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Risk Management Practices and their Implications for Performance and Market Share in Indonesian Islamic Banks

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ABSTRACT: This paper analyzes Indonesian Islamic banks' risk management and market share. The mixed-methods research includes a comprehensive literature review and a qualitative case study of three of Indonesia's major Islamic banks.

The case study finds that risk management best practices helped the chosen Islamic banks prosper. These steps include some common practices such as diversification of the financing portfolio, efficient internal control systems, and strict compliance with Shariah principles. Additionally, the study suggests that the implementation of risk management practices should be tailored to the specific needs and characteristics of each Islamic bank. practices such as diversification of investment portfolios, strict adherence to Shariah principles, and the use of advanced risk management tools and techniques. Additionally, the study suggests that effective risk management can enhance the reputation and credibility of Islamic banks in the eyes of their stakeholders. Getting up a department for risk management, integrating risk management, and making the organization's risk culture stronger This study emphasizes risk management's role in Indonesia's Islamic banking's long-term growth. By tackling risk management challenges and creating solid risk management methods, Indonesian Islamic banks can enhance their performance, increase their market share, and help grow a vibrant Islamic banking industry

KEYWORDS: best practices, challenges sustainability, Indonesia, Islamic banking, risk management

1. INTRODUCTION

In 2019, Islamic banking assets are anticipated to account for 2.5% of worldwide banking assets. The Islamic banking industry has undergone substantial expansion over the past several years (Ernst & Young, 2020). Indonesia is one of the largest markets for Islamic banking, with 202 million Muslims representing 88% of Indonesian citizens and 12,9% of the worldwide Muslim population. Although Islamic banking assets comprise about 5% of total banking assets in the country, The Financial Services Authority (OJK) noted that the market share of Islamic finance increases yearly (Bank Indonesia, 2020). Several reasons have contributed to the expansion of Islamic banking in Indonesia, including the country's huge Muslim population, the high demand for Shariah-compliant financial products, and the government's support for the growth of Islamic finance.

The appropriate management of risks is one of the major obstacles facing Islamic banking in Indonesia. Islamic banks are susceptible to a variety of hazards, including credit risk, market risk, liquidity risk, and operational risk. Yet, the distinctive aspects of Islamic finance, such as the prohibition on interest and the need that transactions be based on real assets and actual economic activity, present extra hurdles for risk management in Islamic banks.

Good risk management is crucial for the continued existence and expansion of Islamic banks, as it ensures that banks can properly manage their risks and make well-informed decisions on their operations and investments. In addition, proper risk management can contribute to the enhancement of Islamic finance's legitimacy and growth.This literature study aims to give a complete overview of the literature regarding the impact of risk management on performance and market share in Islamic banks in Indonesia. Specifically, the following research topics will be addressed in this synthesis:

1. What is the present state of risk management in Islamic banks in Indonesia?
2. What is the connection between risk management strategies and financial success in Indonesian Islamic banks?
3. What is the relationship between Indonesian Islamic banks' risk management strategies and market share?
4. What are the most important obstacles and opportunities for risk management in Islamic banks in Indonesia?

The results of this literature review will shed light on the current condition of risk management methods in Islamic banks in Indonesia as well as their impact on financial performance and market share. In addition, this synthesis will identify significant challenges and opportunities for risk management in Indonesian Islamic banks, which may be utilized to influence future research and policy development in this area.

2. LITERATURE REVIEW

Theoretical Framework of Risk Management in Islamic Banking

Risk management is a crucial part of banking operations, as it serves to ensure the stability of financial institutions. In the context of Islamic banking, risk management is crucial, as Islamic banks are exposed to specific risks due to the prohibition of interest and the need that transactions be based on real assets and genuine economic activity. Credit risk management, market risk management, liquidity risk management, and operational risk management are the four major components of the theoretical framework of risk management in Islamic banking.

Credit risk management

Credit risk is the possibility that a borrower will default on his or her loan commitments. Good credit risk management is vital for Islamic banks, as lending is their primary source of income. A variety of credit risk management strategies, including credit analysis, credit scoring, and credit risk monitoring, are available to Islamic institutions. In addition, Islamic banks can develop rules for loan origination, underwriting, and monitoring, as well as policies and procedures for managing credit risk.

Using the idea of *musharakah,* which is a sort of partnership in which the Islamic bank and the borrower share the risks and rewards of a project, is one way to manage credit risk in Islamic banking. This strategy can help align the bank's and borrower's interests and lower the chance of default. Yet, *musharakah* might be more difficult and expensive to implement than conventional lending processes.

Market Risk Management

Market risk is the possibility that changes in market conditions will have a negative impact on the profitability or solvency of a financial institution. By investing in financial assets such as sukuk and shares, Islamic banks are subject to market risk. Islamic banks can implement a variety of market risk management strategies, including asset-liability management, value-at-risk (VaR) analysis, and stress testing, to effectively manage market risk. In addition, Islamic banks can adopt policies and procedures for managing market risk, such as selection and diversification requirements for investments.

Using the notion of *mudarabah,* which is a sort of partnership in which the Islamic bank provides the capital, and the partner offers the expertise, is one way to market risk management in Islamic banking. This strategy can help align the bank's and the partner's interests and lessen the chance of a loss. Yet, *mudarabah* can be more complicated and less transparent than conventional investment techniques.

Liquidity Risk Management

The danger that a financial organization will be unable to satisfy its commitments when they come due is known as liquidity risk. While Islamic banks rely largely on short-term funding sources, such as deposits, effective liquidity risk management is vital. Islamic banks can implement a variety of liquidity risk management procedures, such as ratio analysis, cash flow projections, and contingency financing strategies. In addition, Islamic banks can adopt rules and processes for mitigating liquidity risk, such as asset and liability management guidelines and financing diversification regulations.

Using the notion of *murabahah,* which is a sort of sale in which the Islamic bank purchases a commodity and then resells it to the customer for a profit, is one method for managing liquidity risk in Islamic banking. This strategy can help ensure the bank has a constant supply of funds and lessen the danger of financial shortages. Nonetheless, murabahah can be more expensive than conventional fundraising methods.

Operational Risk Management

Operational risk is the risk of loss caused by inadequate or failing internal processes, people, systems, or external events. Due to the complexity of Shariah-compliant financial instruments and the requirement to ensure conformity with Shariah principles, Islamic banks require effective operational risk management. The operational risk management strategies that Islamic banks can use include risk assessment, risk reduction, and risk monitoring. In addition, Islamic banks can adopt policies and processes for operational risk management, such as rules for internal controls, staff training, and Shariah observance.

Using the notion of *wakalah,* which is a type of agency in which the Islamic bank acts as the customer's agent, is one way to implement operational risk management in Islamic banking. By delegating specific services, such as asset management, to thirdparty suppliers, this strategy can help lower the risk of operational failures. Yet, *wakalah* might be more complicated and necessitate further scrutiny to assure conformity with Shariah rules.

Components of Integrated Risk Management

While each of these risk management components is significant, successful risk management in Islamic banking necessitates an integrated approach that takes into consideration the interconnected nature of these risks. For instance, credit risk management policies and processes must be integrated with liquidity risk management policies and procedures in order to ensure that the bank can satisfy its obligations when they fall due. Similarly, operational risk management policies and processes must be integrated with market risk management policies and procedures for the bank to be able to respond effectively to changes in market conditions.

In addition, successful risk management in Islamic banking demands an organization-wide risk culture that is robust. This involves an organization-wide commitment to risk management, effective communication and reporting mechanisms, and a focus on continual development and learning.

3. LITERATURE STUDY ANALYSIS

The Role of Risk Management in Enhancing Performance and Market Share

Risk management is an essential component of banking operations that seeks to detect, evaluate, and minimize any risks that could have a negative impact on the financial organization. Effective risk management plays a critical role in ensuring the safety and soundness of Islamic banks, which is also true of Islamic banking. In addition, risk management is crucial in Islamic banking to ensure conformity with Shariah principles and values. In this study, we examine the impact of risk management on the performance and market share of Islamic banks. Specifically, we investigate how good risk management may increase asset quality, efficiency, reputation, and trustworthiness, as well as find new business prospects.

In 2022, financing growth in Indonesia's Islamic banking sector increased by 18.8%, driven by expansion in the consumer segment, which accounts for 51% of the sharia-financing market share. Recent consolidation, such as the merger of PT Bank Syariah Indonesia Tbk, positions Islamic banks in a better position to go into syndication loans, a hitherto underserved market. At the conclusion of 3Q22, Islamic banks held 7.6% of the financing market. According to data from the Islamic Financial Services Board, Indonesia's Islamic banking assets had a global market share of 1.9% by the end of 2021, trailing Bahrain's 3.3% and Turkey's 2.9%. The termination of universal forbearance in 1Q23 will put a minor strain on the average non-performing financing (NPF) ratio. This will be offset by rapid expansion in financing. Increased reserve coverage will also help to improve asset quality.

Enhancing the Value of Assets

One of the key objectives of risk management is to enhance the quality of Islamic bank assets. The quality of assets refers to the borrower's ability to repay the loan, which is determined through credit risk analysis. Credit risk analysis is the evaluation of a borrower's creditworthiness to assess the probability of default. Good risk management can assist in mitigating credit risk by ensuring that only creditworthy borrowers are provided credit.

Islamic banks must implement robust credit risk management policies and procedures in order to effectively manage credit risk. This covers credit approval, monitoring, and collection policies. Moreover, Islamic banks must evaluate the creditworthiness of borrowers in accordance with Shariah-compliant criteria. For instance, Islamic banks must ensure that the loan is used for Shariah-compliant objectives and that the borrower can repay the loan without using non-Shariah-compliant means.

Good credit risk management can increase Islamic banks' profitability. By giving loans to only creditworthy clients, Islamic banks can decrease the risk of loan defaults and the requirement for loan loss reserves. Hence, performance indicators like return on assets (ROA),return on equity (ROE) and non-performing financing (NPF) can improve.

Improving Performance

Moreover, risk management can boost the effectiveness of Islamic banks. This can be accomplished in part by decreasing the amount of capital necessary to fund banking operations. To absorb losses in the case of a loan default or other risk event, capital is required. By managing risk properly, Islamic banks can reduce the amount of capital needed to fund their operations. This can result in higher capital efficiency and increased profitability. When comparing non-performing financing to the amount of financing given, a growth in NPF in Islamic banks is generally referred to as a failure of financing policies, risk policy, and an increase in NPF is the main reason for a decline in bank profits.

By minimizing the costs associated with risk management, effective risk management can also increase the efficiency of Islamic institutions. Effective liquidity risk management, for instance, can lower the need to keep surplus liquidity, which can result in a higher return on assets (ROA). Similarly, good market risk management can reduce the impact of market changes on a bank's operations, resulting in increased profitability.

Enhancing Reputation and Establishing Trust

Good risk management can assist Islamic banks in enhancing their reputation and gaining customer confidence. By demonstrating a commitment to prudent risk management methods, Islamic banks can increase investor confidence and attract new clients. This can lead to a rise in market share.

Islamic banks must have solid risk management policies and procedures in place in order to effectively build trust. This covers risk identification, evaluation, mitigation, and reporting policies. The risk management framework of Islamic banks must be integrated with the organization's entire strategic plan. This can ensure that risk management is a priority at all organizational levels. Government assistance is also needed in the form of various sorts of government policies to maintain economic stability, such as during a pandemic with lockdowns, social restrictions, and so on.

New Business Opportunity Identification

Also, effective risk management can aid Islamic banks in recognizing and capitalizing on new business opportunities. By efficiently managing risk, Islamic banks are able to be more adaptable and responsive to fluctuating market conditions. This can assist companies in identifying and pursuing new business possibilities that can boost company profitability and market share.

To effectively find new business possibilities, Islamic banks must incorporate risk management into their strategic planning process. This includes regularly conducting risk assessments and scenario analyses to identify potential threats and opportunities. By evaluating the market's dangers and opportunities, Islamic banks can offer innovative goods and services that adhere to Shariah principles and suit their clients' expectations.

For instance, effective risk management can assist Islamic banks in identifying unsatisfied market sectors or client needs. This might result in the creation of new goods and services that enable Islamic banks to differentiate themselves from their rivals and increase their market share.

Previous Empirical Studies on Risk Management and its Impact on Islamic Banking Performance and Market Share

In recent years, various empirical studies have examined the influence of risk management on the performance and market share of Islamic banking. The purpose of these studies was to examine the relationship between risk management techniques and financial performance in Islamic banks, as well as the effect of risk management on market share and customer loyalty. In this section, we will examine some of the most important empirical research undertaken on this topic and emphasize its most important conclusions.

Akkizidis and Khandelwal (2008) evaluated the effect of risk management on the performance of Islamic banks in Malaysia in one of the early studies on this topic. Effective risk management techniques have a substantial positive impact on the financial performance of Islamic banks, especially in terms of profitability and asset quality, according to the report. The authors reached the conclusion that risk management was a crucial success element for Malaysian Islamic banks.

Tariq and Ali (2012) explored the association between Islamic banking risk management practices and customer satisfaction in a separate study. Effective risk management methods were discovered to have a positive correlation with customer satisfaction, which had a beneficial effect on market share and customer loyalty. The authors hypothesized that Islamic banks may use risk management to increase customer happiness and loyalty, thereby enhancing their market competitiveness.

In a more recent study, Azmi and Nair (2017) evaluated the effect of risk management on the financial performance of Islamic banks in the GCC region. Effective risk management techniques have a substantial positive effect on the financial performance of Islamic banks, notably in terms of profitability and efficiency, according to the study. Also, the authors discovered that Islamic banks with stronger risk management methods tended to have a larger market share and greater client loyalty than those with inferior risk management policies.

Al-Tamimi and Al-Azrooei (2018) also looked at how Islamic banking risk management techniques and market share are related. Effective risk management methods were found to be related to market share in a positive way. This means that Islamic banks that could handle risks well were more likely to get a bigger piece of the market. The authors said that risk management could be used as a strategic tool to grow the Islamic banking industry's market share and make it more competitive.

Rahman and Rashid (2018) did another study that looked at how risk management affects how well Bangladeshi Islamic banks do financially. The study found that effective risk management techniques help Islamic banks do better financially, especially in terms of the quality of their assets and how much money they make. The authors came to the conclusion that risk management was a big part of how well Islamic banks did financially, and that Islamic banks that were good at-risk management were more likely to do well in the very competitive banking business.

Al-Mamun et al. (2018) also looked into how risk management affects how well Islamic banks in Malaysia do financially. The study found that effective risk management procedures help Islamic banks do well financially, especially when it comes to making money and being efficient. Furthermore, the authors discovered that Islamic banks with stronger risk management methods tended to have a larger market share and greater customer loyalty than Islamic banks with weaker risk management policies.

4. CURRENT STATE OF RISK MANAGEMENT PRACTICES IN ISLAMIC BANKS IN INDONESIA

The Bank Indonesia rule on risk management in Islamic banks (PBI No. 21/9/PBI/2019) establishes the minimum requirements for risk management in Indonesian Islamic banks. The rule says that Islamic banks must use a risk management system that covers all risks, including credit risk, market risk, liquidity risk, operational risk, and shariah risk. In addition, the rule mandates that Islamic banks construct a risk appetite framework that outlines the bank's risk tolerance and risk limits for each type of risk.

According to a survey conducted by Bank Indonesia in 2018, most Islamic banks in Indonesia have implemented risk management policies and procedures that comply with PBI regulations. According to the poll, 95% of Islamic banks have established a risk management committee, and 100% have established a risk management unit or department. Most Islamic banks have built risk appetite guidelines and risk monitoring and reporting systems, according to the survey.

Yet, the survey also revealed several flaws in the risk management techniques of Indonesian Islamic banks. For instance, the survey revealed that just fifty percent of Islamic banks have built an all-encompassing risk management framework. Several Islamic banks rely on manual processes and Excel spreadsheets to monitor and report risk, according to the findings of the survey.

Credit Risk Management

Credit risk is one of the greatest threats Islamic banks in Indonesia face. According to a survey conducted by Bank Indonesia, most Islamic banks have created credit risk management policies and procedures that comply with PBI regulations. Nonetheless, the survey also revealed that certain Islamic banks had deficiencies in their credit risk management systems, particularly in the areas of credit risk assessment, credit risk monitoring, and credit risk reporting.

Market Risk Management

Another big risk that Islamic banks in Indonesia confront is market risk, especially considering the volatility of global financial markets. According to a survey conducted by Bank Indonesia, the majority of Islamic banks have created market risk management policies and procedures that comply with PBI regulations. Yet, the survey revealed that certain Islamic banks had deficiencies in their market risk management systems, particularly in the areas of market risk assessment and market risk reporting.

Liquidity Risk Management

Given the specific characteristics of Islamic finance, such as the prohibition on interest and the requirement for asset-backed financing, liquidity risk is a significant concern for Islamic banks in Indonesia. According to a Bank Indonesia survey, the majority of Islamic banks have implemented PBI-compliant liquidity risk management policies and processes. The survey also revealed that certain Islamic banks had deficiencies in their liquidity risk management policies, particularly in the areas of liquidity risk measurement and liquidity risk reporting.

Enterprise Risk Management

The operational risk posed by all banks, including Islamic banks in Indonesia, is high. According to the Bank Indonesia survey, the vast majority of Islamic banks have operational risk management policies and procedures that comply with PBI regulations. Yet, the survey also revealed that several Islamic banks had deficiencies in their operational risk management systems, especially in the areas of operational risk identification and operational risk reporting.

Shariah Risk Management

Due to their reliance on shariah-compliant financing and investment activities, Islamic banks in Indonesia are exposed to a unique Shariah risk.

Despite the progress made in recent years, Islamic banks in Indonesia still face a number of obstacles in their risk management methods. The lack of competent and experienced risk management specialists in the country is one of the greatest obstacles. This lack of qualified risk management specialists has been cited as a significant obstacle to the establishment of effective risk management processes in Indonesian Islamic institutions. The paucity of skilled risk management experts has been linked to a number of causes, including a lack of training and educational opportunities in risk management as well as relatively low incomes and limited career opportunities for risk management professionals in the country.The restricted availability of trustworthy data and information on the dangers Islamic banks face in Indonesia is another significant obstacle for risk management techniques in

Islamic banks in the nation. Due to the restricted availability of trustworthy data and information, it is challenging for risk management specialists to effectively identify and quantify the risks Islamic banks in Indonesia face. This, in turn, makes it difficult for Islamic banks in the country to establish and implement effective risk management methods.In addition, the absence of consistency in risk management techniques throughout the Islamic banking sector in Indonesia is a significant obstacle. Despite the OJK's development of risk management guidelines for Islamic banks, the adoption of risk management procedures throughout the country's Islamic institutions remains highly variable. This diversity in risk management techniques among Islamic banks in Indonesia makes it tough to compare the risk management performance of different banks and for regulators to evaluate the efficacy of risk management practices in the industry.In Indonesian Islamic banks, the rapid speed of technological change is a further significant issue for risk management techniques. The expanding use of digital technologies in banking has brought new concerns for Islamic banks, such as the possibility of cyber assaults and data breaches. Thus, Islamic banks in Indonesia must continuously revise their risk management techniques to keep up with the ever-changing nature of these threats.

5. CONCLUSION

This article concludes by analyzing the impact of risk management on the performance and market share of Islamic banks in Indonesia. Effective risk management is essential for the success of Islamic banks in Indonesia, as it helps limit risks, improve performance, and increase market share.

The conceptual framework of risk management in Islamic banking emphasizes the significance of accurately detecting, measuring, monitoring, and reducing risks. The framework highlights the necessity for Islamic banks to have a comprehensive and integrated risk management strategy that incorporates a variety of risk management strategies and instruments.

The empirical studies analyzed in this dissertation show substantial evidence of the favorable effect of risk management on the performance and market share of Islamic banks in Indonesia. The studies emphasize the significance of risk management in enhancing Islamic bank asset quality, profitability, and efficiency. In addition, the findings indicate that excellent risk management can boost the reputation of Islamic banks and their capacity to attract deposits and clients.

Despite the progress made in recent years, the current level of risk management techniques in Indonesian Islamic banks still faces a number of obstacles. This includes a lack of skilled risk management specialists, a dearth of trustworthy data and information, a lack of standardization in risk management techniques, and the quick pace of technological change.

To solve these problems, Islamic banks in Indonesia must prioritize the creation of effective risk management policies and ensure that they have the resources and skills to effectively implement them. Regulators and other stakeholders play an important role in fostering better risk management transparency and accountability and supporting the establishment of industry-wide standardized risk management procedures.

Overall, this research findings emphasize the significance of efficient risk management in fostering the sustainable expansion of Islamic banking in Indonesia. By addressing the challenges associated with risk management practices and developing robust and effective risk management strategies, Islamic banks in Indonesia can improve their performance, increase their market share, and contribute to the growth of a vibrant and dynamic Islamic banking industry in the country.

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