CHAPTER I

INTRODUCTION

A. Research Background

The development of financial distress is very rapid at this time which is a serious challenge in Indonesia that must be resolved. The financial distress that has occurred in Indonesia is due to the lack of implementation of risk management in banks, with the implementation of risk management it is expected that banks can analyze problems earlier so that they can prevent their impact faster (Limbong, 2022). Financial distress is the inability to generate sufficient profits or can be called the inability of a company to fulfil its obligations. Financial distress is an early symptom before bankruptcy (Djariyah et al., 2023). The causes of this financial distress vary, ranging from internal characteristics such as monetary policy including debt to external factors which can be global economic pressures, government regulations, laws, or other information that can significantly identify financial conditions.

In 2020, a phenomenon occurred at Bank Bukopin Syariah. That was Bank Bukopin Syariah had difficulty in withdrawing funds, even almost unable to withdraw funds from all Bank Bukopin Syariah in Indonesia. Limbong (2022) stated that one example of a case that occurred was a customer who wanted to withdraw his funds amounting to Rp. 45 Billion, but Bank Bukopin Syariah only agreed to disburse funds of Rp. 640 Million. In this case, it means that Bank Bukopin Syariah is having difficulty in fulfilling its obligations in the form of channelling customer funds and can show that Bank Bukopin Syariah is experiencing liquidity problems. Liquidity problems can indicate that the bank is experiencing risks that can lead to financial distress (Wijayanti et al., 2018).

In the phenomenon of Islamic banks, Islamic banks can maintain customer trust by maintaining bank stability and identifying risks that may occur in Islamic banks. Islamic banks are banks that carry out business activities based on Sharia principles in their activities to provide banking industry payment traffic services (Muhammadun, 2022). In the Indonesian context, Sharia is the principles of Islam that are applied in the banking world.

A bank is a financial institution with an important role in the country's economic sector. Banking is an industry engaged in finance that plays a role in the progress of a country's economy which has a role as an intermediary between surplus spending units and deficit spending units which indirectly helps the circulation of money in the economic activities of society (Yuliani and Haryati, 2023). With the existence of credit and various services provided by banks, it can serve various needs in various economic and trade sectors. So it can be said that banks are the core of the financial sector of every sector. Banks are financial intermediaries between people who have excess funds and people who lack funds. Based on its basic function as a collector and distributor of funds, the bank will always be concerned with parties with excess funds and also parties who lack or need funds, which are often referred to as creditors, this is called the intermediation function, which can be said that banks are channelling funds from economic units that have excess funds to units that lack funds.

Based on the function of the role of the bank, every country strives for banking institutions to always be in a healthy, safe, and stable condition. The stability of a bank is the ability of a bank to carry out normal banking operations and be able to fulfil all its obligations properly in ways that follow applicable banking regulations. A banking system in an unhealthy condition will cause the bank's function as an intermediary institution to not function optimally. Law number 9 of 2016 concerning the prevention and handling of financial system crises updated by law number 4 of 2023 concerning the development and strengthening of the financial sector which regulates crisis management protocols (Muliati, 2016).

Crisis management protocols (CMP), which are contained in the PPSK Law, also play a role in helping to prevent financial distress so that banks remain stable. Bank stability is an assessment of the condition of the bank based on risk and performance, in other words, the degree of bank stability shows how well a bank can carry out its duties (Li and Elnahass, 2023). The importance of bank stability itself will be used by various parties including such as third parties which will be used in carrying out investment activities or the like. The level of bank stability or bank financial performance is presented in the form of financial ratios which are measurement indicators of several factors assessing the level of bank stability. The level of bank stability can be interpreted as the ability of a bank to carry out banking activities to operate normally and be able to fulfill all its obligations properly in ways that are by applicable banking regulations (Stella and Puspitasari 2020). The impact of the level of bank stability affects customer trust because better bank stability will lead customers to save and entrust the management of funds to the bank (Arini, 2023). Therefore, it can reduce financial distress with bank stability. A bank should re-analyze its financial statements. Financial statements are reports that show the financial condition of a company during a certain period to see whether or not the company's performance is good (Ardyanfitri et al., 2019).

Islam has regulated its people to manage finances as well as possible to remain stable and record all financial transaction systems that are carried out with the best possible reports, as the command of Allah SWT revealed in AlQuran verse 282 (Translation of the Quran, Ministry of Religious Affairs of the Republic of Indonesia) Alquran where it is clear that Islamic principles play an important role in regulating financial transactions and financial management.

يَـٰٓأَيُّهَا ٱلَّذِينَ ءَامَنُوٓا۟ إِذَا تَدَايَنتُم بِدَيْنٍ إِلَىٰٓ أَجَلٍ مُّسَمًّى فَٱكْتُبُوهُ ۚ وَلْيَكْتُب بَّيْنَكُمْ كَاتِبٌۢ بِٱلْعَدْلِ ۚ وَلَا يَأْبَ كَاتِبٌ أَن يَكْتُبَ
كَمَا عَلَّمَهُ ٱللَّهُ ۚ فَلْيَكْتُبْ وَلْيُمْلِلِ ٱلَّذِى عَلَيْهِ ٱلْحَقُّ وَلْيَتَّقِ ٱللَّهَ رَبَّهُۥ وَلَا يَبْخَسْ مِنْهُ شَيْـًٔا ۚ فَإِن كَانَ ٱلَّذِى عَلَيْهِ ٱلْحَقُّ
سَفِيهًا أَوْ ضَعِيفًا أَوْ لَا يَسْتَطِيعُ أَن يُمِلَّ هُوَ فَلْيُمْلِلْ وَلِيُّهُۥ بِٱلْعَدْلِ ۚ وَٱسْتَشْهِدُوا۟ شَهِيدَيْنِ مِن رِّجَالِكُمْ ۖ فَإِن لَّمْ يَكُونَا
رَجُلَيْنِ فَرَجُلٌ وَٱمْرَأَتَانِ مِمَّن تَرْضَوْنَ مِنَ ٱلشُّهَدَآءِ أَن تَضِلَّ إِحْدَىٰهُمَا فَتُذَكِّرَ إِحْدَىٰهُمَا ٱلْأُخْرَىٰ ۚ وَلَا يَأْبَ ٱلشُّهَدَآءُ
إِذَا مَا دُعُوا۟ ۚ وَلَا تَسْـَٔمُوٓا۟ أَن تَكْتُبُوهُ صَغِيرًا أَوْ كَبِيرًا إِلَىٰٓ أَجَلِهِۦ ۚ ذَٰلِكُمْ أَقْسَطُ عِندَ ٱللَّهِ وَأَقْوَمُ لِلشَّهَـٰدَةِ وَأَدْنَىٰٓ أَلَّا
تَرْتَابُوٓا۟ ۖ إِلَّآ أَن تَكُونَ تِجَـٰرَةً حَاضِرَةً تُدِيرُونَهَا بَيْنَكُمْ فَلَيْسَ عَلَيْكُمْ جُنَاحٌ أَلَّا تَكْتُبُوهَا ۗ وَأَشْهِدُوٓا۟ إِذَا تَبَايَعْتُمْ ۚ وَلَا
يُضَآرَّ كَاتِبٌ وَلَا شَهِيدٌ ۚ وَإِن تَفْعَلُوا۟ فَإِنَّهُۥ فُسُوقٌۢ بِكُمْ ۗ وَٱتَّقُوا۟ ٱللَّهَ ۖ وَيُعَلِّمُكُمُ ٱللَّهُ ۗ وَٱللَّهُ بِكُلِّ شَىْءٍ عَلِيمٌ ٢٨٢

O believers! When you contract a loan for a fixed period, commit it to writing. Let the scribe maintain justice between the parties. The scribe should not refuse to write as Allah has taught them to write. They will write what the debtor dictates, bearing Allah in mind and not defrauding the debt. If the debtor is incompetent, weak, or unable to dictate, let their guardian dictate for them with justice. Call upon two of your men to witness. If two men cannot be found, then one man and two women of your choice will witness—so if one of the women forgets the other may remind her.1 The witnesses must not refuse when they are summoned. You must not be against writing ˹contracts˺ for a fixed period—whether the sum is small or great. This is more just for you in the sight of Allah, and more convenient to establish evidence and remove doubts. However, if you conduct an immediate transaction among yourselves, then there is no need for you to record it, but call upon witnesses when a deal is finalized. Let no harm come to the scribe or witnesses. If you do, then you have gravely exceeded your limits. Be mindful of Allah, for Allah is the One Who' teaches you. And Allah has perfect knowledge of all things (Al-Quran Translation of the Ministry of Religious Affairs, QS. Al-Baqarah: 282).

An assessment of bank stability can be measured by several ratio indicators, including using several indicators such as Non-Performing Financing (NPF), Return On Asset (ROA), and Capital Adequacy Ratio (CAR).

Table 1. 1 Islamic Bank Financial Ratio

Ratio	2018	2019	2020	2021	2022
NPF (%)	3,26	3,23	3,13	2,59	2,35
ROA (%)	1,28	1,73	1,4	1,55	2,00
CAR (%)	20,39	20,59	21,64	25,71	26,28

Source: SPI OJK

Based on the table above, the NPF, ROA and CAR ratios are important indicators that refer to financial ratios. In the NPF ratio, the higher the NPF ratio of a bank, the greater the level of risk of non-performing financing borne by the bank (Kuswahariani et al., 2020). Based on the table above, the NPL in 2018-2022 Sharia Bank can be said to still experience a lot of non-performing loans even though it has not reached the maximum, which is known to be 5%. The ROA ratio shows how well the company uses assets to generate income. Based on the table above, ROA in 2018-2022 Bank Syariah has not been able to generate profits well because it is still below 5% as the minimum good ROA is 5%. The CAR ratio or Capital Adequacy Ratio is a ratio to measure the adequacy of capital to overcome the risk of loss of a bank. Based on the ratio table above, it is said that the CAR of Islamic Banks in 2018-2022 is above 8%, which is already capable in terms of capital to cover the risks faced because according to Bank Indonesia standards, if it is above 8%, a bank can provide its capital.

In the context of using the financial ratio method above, the RGEC method can also measure the stability of Islamic banks. The RGEC method is a development of the previous method, CAMELS, which was previously regulated in PBI No.06/10/PBI/2004 (Djariyah et al., 2023). Regulations that specifically discuss banking health using the RGEC method are Bank Indonesia Regulation (PBI) No.13/1/PBI/2011 and SE BI No. 13/24/DPNP dated October 25, 2011 (Susanto et al., 2016). In the financial services authority circular number 14 / SEOJK.03 / 2017 concerning health assessment, to measure the health level of banks using the RGEC method.

The RGEC method plays an important role in the assessment of bank stability. This aspect will be taken into account in the risk profile, good corporate governance, earnings, and capital strategies according to the criteria set by the bank. The availability of capital means that the bank has sufficient buffer to address risks and overcome external challenges. The RGEC calculation method is now used to assess the extent of stability of Islamic banks through risk profile, good corporate governance, earnings, and capital. The RGEC method is not just a method to measure the stability of the bank but also helps maintain the stability of the bank in the future. Assessment of financial statements and risk management of stability in a bank using RGEC is considered very effective because of the important pillars that are considered very effective. Good management quality can be known from the results of the implementation of risk management and RGEC in the bank. The assessment of profitability and capital factors is only the impact of strategies carried out by management (Permana, 2012).

The RGEC method consists of risk profile, good corporate governance, earnings, and capital, which play a role in analyzing bank stability. Risk profile assessment plays an important role in the bank stability process because it can identify and measure the risks faced by the bank. Risk profile assessment is identified based on credit risk; this is the risk that occurs due to the failure of debtors or external parties to fulfil their obligations. Financial distress affects the level of ability of debtors or external parties to be affected by financial distress in paying obligations as indicated by the increase in the NPF ratio, which means that the level of credit risk in Islamic banks increases when financial distress occurs (Alvidianita and Rachmawati, 2019). Furthermore, market risk is a risk that occurs due to instability in the value of financial assets in financial markets. This is in line with previous research conducted by Dwijayanti (2010), if the company's financial condition appears to be experiencing instability in the financial market, management must be careful because these conditions can lead to financial distress.

Furthermore, liquidity risk is the risk of inability to generate assets, usually occurring in the short term. Liquidity risk that occurs in banking is one sign that the bank is experiencing potential financial distress (Limbong, 2022). The last risk profile assessment is operational risk, and operational risk is the risk that occurs when there is a system malfunction or employee and external party errors. Banks need to identify operational risks early on to set the right strategies and policies before experiencing financial distress (Andari and Wiksuana, 2017).

In the assessment of good corporate governance to maintain the integrity and efficiency of Islamic banks by fulfilling the principles of transparency, accountability, responsibility, independence, and fairness. The weakness of good corporate governance is one of the causes of financial distress in Indonesia (Ermar and Suhono, 2021). Earnings assessment is done to show the bank's ability to generate profits. In the earnings assessment, it can be seen which banks are able to manage their profits stably. In this case, one way to increase profits can be through economic activity. So that when the bank can manage its profits, it can be used to overcome financial distress conditions (Andari and Wiksuana, 2017). The last assessment is the capital assessment, which is an assessment conducted to measure the bank's ability to generate capital. Capital has an important role for companies in carrying out their activities so that they can cover the risks of both activities and assets so that companies can obtain more capital and avoid financial distress (Buchdadi et al., 2020).

The explanation above is in line with previous research by Hasibuan, et al. (2020), which explains that the measurement of credit risk assessment has a positive and significant effect on financial distress. This research is different from previous research from Muannasa, et al. (2023), which shows that credit risk does not affect financial distress. In market risk, previous research explains that market risk has a positive influence on financial performance or financial distress (Desiko, 2020). This research is not in line with previous research conducted by Hong Vo (2023), which says that market risk does not affect financial distress. In liquidity risk, previous research by Wijayanti, et al. (2018) states that liquidity risk has an impact on financial distress.

In contrast to previous research from Djariyah et al. (2023), liquidity risk hurts the financial distress in banking companies. In operational risk, previous research explains that operational risk has a positive influence on financial distress (Masruri, 2020). This is different from previous research from Sukma, et al. (2019) explain that operational risk has a significant negative effect on financial distress.

In good corporate governance (GCG), previous research conducted by Alvidianita and Rachmawati (2019) explain that good corporate governance has no significant effect on financial distress. This research is different from the results of research by Djariyah, et al. (2023), which states that good corporate governance has a positive influence on financial distress. In previous research on earnings, Ismawati and Istria (2015) also stated that earnings hurt financial distress. Different from Djariyah, et al. (2023) which state that earnings as measured using ROA do not affect financial distress. On Capital, Djariyah, et al. (2023) state that CAR hurts financial distress. In contrast to previous research, Theodorus and Artini (2018) state that capital has a positive effect in predicting the profitability of banking companies experiencing financial distress.

Based on the description above, this research is titled "The Analysis of Bank Stability Using the RGEC Method to Predict Financial Distress on Islamic Banks in Indonesia in 2018-2022". This research is a development of previous research entitled The Influence of Bank Health Level Using RGEC on Financial Distress of Banks in Indonesia by (Djariyah et al., 2023). In previous studies measuring the health level of banks using the RGEC method, namely on the risk profile using NPL / NPF and LDR / FD, on Good Corporate Governance only using self-assessment results from the annual report of each bank, on Earning using Return on Assets (ROA), Net Interest Margin (NIM), and Operating expenses operating income (BOPO), and on Capital using the Capital Adequacy Ratio (CAR) as an indicator of the health of bank capital. This study analyzes bank stability using the RGEC method, namely measuring risk profile using the main risks experienced by external parties and internal parties, to maintain the stability of Islamic banks, namely using credit risk, market risk, liquidity risk, and operational risk. Good corporate governance is measured based on the results of the self-assessment assessment and the principles of transparency, accountability, responsibility, independence, and fairness in the annual report of good corporate governance. Earnings using the return on asset (ROA) ratio. In capital using the capital adequacy ratio (CAR). Another difference is that this research only focuses on Islamic banks in Indonesia in 2018-2022 so it expands from previous research which only focuses on conventional banks in 2018-2021. Besides that, to provide a more detailed explanation related to information on the stability of Islamic banks in Indonesia and a benchmark for the extent to which Islamic banks in Indonesia can run well with the majority of people who are Muslim.

B. Research Question

Based on the background above, the research questions include:

1. Does Credit Risk Positively influence the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022?

2. Does Market Risk Positively influence the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022?
3. Does Liquidity Risk Positively influence the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022?
4. Does Operational Risk Positively influence the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022?
5. Does Good Corporate Governance hurt the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022?
6. Does Earnings hurt the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022?
7. Does Capital hurt the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022?

C. Research Objectives

Based on the research question above, the research objects in this research include:

1. To empirically test the positive effect of Credit Risk on the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022.
2. To empirically test the positive effect of Market Risk on the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022.
3. To empirically test the positive effect of Liquidity Risk on the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022.
4. To empirically test the positive effect of Operational Risk on the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022.

5. To empirically test the negative effect of Good Corporate Governance on the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022.
6. To empirically test the negative effect of Earnings on the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022.
7. To empirically test the negative effect of Capital on the prediction of Financial Distress of Islamic banks in Indonesia for the period 2018-2022.

D. Research Benefit

Based on the research question and research objectives above, the benefits of this research are as follows:

1. Theoretical

The results of this study are expected for Islamic banks in Indonesia to obtain information about bank stability and the influence of Risk Profile, Good Corporate Governance, Earning, and Capital on Financial Distress.

2. Practical

a. For the Company

The results of this study are expected to provide information about the factors that influence financial distress in Islamic banks in Indonesia. As a guide to policymakers to improve the sustainability of Islamic banks. They can be useful as a means of additional information in making decisions in the financial sector on what factors affect financial distress in Islamic banks in Indonesia.

b. For Future Research

In addition, the results of this study are also useful as reference material for other researchers in making decisions on research objects related to credit risk, market risk, operational risk, liquidity risk and financial distress in Indonesian Islamic banks.