show an increase in the interbank risk spillover index, meaning a liquidity or financial crisis in one bank can have a greater impact on the system as a whole. Nevertheless, Islamic banks are more resilient to systemic risk during the pandemic due to asset-based financing models and profit sharing that reduce default pressures (Rizwan et al., 2022). However, major challenges remain, especially in the increasing potential risks due to dependence on certain economic sectors such as MSMEs which have been severely impacted by the pandemic.

In managing systemic risk, Islamic banks in Indonesia adopt a sharia-based approach such as risk sharing, asset-based financing, and limiting exposure to speculative instruments. Bank Indonesia and the Financial Services Authority (OJK) also strengthen systemic risk mitigation policies through liquidity guarantee mechanisms, stress testing, and supervision of leverage levels. Islamic banks strengthen connections with the real sector to mitigate direct links to the global financial crisis (Hidayah et al., 2021). Conventional banks have broader systemic connections due to exposure to derivative instruments and involvement in capital market activities, and thus tend to be more vulnerable to systemic risk. During the pandemic, conventional banks showed a significant increase in systemic risk compared to Islamic banks, with a reliance on riskier large corporate loans. In contrast, Islamic banks showed better stability, especially in terms of managing the impact of external shocks on the banking system (Wijana & Widnyana, 2022).

CONCLUSIONS AND RECOMMENDATIONS

The pandemic has quite an impact on various risks in Islamic banks. The results of the study show that Islamic banks during the pandemic experienced a decline in profitability and an increase in NPF but were still quite stable in terms of financing so that they were not quite at risk. The pandemic caused a spike in non-performing financing (NPF) due to the inability of customers to pay their obligations. However, profit sharing contracts are quite influential in reducing the impact of financing risks, because through this contract, the risk sharing losses are more flexible. While in liquidity risk, the high FDR poses a fairly high liquidity risk to Islamic banks. The pandemic caused a spike in non-performing

financing (NPF) due to the inability of customers to pay their obligations. To overcome this challenge, Islamic banks have begun to adopt strategic steps, such as utilizing Sukuk and Bank Indonesia Sharia Certificates (SBIS) to expand liquidity.

In terms of operations, Islamic banks have a higher Operating Costs to Operating Income (BOPO) ratio, reflecting a lower level of operational efficiency. In addition, the implementation of the Advanced Measurement Approach (AMA) has helped Islamic banks manage capital more efficiently to cover operational risks. Islamic banks also have limited exposure to high-risk derivative instruments and focus on the real sector, thereby reducing the potential for systemic linkages, so that in managing systemic risk, Islamic banks in Indonesia adopt a sharia-based approach such as risk sharing, asset-based financing, and limiting exposure to speculative instruments.

ADVANCE RESEARCH

Future research can explore the long-term resilience of Islamic banks by analyzing post-pandemic recovery strategies and their effectiveness in mitigating financial risks. A comparative study between Islamic and conventional banks in responding to economic shocks could provide deeper insights into the unique risk management mechanisms of Islamic finance. Additionally, further investigation into the role of Sukuk and Bank Indonesia Sharia Certificates (SBIS) in enhancing liquidity management can help refine regulatory policies. The impact of digital transformation on operational efficiency and risk mitigation in Islamic banking also presents an important area for exploration. Lastly, integrating machine learning and big data analytics into risk assessment models could enhance the predictive capabilities of Islamic banks in identifying and mitigating potential financial disruptions.

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