CHAPTER I

INTRODUCTION

A. Background

Banking is one of the important factors in driving the national economy to run its operations by carrying out activities to collect funds from the public as a surplus unit, then channeling it to the deficit unit in the form of credit and providing other financial services which are additional facilities which makes bank become a very important institution in encouraging economic growth and creating credit to improve the investment and business climate which have an impact on reducing the unemployment rate in Indonesia.

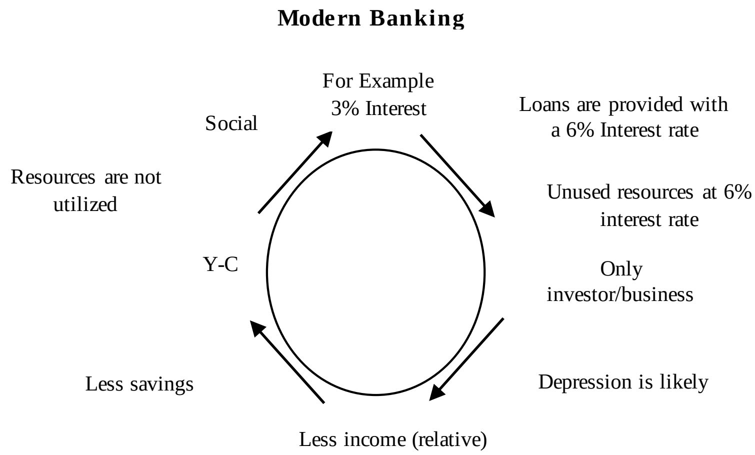
The financial crisis in 2008 changed Indonesia which was previously a country with good economic growth, experiencing an economic downturn when the crisis occurred which was caused by mismanagement in financial innovations involving the Subprime Residential Mortgage which caused an explosion in housing prices where housing prices increased of its intrinsic value. The crisis spread globally, resulting in a substantial drop in the balance sheets of banks and other financial institutions. The crisis also had an impact on developing market countries which were caused by errors in the management of financial globalization and resulted in a weakening of bank balance sheets which led to fiscal imbalances. On the other hand, there was a decline in currency in which the domestic currency slid sharply, this was caused by speculative attacks on the currency resulting in an increase in interest rates and inflation which caused huge losses for banks and triggered the banking crisis.

TABLE 1.1.
Global Economic Growth

Negara	2018	2019				Projections (Annual)	Estimate	Projection	
	Annual	Q1	Q2	Q3	Q4	2019e	2020	2021	2022
Global	**3,6**					**2,9**	**-3,5**	**5,5**	**4,2**
Negara Maju	**2,2**					**1,7**	**-4,9**	**4,3**	**3,1**
United States	2,9	2,7	2,3	2,1	2,3	2,4	-3,4	5,1	2,5
Euro Zone	1,8	1,4	1,3	1,4	1	1,2	-7,2	4,2	3,6
Japan	0,3	-0,4	0,8	0,8	1,7	0,9	-5,1	3,1	2,4
United Kingdom	1,4	2	1,4	1,3	1,1	1,2	-10,0	4,5	5,0
Negara Berkembang	**4,5**					**3,9**	**-1,1**	**8,3**	**5,9**
China	6,6	6,4	6,2	6	6	6,1	2,3	8,1	5,6
India	7,1	5,7	5,2	4,4	4,1	6,1	-8,0	11,5	6,8
Brazil	1,1	0,6	1,1	1,2	1,7	0,9	-4,5	3,6	2,6
Indonesia	5,2	5,1	5,1	5	5	5	2,07	4,9	5,4

Source: IMF World Economic Outlook Januari (2020), CEIC

In 2019, global economic conditions experienced a delay due to the escalation of the US-China trade war with a growth rate of 2,9% in 2019, slowing down compared to 2018 which grew by 3,6%. This caused the US Reserve Federation to lower its benchmark interest rate by 75 bps and purchase bonds amounting to USD 60 billion per month until Q2 in 2020. However, these measures have not been able to overcome the downturn in global economic conditions. In line with slowing global economic growth, Indonesia has also experienced a decline in economic growth. In 2019 Indonesias' economic growth was only 5,0%, slower than in 2018 which reached 5,2%. This delay was caused by a contraction in the real sector, such as the real sales index, motor vehicle sales, and manufacture purchasing managers' index, which has an impact on the decline in investment in machinery and vehicles. However, the inflation rate was maintained to maintain peoples' purchasing power and the trade balance which tended to improve. In addition, there will be a global economic downturn in 2020 as a result of the outbreak of the COVID-19 epidemic. However, it is projected that the global economy will recover in 2021 and 2022

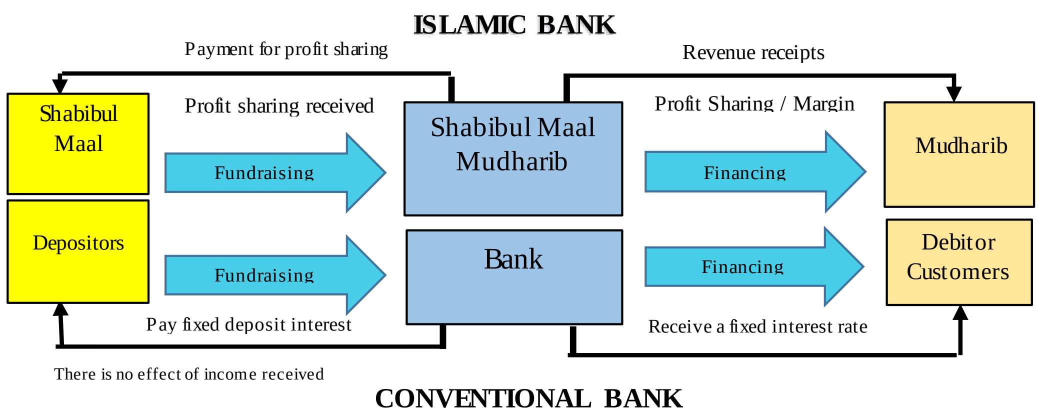


Source: Nasution (2018)

FIGURE 1.1.
Modern Banking

In essence, conventional banks have an operational system using an interesting system. Mannan (1997) argues that an economic system with an interesting system can be detrimental to the health of the economy where the interest system can cause chronic depression, exacerbate the problem of unemployment and encourage inequality in income distribution.

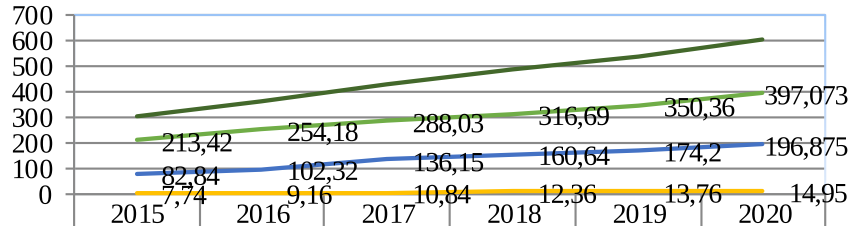
The Islamic Economic System comes with the prohibition of interest as a manifestation of fair equality between capital owners and businesses without exploitation, equitable distribution, and the possibility of depression will be low given a healthy investment (Ali, 2013). Islamic banking proved its performance by surviving during the crisis that hit the world at that time. This is because Islamic banking tends to be conservative and based on basic assets. Besides that, Islamic bank financing activities also focus on the real sector so that if there is a shock in the economy, Islamic banks tend not to be significantly affected (Rahman, 2015).



Source: Financial Services Authority (2019)

FIGURE 1.2.
Islamic Bank and Conventional Bank Operational Scheme

In carrying out its operational system, Islamic banking carries out activities to collect funds from the public then channeled to the deficit unit by charging compensation based on sharia principles. This is what distinguishes it from conventional banks which tend to be speculative. The use of interest on conventional banks causes a deterioration in the conventional economic system because of the large interest expense that must be borne when interest rates rise. There are at least four main objectives of Islamic banking regulations. First, a systemic arrangement is needed to avoid the contagious effect of individual bank failures and ensure public losses; Second, business rules must ensure that Islamic banks deal with consumers adequately; Third, prudential regulations are needed to promote the safety and health of the banking system to avoid individual bank failures; Fourth, sharia compliance regulations need to guide and ensure all market participants comply with sharia rules (Suseno, 2005). Thus, in the Islamic framework, regulation and supervision are not only seen as the main factors to minimize market failures but also as a driving force for market players to improve higher social welfare.



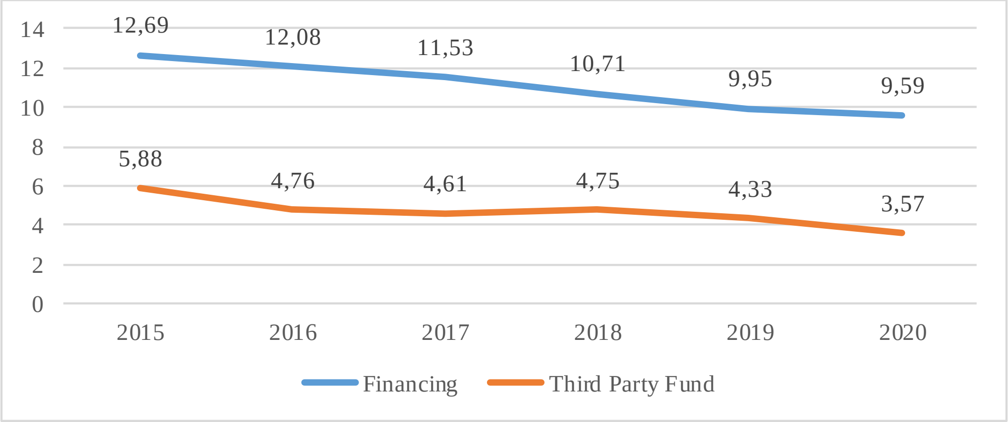
	2015	2016	2017	2018	2019	2020
BUS	213,42	254,18	288,03	316,69	350,36	397,073
UUS	82,84	102,32	136,15	160,64	174,2	196,875
BRPS	7,74	9,16	10,84	12,36	13,76	14,95
Total	304	365,66	435,02	489,69	538,32	608,9

Source: Financial Services Authority (2020)

FIGURE 1.3.
The Total Assets of Islamic Bank (Trillion IDR)

The most important elements in the development of financial institutions is how to obtain optimum benefits. This is done to increase income for Islamic banking (Muhayatsyah, 2020). Based on figure 1.3., Islamic Commercial Banks was the biggest contributor in supporting the development of Islamic banking assets. The Financial Services Authority (OJK) recorded total assets of Islamic banking reaching IDR 538,23 trillion in 2019, this figure is higher when compared to the total assets in the previous year which only reached IDR 489,69 trillion. Islamic banking is supported by several subsectors, such as the total assets of Islamic Commercial Bank reaching

IDR 350,36 trillion, with a growth of 10,63%. The total assets of the Sharia Business Unit reached IDR 174,20 trillion, with a growth of 9,93%. The total assets of the Credit Banks reached IDR 13,76 trillion, with a growth of 11,30%. In terms of the percentage of distribution of financing, most of the operational funds for Islamic banking are played in the financing instrument for Islamic Commercial Banks.

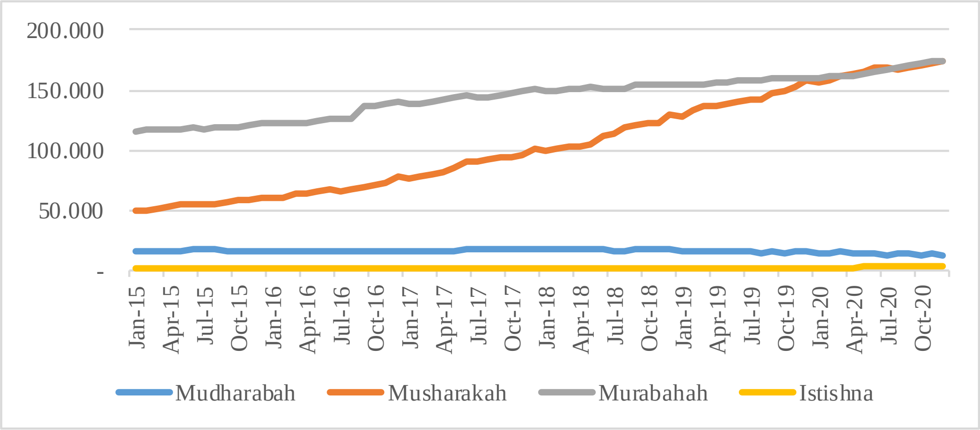


Source: Financial Services Authority (2020)

FIGURE 1.4.
The Equivalent of Yield Rate

Productive asset is the main factor in driving the development of Islamic banking financing. Productive asset is assets or resources that are managed to generate profits and have a potential to increase bank profitability. As an institution that have functions as an intermediary institution and provides financial service facilities to customers, bank provides the largest distribution of funds in the form of financing. Thus, it can be seen that the profit-sharing applied by Islamic banks is very important in achieving profitability. Based on figure 1.4. above, the equivalent level of payment for financing has the largest percentage compared to TPF (Third Party Funds). It is concluded that financing activities are a very important factor in increasing the profitability of Islamic bank. According to Helfert (1997), profitability is the ability to assess a company from a management point of view regarding the effectiveness of operations, the effectiveness of capital utilization, and the profitability achieved on the assets used. Thus, the profits obtained are not only used to ensure the survival of the business entity but also to improve its operation performance.

In maximizing its profit, Islamic banking needs to form a portfolio. A portfolio is a collection of investment instruments owned by investors in order to select an efficient combination of existing instruments. According to Pracanda and Abundanti (2017) a portfolio is a collection of several assets selected from various sectors. The formation of a financing portfolio by choosing the best financing instrument is very useful for Islamic banking to combine its financing instruments to produce maximum returns with a low level of risk. The financing portfolio gets remuneration through a profit-sharing system. In addition, on the credit side, in sharia regulations, banks act as the seller, while customers act as buyers so that kind of mechanism can prevent speculative transactions (Zuhdi et al., 2013). Unlike the credit portfolio run by conventional bank, many credit portfolio pose a high risk considering conventional banks apply an interesting system so that it can threaten the health of the economy due to the interest burden that must be borne if interest rates rise. The credit portfolio places more emphasis on earning interest so that the amount of loan repayment that must be paid by debtors is the number of credit loans received along with the amount of credit interest set by the bank. So that the interest earned from these transactions is included in the bank's income and profits (Chikmah, 2016). Based on sharia regulations, the principles applied by conventional banks include acts of usury because the investment is based on an interesting system, which can lead to speculative transactions and uneven income.



Source: Financial Services Authority (2020)

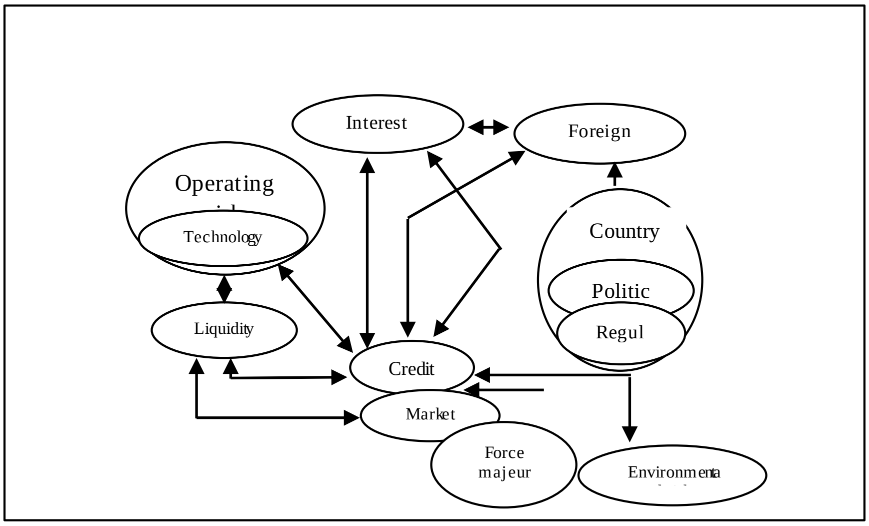
FIGURE 1.5.
The Development of Sharia Financing Contracts in Indonesia (Billion IDR)

The development of financing contracts in Indonesia are dominated by four contracts, namely mudharabah, musharakah, murabahah, and istishna. Based on figure 1.5. above, it can be seen that in the period 2010 to 2020 the value of the number of mudharabah financing contracts showed a decreasing trend in the last ten years. In December 2020 the amount of mudharabah contract financing was IDR 12.883 billion, a decrease compared to the previous year in the same month, reaching IDR 14.972 billion. Both in terms of amount and time, causing Islamic banks to hesitate to channel mudharabah financing. Meanwhile, the financing for the istishna contract increased which was not too significant with the amount of financing in December 2020 reached IDR 2.364 billion, increase compared to the previous year in the same month which reached IDR 2.097 billion. However, a significant increase in the amount of financing occurred in the musharakah and murabahah financing contracts. The amount of Musharakah financing reached IDR 174.919 billion and the amount of murabahah financing reached IDR 74.323 billion in December 2020. This significant increase in financing could be an alternative for the resilience of Islamic banks. Musharakah Profit-Loss Sharing financing offers a high return and murabahah Non-Profit-Loss Sharing financing offers a low risk, which is good for Islamic bank to choose to increase Profit-Loss Sharing financing when financial conditions are stable and increase Non-Profit-Loss Sharing financing when a crisis occurs (Ascarya and Anwar, 2013). Thus, Islamic bank can survive in all economic conditions.

The growth of sharia financing contracts in Indonesia is getting better, this also encourages the interest of Islamic bank as an investor to allocate their funds to sharia financing contracts whose growth has also increased very well. Seeing the sharia financing contract which is unique and has different characteristics by looking at the growth of musharakah and murabahah financing contracts which are quite good makes Islamic banks more interested in investing their funds in musharakah and murabahah contracts.

Until now, Islamic bank financing has led to the real sector as well as the consumption sector, so that this cannot be separated from the risk of non-performing financing. If there is a shock in the economy or human resources management in managing financing is not well managed, then this has the potential to create a risk of financing problems. There are three risks faced by Islamic bank, such as liquidity risk, credit risk, and financing risk. These risk also refers to credit risk, although credit risk is used more for conventional bank, credit risk can also be used for financing in Islamic bank. Non-performing financing is categorized as a financing risk, where this risk is often associated with the risk of default, this is because debtors cannot return the capital provided by the bank or the profits obtained by the bank (Nasution, 2018). Financing risk itself can come from financial risk, business risk, industry risk, and debtor management (Nasution, 2018).

Yusgiantoro and Raymond (2015) stated that pressure on banks occurred in the second quarter of 2005 to the third quarter of 2006. The increase in risk in that period was marked by an increase in the price of goods by 17.1% caused by the increase in fuel prices in March and October 2005, thus having an impact on decreasing public purchasing power which results in creditors being unable to pay their obligations to the bank resulting in non-performing financing which is categorized as a financing risk.. Charles Schell in Nasution (2018) states that the financing risk with other risks has a very complex relationship in the following scheme:



Source: Charles Schell in Nasution (2018)

FIGURE 1.6.
Financing Risk Relationship with Other Risks

The relationship between financing risk and market risk is a decrease in the value of collateral due to a decrease in the market value of the pledged asset, this is due to the movement of market variables (adverse movement) in the form of interest rates. However, Islamic banks do not experience the risk caused by an increase in interest rates so that Islamic banks only need to manage market risk associated with changes in exchange rates that can cause losses to the bank. Market risk itself includes interest rate risk, foreign exchange risk, price risk, and liquidity risk. According to Wiranatakusuma and Duasa (2016) liquidity risk, credit risk, and exchange rate risk are inherent elements due to several reasons such as the dual system adopted by banks in Indonesia which implies several connected relationships between the development of conventional banking and Islamic banking. which affects the consumer behavior of Islamic depositors who are still influenced by the interest rates offered by conventional banks, besides the practice of Islamic banks that are not fully following the operational basis of Islamic banks because they are predominantly operating under debt and trade-based transactions, not promoting equity-based contracts.

The large contribution of financing products in improving the quality of productive assets of Islamic banks, at the same time making Islamic bank financing the biggest source of business operation risk, which triggers problematic financing, which will disrupt the operational performance and bank liquidity (Andrianto and Firmansyah, 2019)**.** These risks can create systemic risks that lead to loss of trust and increased uncertainty in the financial system, which can threaten the stability of the Islamic banking financial system and have negative effects on the economy, such as an increase in the number of disruptions to the payment system, credit flows, and a decrease in asset value. Thus, there needs to be an effort to mitigate the risks.

Risks that arise can be minimized by mitigating risks so that in the end they can form an optimal portfolio. An optimal portfolio is a portfolio that is formed with the best-expected return and risk. The optimal portfolio can increase profits so that it has an impact on increasing the income earned by Islamic banking, considering that the financing instrument is a productive business of Islamic banking. The income received from the main business is included in operating income so that it affects improving operational performance.

If Islamic banking chooses the wrong financing instrument in investing its funds, then Islamic banking can experience losses. Thus, Islamic banking is required to be able to determine the right financing instrument to invest, the number of funds invested, and determine the right time to invest (Wibowo, 2014).

Risk mitigation can be carried out through a monitoring strategy, stress identification, risk assessment, and risk signaling; as well as the development of appropriate policy instruments (Bank Indonesia, 2016). Thus, a series of monitoring indicators and methods are needed that are capable of capturing imbalances, determining optimal threshold values, and being able to assess potential losses to maintain stability and optimize the operational performance of Islamic bank in Indonesia. One method that can be used is the EWS (Early Warning System) early detection system. Kusuma and Asif (2012) argue that risk can be mitigated by the EWS (Early Warning System) method. Adiwarman Karim in Nasution (2018) argues that risk management functions as a filter or EWS (Early Warning System). The early warning system is very important and needs to be done to predict the performance of Islamic banking and information about problems that may be faced by Islamic banking, besides that with the EWS for Islamic banking it will save bank band performance costs or failure for depositors, owners, and the public (Kusuma and Asif, 2012).

Based on the background above, this study intends to analyze and mitigate risk by using a monitoring indicator, namely a composite indicator in order to find out the level of optimal performance. Indonesia Bank (2016) suggests that a composite indicator is a tool for measuring risk by combining related indicators to assess the likelihood of systemic impacts and the EWS (Early Warning Indicator) financial crisis detection indicator so it is expected to anticipate the possibility of failure from various market conditions, also policymakers can prepare various policies to reduce the impact of economic instability, detect risks in financing products as related indicators, and can form an optimal portfolio of the selected financing instruments so that they can serve as guidelines for Islamic banks in investing their funds and improve the quality of its assets appropriately in order to increase the banks' liquidity and profitability because high levels of liquidity and profitability indicate high bank operational performance as well which will maintain the resilience and stability of Islamic banks.

B. Problem Statement

Based on the above background, PLS (Profit-Loss Sharing) Financing and Non-PLS (Non-Profit-Loss Sharing) Financing have different uniqueness and characteristics. Islamic banking also has different preferences for types of financing products to improve operational performance. Thus, Islamic banks must be directed to maintain optimal financing in order to encourage the optimization of operational performance. Thus, the problem formulations that must be resolved are:

1. How is the optimal level of selected Sharia financing at Islamic Banking in Indonesia?
2. What are the optimal financing contracts that has an effect on creating the optimal operational performance of Islamic banks?

C. Research Objectives

Based on the formulation of the above problems, the objectives of this study are:

1. To determine the optimal level of selected Sharia financing at Islamic banking in Indonesia.

2. To find out the optimal financing contracts that has an effect on creating the optimal operational performance of Islamic banks

D. Research Benefits

This research is expected to prove benefits for many parties:

1. For the government/policymakers, this research will be useful for creating new policies to improve the operational performance of Islamic banking
2. For the academic community, this research can be used as a reference for developing the operational financial system
3. For the public, this research can provide new knowledge and insights about Islamic banking in Indonesia.