CHAPTER I

INTRODUCTION

A. BACKGROUND

The growth of Islamic banks around the world is strongly intertwined with digital and technological innovations. Many businesses, including banking, are being forced to adapt as a result of the expanding globalization. Banking activities have been substantially enhanced as a result of globalization, which has improved the efficiency of the service process. The first ATM (automated teller machine) was operated in London on June 27, 1967, demonstrating the banking industry's willingness to adapt to technology changes. The growth of banking, particularly Islamic banking, is also reflected by a rise in assets held by the industry. In 2018, global Islamic bank assets totaled US$2.52 trillion, up 3.5 percent from US$2.46 trillion the previous year. Islamic banking is expected to grow at a rate of 5.5 percent per year, reaching $3.47 trillion in assets by 2024. (Hidayah, 2020).

The number of networks owned by sharia banking has also increased, from 184 in 2010 to 197 in 2013 and 2014, consisting of 12 Sharia Commercial Banks, 22 Sharia Business Units, and 163 Sharia Rural Banks (Syafrida & Aminah, 2015). This is essential to providing accessibility for users so that banks can serve customers better. Of course, the bank's growth is strongly intertwined to consumers' trust in the bank's ability to collect and distribute funds. Both the bank and the customer, as well as the principle of Islamic banking itself, namely profit sharing or profit from the activities carried out, aim to gain from each other. The greater the government's faith in the bank, the more third-party money comes into it, because the public will feel safe trading in big amounts with Islamic banks, increasing the bank's ability to develop and advance. This is demonstrated by the achievement of Islamic Commercial Banks and Sharia Business Units in 2013, which earned Rp. 156.96 trillion in third-party funds, a 6.41 percent growth over the past year. This data demonstrates the public's growing confidence in Islamic financial institutions (Wijayani, 2017). During the global financial crisis in 1998, almost all Indonesian banks went bankrupt due to high interest rates; however, this was not the only cause of the crisis; the rapid and significant changes in the rupiah exchange rate from Rp 2,450. per dollar (June 1997) to Rp 13,513. per dollar (July 1998) also were felt (January 1998). In addition to high inflation, the large number of private sectors borrowing large amounts of foreign funds, combined with the maturing of foreign debt at the same time as the economic phenomenon that brought the Indonesian economy to an economic crisis that had an impact on the economy, impacted the uncontrolled economic conditions. across industries and levels of society (Tarmidi, 1999). There are three focuses on tackling problems that are regarded critical at the time of the crisis, according to (Mariana, 2002);

a) Efforts to manage inflation in order to stabilize the value of the rupiah, which will speed up the economic recovery process as well as business and investment activity

b) Efforts to mitigate the crisis' impact on the lower middle class

c) Efforts to re-establish public trust in banking so that the banking intermediary function can be successfully carried out and economic growth could be stimulated.

To lessen the impact of the crisis on small communities, the government provided subsidies for basic commodities such as food, fuel, electricity, and fertilizers worth a total Rp. 58.8 trillion, or around 6.2% of GDP, it is expected that the deficit would reach 8.5% of GDP this year and well almost all of the budget deficit will be financed with foreign funds. The government issued a Bank Indonesia Liquidity Credit (KLBI) strategy to stimulate food supply activities, small business development, and cooperatives, which was implemented systematically to maintain economic stability.

Despite the numerous losses, an independent Islamic bank, the first and only Islamic bank at the time, stayed firm in contrast to conventional banks, which were unable to survive at the time. Islamic banks that rely on the real sector put their funds in something that is based on Islam rather than gambling on those that are prohibited in Islam.

The public's demand for sharia-compliant banking products is also significant, not just because Indonesia is dominated by Muslims, but also because of the growing awareness of the Islamic prohibition on usury. Usury, in addition to being unlawful, only benefits one entity. The Al-Quran states in Surah Al-Baqarah, verse 275, stating staying away from usury is a must :

اَلَّذِيْنَ يَأْكُلُوْنَ الرِّبٰوا لَا يَقُوْمُوْنَ اِلَّا كَمَا يَقُوْمُ الَّذِيْ يَتَخَبَّطُهُ الشَّيْطٰنُ مِنَ
الْمَسِّۗ ذٰلِكَ بِاَنَّهُمْ قَالُوْٓا اِنَّمَا الْبَيْعُ مِثْلُ الرِّبٰواۘ وَاَحَلَّ اللّٰهُ الْبَيْعَ
وَحَرَّمَ الرِّبٰواۗ فَمَنْ جَاۤءَهٗ مَوْعِظَةٌ مِّنْ رَّبِّهٖ فَانْتَهٰى فَلَهٗ مَا سَلَفَۗ وَاَمْرُهٗٓ اِلَى اللّٰهِ ۗ
وَمَنْ عَادَ فَاُولٰۤىِٕكَ اَصْحٰبُ النَّارِ ۚ هُمْ فِيْهَا خٰلِدُوْنَ

Which means :

"Those who eat usury cannot stand unless in the same way that people who enter the devil because of insanity cannot stand. That's because they argue that purchasing and selling are both forms of

usury. Allah, on the other hand, has permitted trading while prohibiting usury. Whoever receives instruction from his Lord and desires, then he has what he had before, and his affairs are with Allah. Whoever repeats, they are the inhabitants of hell, and they will spend eternity there."

This is also one of the grounds that motivated the founding of the first Islamic bank in Indonesia in 1992, as mentioned in the verse regarding the prohibition and dangers of usury. Since then, the public's awareness of the consequences of usury has grown, leading to a gradual shift away from conventional banks that had already established themselves in Indonesia. The growing demand for sharia banking services in Indonesia requires changes to the law governing sharia banking, which must be integrated as soon as possible into the law of the Republic of Indonesia number 21 of 2008 on sharia banking, which compromises the law of the Republic of Indonesia number 10 of 1998 on sharia banking. The sound of the law itself is "that in line with Indonesia's national development goals to achieve the creation of a just and prosperous society based on economic democracy, a system of an economy based on the values of justice, togetherness, equity, and benefit in accordance with Indonesia's national development goals to achieve the creation of a just and prosperous society based on economic democracy, a system of an economy based on the values of justice, togetherness, equity, and benefit in accordance with the law" Following the reforms, it is expected that Islamic banking will succeed in accordance with sharia principles and contribute to the growth of the Indonesian economy.

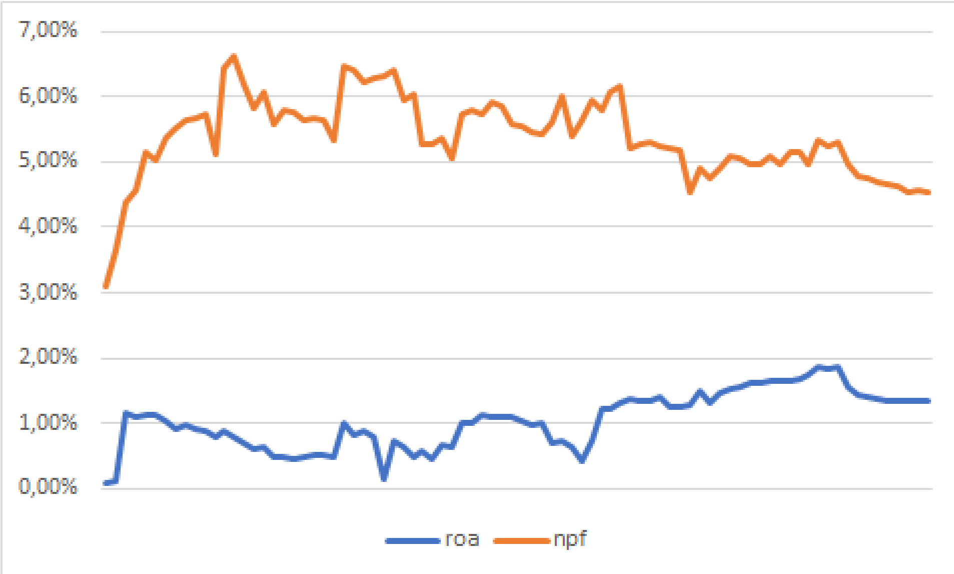
Developments in Islamic banking have an impact on how products are developed within the Islamic banking industry. Naturally, the more services offered, the greater the risk to the bank. Technological developments have also made the banking transaction process more dynamic, starting with the availability of internet banking, mobile banking, and other similar services, which can increase the potential for operational risk by limiting the amount of time available to address problems caused by these effects. Islamic banking is a new bank compared to its competitors, conventional banking, which has a lot of experience with various types of risks, but the risks faced by Islamic banking are more complex. In addition to the general risks that banks face, Islamic banking also has to deal with sharia compliance risk and sharia-compliant investment risk (Mutafarida, 2017) .

Statistical data from 2014 to early 2015 revealed a downturn in Islamic banking performance, with asset growth, financing, and third-party funds all declining, followed by further reductions. The impact of the global financial crisis is thought to have contributed to this reduction. As a result, it's critical to assess the elements that are driving the slowdown in growth, as well as potential solutions, so that in the case of a future crisis, we'll be prepared (Syafrida & Aminah, 2015).

Source : Indonesian Banking Statistics

FIGURE 1. 1

FDR growth data for 2014-20200



Source : Indonesian Banking Statistics

FIGURE 1. 2

ROA and NPF growth data for 2014-2020

According to the statistics in Figure 1.2, non-performing financing, or NPF, reached 5.7 percent in May 2015, which is higher than the OJK guideline of 5%. Sharia had an NPF of 6.17% in general. With these facts in mind, an assessment of the issues impeding the development of the Islamic banking industry is required in order to respond correctly if a similar situation arises in the future. Figure 1.1 shows that the FDR movement rate is still constant at 80-110%, as calculated by the OJK, but Islamic banking must be cautious since increased Third Party Fund growth may lead banks to reduce financing distribution requirements. To assess a bank's financial health, one method is to compare its net profit to its total assets, as shown in the ROA percentage in the table above. The standard ROA set by OJK is at least 1.5%, but the percentage that occurs at figure 1.2 above still starts to fall short of the standard, even in 2014. The bank's ROA may be declining since it is still unable to maximize asset management in order to earn a profit, in addition to the uncertain profit obtained as a result of lower asset turnover.

The Financial Services Authority Regulation Number 8/POJK.03/2014 concerning the Assessment of the Soundness of Islamic Commercial Banks and Sharia Business Units, which was made in order to improve the effectiveness of the assessment of the soundness of banks because bank health is a means for supervisors to regulate strategy, also regulates the measurement of the soundness of the bank itself (Risk-based Bank Rating). In the rule, it is stated that Islamic Commercial Banks and Sharia Business Units are obligated to review the soundness of banks both individually and in consolidation, but that this can only be done individually at least every semester for sharia business units. Article 6 further outlines the range of variables that go into determining the soundness of Islamic banks, such as risk profile, excellent corporate governance, earnings, capital, and specifically for sharia business units, only risk profile factors are required to be assessed. The bank's health condition is particularly significant in establishing public trust, both among existing and future bank users, and the bank's health evaluation can also be very helpful to the authorities. Following up on the results of the bank's soundness evaluation, it will be classified into the composite level, and if there are issues that could endanger the bank's continuity, the bank must submit an action plan to the Financial Services Authority. A copy of the Financial Services Authority Circular Letter Number 10/SEOJK.03/2014 concerning the Assessment of the Soundness of Sharia Commercial Banks and Sharia Business Units, which is a continuation of the aforementioned Financial Services Authority regulations, explains the provisions regarding the assessment of the soundness level of Islamic commercial banks and sharia business units.

Based on earlier study (Al-Banna, 2017), he used the VAR/VECM approach to see the dynamic behavior and vulnerabilities of Islamic banks themselves, based on various studies that claimed that Islamic banking was prone to being influenced by the crisis that happened. Another study (Mahdi, 2019) looks at the effect of chosen variables on Non-Performing Financing, which is also one of the determinants of the smoothness of the banking process approach. The VECM approach was used in this investigation.

Based on the previous research, this research is intended to be a reference solution for Islamic banking by conducting an analysis of various factors to determine which factors have the greatest impact on the decline in Islamic banking developments, so that it can then become a focus in dealing with sharia banking growth. The author takes the title **"THE CAUSES OF VULNERABILITY IN ISLAMIC BANKING IN INDONESIA"** because Islamic banking that can grow and advance in all situations, including one that can handle problems in the midst of a crisis that is currently occurring or will occur in the future, is an achievement that must continue to be fought for.

B. RESEARCH LIMITATION

This study will examine the impact of the risk of Islamic banks' activities in order to determine how significant the impact is and to determine which risks of banking activities are likely to hinder Islamic banks' progress and also to see the islamic bank growth factor such as Capital Adequacy Ratio and Financing to Deposit Ratio whether these elements can boost profitability while simultaneously lowering the risk of banks being vulnerable. Based on the foregoing context, it is required to narrow the problem in order to clarify the scope of this study. Many prior similar studies have been conducted, such as (Maliha & Marlina, 2019), which used the logistic regression method to perform research. Interest rates, liquidity ratios, solvency ratios, inflation rates, and export growth are all variables in this study. According to the findings of this investigation, Islamic banks face liquidity issues. (Al-Banna, 2017) used the VAR/VECM method in his research, as well as interest rates, inflation rates, currency rates, and GDP as variables. It can be argued from this study that Islamic banking is more stable during a financial crisis. Another study (Mahdi, 2019) used the VECM technique and included the interest rate, inflation rate, non-performing loan, and GDP as variables. As a result, non-performing loans are significantly affected by inflation. (Harun & Poerwokoesoemo, 2017) used the cross section approach to conduct a comparable investigation. Liquidity ratio, non-performing loans, market risk, portfolio assets, portfolio liabilities, and equity portfolio were the data variables used. Equities and finance have lower volatility indices since they have more assets. (Lisa and Hermanto 2020) used the RGEC approach in their research and included a liquidity ratio, a non-performing loan, and a risk profile as variables. According to the findings, conventional banks have a higher degree of liquidity than Islamic commercial banks. Because the results and factors utilized in the research described above differ, the author decides to focus on Non-Performing Financing, Liquidity Ratio, inflation rate, capital adequacy ratio, financing to deposit ratio and banking interest rates as variable Y variables. The authors consider this variable vital to be used as an indication for the profitability of Islamic banking to be utilized as variable X, based on the research above that primarily contained these variables, Profitability was chosen as a proxy since profit is a measure of a bank's capacity to make money from its operations, and the data was then processed using the Vector Error Correction Model (VECM).

C. RESEARCH PROBLEM

The writer formulates the problems that become the major study problem based on the problem's background:

1) How does non-performing financing affect Islamic banking's vulnerability in Indonesia?
2) How does the liquidity ratio have on the vulnerability of Indonesian Islamic banking?
3) How does the rate of inflation affect the vulnerability of Islamic banking inIndonesia?
4) How does the capital adequacy ratio have on Islamic banking's vulnerability in Indonesia?
5) How does the financing-to-third-party-funds ratio have on Islamic banking's vulnerability in Indonesia?
6) How does interest rate volatility have on the vulnerability of Islamic banking in Indonesia?

D. RESEARCH OBJECTIVES

The following are the study's aims, based on the preceding statement of the problem:

1) To investigate the impact of non-performing financing on Islamic banking's vulnerability in Indonesia.
2) To investigate the impact of liquidity risk on Islamic banking's vulnerability in Indonesia.
3) To investigate the impact of inflation affects the vulnerability of Islamic banking in Indonesia.
4) To investigate the impact of the capital adequacy ratio on Islamic banking's vulnerability in Indonesia.

5) To investigate the impact of the financing to deposit ratio on Islamic banking's vulnerability in Indonesia.

6) To investigate the impact of interest rates on the vulnerability of Islamic banking in Indonesia.

E. RESEARCH BENEFITS

The following are some of the benefits that can be gained from the study's findings:

1) Further Researcher.

The findings of this study are likely to serve as a reference and source of knowledge for future research into the causes of Islamic banks' vulnerability factors.

2) Islamic Banking

The findings of this study are likely to aid Islamic banking in carrying out its banking activities by identifying which elements should be prioritized for attention and enabling Islamic banking to manage risk based on the level of urgency.