CHAPTER I

INTRODUCTION

A. Background

In 1997, the financial crisis began in Thailand and has destroyed the joint economies of Asian countries, especially countries that have similar economic typologies. This crisis was triggered by the actions of speculators who launched a barrage of "attacks" on the Thai currency. Given the economic structure of Thailand at that time where the strengthening of the exchange rate was not accompanied by strengthening in the real sector (Sach., 1998).

According to Bello, et al (2017) the efficiency of risk management practices can be sought as the main reason for a banking collapse. The risk such liquidity risk, credit risk and operational risk, will need a special treatment and forcing a bank in critical level to received bailout funds. The main lesson from this situation is when risks are not mitigated properly, maybe not only affect the overall financial system but also cause bank ruin.

In august 2007 a financial crisis started when one of the largest French banks of the BNP announced a freeze of some securities in the United States concerning high-risk housing loans (subprime mortgage). This incident triggered a decline in the level of public confidence in the banking sector and led to bank failures around the world. Liquidity crisis causes 2008 have been declining in the household and corporate sector confidence toward economic conditions. Financial turmoil and declining demand due to the financial crisis can lead to a depreciation of the exchange, strong inflationary pressures and rising interest rates also affect lending in Indonesian banks (Haryanti, 2009).

The growth of national banking credit is also still experiencing slowdown. As of the end of 2015, credit growth was recorded at 9.2%, far lower than in 2014 of 13.4%. Credit growth in 2015 was the lowest growth in the last 5 years. In addition, credit risk as indicated by the level of Non-Performing Loans (NPLs) tends to increase even though it is still below 5%. Gross NPL in 2015 was 2.6% or higher than in 2014 of 2.2%. Likewise, the growth of national banking Third Party Funds (TPF) decreased compared to the end of 2014 from 12.3% to 8.06%. Meanwhile, the national banking capital level increased by 1.82% from 2014 with Capital Adequacy Ratio (CAR) ratio of 19.57% increasing to 21.93%. This CAR value is the highest in the last 5 years. This shows that Indonesian banks have sufficient resilience to anticipate potential risks.

TABEL 1.1

Main Indicator of National Banking in Indonesia

	2011	20 12	2013	2014	2015
Total Asset (Rp Billion)	3,709	4,33	5,032	5,705	6,234
Asset Growth (Yoy)	-	16,70%	16,2%	13,4%	9,3%
Total Credit (Rp Billion)	3,466	4,237	4,898	5,556	6,067
Credit growth (yoy)	-	22,2%	15,6%	13,4%	9,2%
CAR	16,05%	17,43%	18,13%	19,57%	21,39%
ROA	3,03%	3,11%	3,08%	2,85%	2,32%
LDR	78,77%	83,58%	89,70%	89,42%	92,11%
BOPO	85,42%	74,10%	74,08%	76,29%	81,49%
NIM	-	5,49%	4,89%	4,23%	5,39%

Sources: Shariah Banking and Finance Development Report 2015

According to Financial Services Authority (OJK) (2015) the slowdown in national banking conditions, led the development of Shariah Banking in 2015 also tended to slow down. Although it still showing a positive figures, the growth of shariah banking in 2015 no longer as high as in previous years which reached relatively high double digits (even higher than conventional banking). The growth of assets, channeled financing and third party funds (DPK) of the national sharia banking industry in 2015 consisting of Sharia (Islamic) Banks, Sharia Business Unit (UUS) and Sharia Rural Bank (BPRS) growth of 9.00%, 7.06% and 6.37%. The total assets of the national sharia banking industry in 2015 reached ± Rp304.0 trillion, PYD of ± Rp218, 7 trillion and DPK of ± Rp236.0 trillion. While financial ratios like NPF, ROA, BOPO, and FDR are relatively higher compared to 2014 position, except for CAR's declining capital ratio from 16.10% in 2014 to 15.02% by 2015. This is due to the obligation to increase the formation of CKPN and the enactment of KPMM POJK which launch in January 1, 2015 and which requires Islamic banks to calculate RWA operational risk in the calculation of CAR.

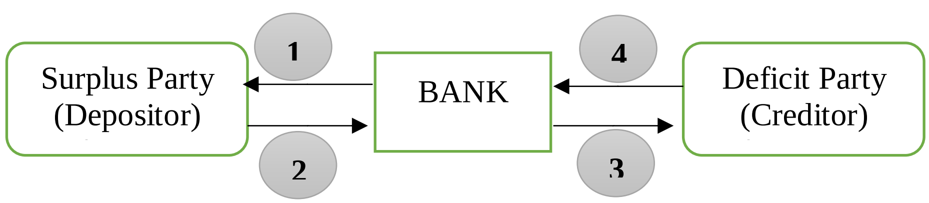
According to Bank Indonesia (2016), the systemic risk is the instability potential as a result of contagion in some or all financial systems. It is because of the interaction of size, complexity, interconnectedness of institutions and financial markets, and excessive behavioral tendencies from actors or financial institutions to follow the economic cycle (*procyclicality*). In general, systemic risk is interpreted into 3 parts, namely: (a) the magnitude of the source of risk, for example: the sudden occurrence of shock and the probability of systemic risk; (b) The process of risk formation (transmission) such as interconnectedness between elements in the financial system and contagion / domino effect; (c) The combination of these three perspectives or the impact it has caused, which is linking the impact of systemic risk to the economy and loss of confidence.

Systemic risk mitigation efforts cannot be done only by using a single indicator or 1 (*one*) measurement method. A comprehensive set of systemic risk measurement tools is needed. As an authority in the macro prudential field, Central Bank of Indonesia continues to develop systemic risk mitigation indicators, methods and tools. Hence, that it is expected to be able to create an efficient supervision and develop appropriate policy instruments to support the achievement of financial system stability.

The banking sector itself has an impact on economic growth in a country, which causing uncontrolled banking risks. Several type Risks to banks due to economic instability are including: ***First***, Liquidity Risk. This risk is a risk where banks cannot meet the needs of customers in the short term. According to Banker Association for Risk Management (2015) if a bank was unable to meet the liquidity needs of its customers, (for example from interbank loans), the level of public trust will decrease. Therefore, the liquidity problems in banks will created, which in turn will have an impact on other financial aspects that could threaten the business continuity of the bank. Liquidity risk is influenced by several factors, including; accuracy of cash flow planning, accuracy in managing funds, availability of assets that are ready to be converted into cash, and the ability to create access to the interbank market. Variables that later support the risk of liquidity are Financing to Deposit Ratio (FDR).

Second, Credit Risk is the risk of loss due to the failure of the counterparty to fulfill obligations. Credit risk can come from a variety of functional bank activities such as credit (financing), treasury activities (placement of funds between banks, buying corporate bonds), and activities related to investment and trade financing. The variables that later support the credit risk is Non Performing Financing (NPF). ***Third***, Operational Risk is the risk caused by inadequate or non-functioning internal processes, due to human error or technological system failure and external events that affect the bank's operational performance. Operational risk have one or several causes in each event. Understanding the cause is a major thing that increases the probability of an event occurring. Therefore, in identifying the main cause of an event, the bank must be able to determine the most dominant cause. At Operational risk, The Ratio of Operational Expenses to Operational Revenue (BOPO) variable will be used to support this research.

Risks that significantly affect the overall risk profile of Islamic banks are credit risk and operational risk. The potential credit risk in Islamic banks can be mitigated, among others, by increasing financing control and monitoring functions, reducing the concentration of fund disbursement to core debtors or certain economic sectors, improving policies and procedures, strengthening information systems technology and fulfilling human resources with adequate competence. In addition, Islamic banks also need to increase their understanding of the Islamic contract.



1. Money Deposited
2. Money withdraw

3. Financing Contract
4. Profit Loss Sharing

Sources: Bank Indonesia

FIGURE 1.1
Shariah Banking as a Financial Intermediary

According to Bank Indonesia (2011), Shariah Banking has two main sides due to its function, namely the right and left side. The left side shows that in the banking sector there is a surplus of money called depositors. Meanwhile, the right side shows that households and employers need money to support their needs by financing in Shariah Banking.

The instability of the economic stability resulted in disruption of the banking function. Shariah Banking has a liability structure that is quite sensitive to interest rates. As a result, it is difficult for Shariah Banking to react directly and quickly to changes in market interest because of the different structural assets and liabilities (*Mismatch*). The condition of this mismatch makes Shariah Banking experience a displaced commercial risk (transfer of risk associated with deposits to equity holders). This condition causes asset-liability mismatches (Musri & Rama, 2015). Mismatch between assets and liabilities results in the emergence of displaced commercial risk (DCR) risk where there will be risk transfer to equity holders.

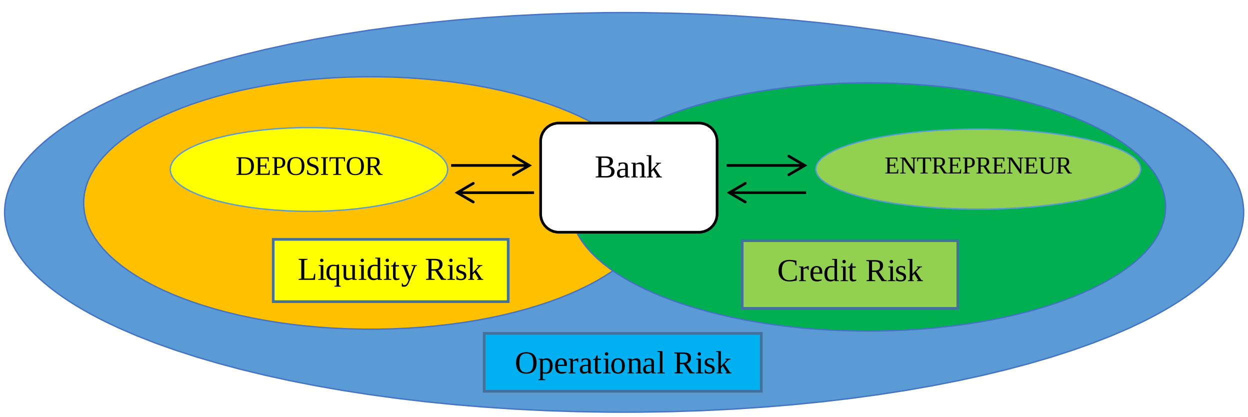
The role of quality management is planning, organizing, implementing and supervising. Good management quality can certainly be measured well or not by the implementation of Good Corporate Governance and risk management at the bank. According to Permana (2014) if we l ook at the actual business in the bank as well as other businesses. But because banks use funds sourced from the public, the risk level is higher when compared to other businesses. However, having a high level of risk is not to be avoided but must be better managed.

Based on the above discussion, this research aims to determine more about the risks of what will become a Leading Risk and how to mitigate Risk on Shariah Banking in Indonesia. Therefore the researcher conducted a study which entitle **"Risk Analyses on Shariah Banking in Indonesia"**

B. Limitation of The Study

To clarify and limit the problem, avoid problems that widen from what has been mentioned in the background, then limit the problem as follows:

1. Variable FDR, NPF, BOPO



This Research only focus on Financing to Deposit Ratio (FDR), Non Performing Financing (NPF) and The Operational Expenses to Operational Revenue (BOPO) of Shariah Banking in Indonesia, with 9 Years duration of time Monthly data from January 2010 – August 2018.

C. Problem Statement of Study

1. Does Liquidity Risk have significant impact toward overall risk on Shariah Banking in Indonesia?
2. Does Credit Risk have significant impact toward overall risk on Shariah Banking in Indonesia?
3. Does Operational Risk have significant impact toward overall risk on Shariah Banking in Indonesia?

D. Objective of The Study

1. To determine Liquidity Risk has significant impact toward overall risk on Shariah Banking in Indonesia.
2. To determine Credit Risk has significant impact toward overall risk on Shariah Banking in Indonesia.
3. To determine Operational Risk has significant impact toward overall risk on Shariah Banking in Indonesia.

E. Benefits of The Study

1. It is expected to give suggestion for the banker to have deep understanding about as input for Shariah Banking to determine policies in Indonesia
2. As a reference for policy makers
3. It is expected to be references for future researchers.