ISLAMIC BANK RISK MANAGEMENT

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Abstract: Risk is the possibility of an undesirable occurrence, which can cause losses if it is not anticipated or managed properly. While risk management is a series of methodologies and procedures used to identify, measure, monitor and control risks arising from all bank business activities. Risk management of Islamic banks has a different character from conventional banks, mainly because of the types of types of risks that are inherent only in bank that operates in sharia ways. The characteristics of risk management in Islamic banks are risk identification, risk assessment, risk anticipation and risk monitoring.

Keywords: Management, Risk, Islamic Banking.

Introduction

Islamic banks will always be faced with various types of risks with varying complexity and inherent in their business activities. Risk in the banking context is a potential event, either anticipated or unanticipated, which has a negative impact on bank income and capital (Karim, 2013).

The external and internal situation of banking is experiencing rapid development which is accompanied by increasingly complex risks in banking business activities, so that the implementation of mature risk management is required. The implementation of risk management will provide benefits to both banks and banking supervisory authorities. Risk management is needed to identify, measure and control various types of risks (Veitzal and Arifin, 2010).

The world financial crisis that began in 2008, and continues to this day, increasingly emphasizes the need for consistent implementation of risk management. Compared to the 1998 financial crisis, in facing the 2008 crisis, Indonesian banks were better prepared (Indonesian Bankers Association, 2014). The mechanisms contained in sharia banking cannot be separated from the risks in running the business (Saputra, 2012).

Therefore, Islamic banks must be able to identify every risk being faced Romdhoni, 2012). Risk management for Islamic banking financial products and services is one of the biggest challenges facing many Islamic banks today. The central issue is the implications of sharia compliance for risk management systems. The benefits provided to users of the product, as well as the outstanding level of innovation in the product, have presented itself as a practical alternative to conventional finance. Currently, Islamic banking deserves recognition as a valuable constituent

in the global financial system (Grira & Labidi, 2020).

Globally, Islamic banking has also achieved substantial growth throughout the world. The two most important elements for realizing further substantial development in the Islamic banking industry are product development and standardization of regulatory practices. The banking industry also requires human resource development and marketing (Harahap et al., 2021). The discussion in the following paper will discuss in more depth the risks that exist and the risk management carried out by Islamic banks.

Literature Review

The term risk management comes from the word to manage, meaning control. In Indonesian, it can be interpreted as controlling, handling and managing. In the Big Indonesian Dictionary (KBBI) it can be interpreted as the effective use of resources to achieve targets. Stephen P. Robbin provides an understanding that management is a process of coordinating and integrating work activities so that they can be completed efficiently and effectively through other people (Syarofi 2022). Risk management is a series of procedures and methods used to identify, monitor, measure and control risks arising from bank business activities (Mukhlishin & Suhendri 2018).

Risk management is the main activity of a bank as an intermediation institution which aims to optimize*trade off* between risk and income, as well as helping to plan and finance business development appropriately, effectively and efficiently. Every financial institution, including banks, must be able to identify and control the risks inherent in the activities of managing deposit funds, productive asset portfolios, and contracts.*off balance sheet* (Veitzal and Arifin, 2010). In sharia banking, the risk management system in banks includes several successive stages as follows: (1) Risk identification, (2) Risk and capital quantification, (3) Collecting or grouping similar risks, (4) Prior control, and (5) Risk monitoring (Emira, 2013).

Method

This research uses qualitative methods with a literature study approach (*library research*), the data sources used in this research were obtained from literature studies, namely books, literature and other sources that are related to this research. The aim of this research is to find out about how Islamic banking risks are managed.

Result and Discussion

Risk is the potential for loss due to the occurrence of a certain event. Risk in the banking context is a potential event, both expected and unpredictable, which has a negative impact on bank income and capital. Risk can also be considered as an obstacle in achieving a goal (Bank Indonesia Circular Letter No. 13 of 2011).

In this decade, the Indonesian banking industry is faced with increasingly complex risks due to the rapid development of diverse banking business activities, requiring banks to increase the need for implementing risk management to minimize risks associated with banking business activities (Sari, 2014)

The future of the Sharia banking industry will depend heavily on its ability to respond to changes in the world of finance. The phenomenon of globalization and the information technology revolution has meant that the scope of Sharia banking as a financial institution has exceeded the

statutory limits of a country. The implication is that the financial sector is becoming increasingly dynamic, competitive and complex. Moreover, there is a growing trend of cross-segment mergers, acquisitions and financial consolidation, which combine the unique risks of each segment of the financial industry (Rahmani, 2009).

Banking business actors (bankers) realize that in carrying out the function of financial services, banks are in a risky business. Risk in banking is a difficult condition for a bank that appears in the financial sector and in other areas. Banks currently have to implement risk management. Banks must accept and manage various types of financial risks effectively, so that negative impacts do not occur in order to minimize losses resulting from not implementing effective and disciplined risk management (Mustikawati, 201).

In order to minimize risks that could cause losses to banks, banks must implement risk management, namely a series of procedures and methodologies used to identify, measure, monitor and control risks arising from bank business activities (Arifin, 2009:). The objectives of risk management are: (1) Providing information about risks to regulators; (2) Ensure that the bank does not experience unacceptable losses; (3) Minimize losses from various sources
uncontrolled risks; (4) Measuring exposure and concentration of risk; (5) Allocating capital and limiting risk (Karim, 2013).

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According to Bank Indonesia, Risk Management policies include the following: (1) Determination of risks related to banking products and transactions; (2) Determining the use of measurement methods and Risk Management information systems; (3) Determination of limits and determination of Risk tolerance; (4) Determination of Risk rating assessment; (5) Preparation of emergency plans (contingency plans) in the worst conditions; (6) Determination of an internal control system in implementing risk management (Circular Letter No. 13 of 2011).

The target of risk management policy is to identify, measure, monitor and control the course of bank business activities with a reasonable level of risk in a directed, integrated and sustainable manner. Thus, risk management functions as a filter or early warning provider (*early warning system*) on bank business activities (Karim, 2013).

Although the main elements of risk management include identifying, measuring, monitoring and managing various risk exposures. However, all of these things cannot be implemented without clear processes and systems. The entire risk management process must cover all departments or work divisions within the institution so that a risk management culture is created (Khan and Ahmed, 2001). Considering differences in market conditions, structure, size and complexity of bank businesses, there is no one universal risk management system for all banks. Thus, each bank must build a risk management system in accordance with the function and

complexity of the bank, and provide a risk management organizational system to the bank in accordance with its needs.
achieve sustainable business growth (*sustainable business growth*) (Indonesian Bankers Association: 342).

Characteristics of Risk Management in Sharia Banking

Sharia banks are one of the business units. Thus, sharia banks will also face risks from the bank's own management. In fact, if we look closely, Islamic banks are banks that are vulnerable to risk (Muhammad, 2011). In general, the risks faced by sharia banking are relatively the same as those faced by conventional banks. However, Islamic banking has its own uniqueness in dealing with risks because it must follow sharia principles (Umam, 2013).

Risk management in sharia banking has a different character from conventional banks, especially because there are types of risks that are unique to banks that operate sharia. In other words, the fundamental difference between Islamic banks and conventional banks lies not in how to measure, but in what is assessed (*what to measure*) (Karim, 2013).

These differences will be visible in the operational risk management process of sharia banking which includes risk identification, risk assessment, risk anticipation and risk monitoring:

1) Identify risks
Risk identification carried out in sharia banking does not only cover the various risks that exist in banks in general. Rather, it covers various risks that are unique only to banks that operate based on sharia principles. In this case, this uniqueness is divided into 6 (six) things, namely, financing transaction processes, management processes, human resources, technology, external environment, and damage (Karim, 2013).
2) Risk Assessment
In risk assessment, the uniqueness of Islamic banking can be seen in the relationship between probability and impact, or what is commonly known as*qualitative approach*.
3) Anticipate risks
Risk anticipation in sharia banking aims to:
(a) *Preventive*. In this case, sharia banking requires DPS approval to prevent process and transaction errors from sharia aspects. Besides that, banking
Sharia also requires an opinion and even a DSN fatwa if Bank Indonesia considers DPS approval to be inadequate or beyond its authority.
(b) *Detective*. Supervision in sharia banking covers two aspects, namely banking aspects by Bank Indonesia and sharia aspects by DPS. Sometimes different understandings arise regarding whether a transaction violates sharia or not. (c)*Recovery*. Correction of an error can involve Bank Indonesia for banking aspects and DSN for sharia aspects (Karim, 2013).
4) Risk Monitoring
Monitoring activities in sharia banking do not only cover Islamic bank management, but also involve the Sharia Supervisory Board. In simple terms, this can be described as follows (Karim, 2013)

Effective risk management in Islamic banks must receive special attention. However, Islamic banks have many complex problems that need to be better understood. In particular, the

risks faced by Islamic banks are almost unlimited. In providing funds, banks use a combination of permitted Islamic modes of financing - PLS and non-PLS. Thus, innovative solutions are needed in managing risk management in order to stabilize the processes of Islamic financial institutions (Makiyan, 2014).

Types of Risks in Sharia Banking

Implementation of Risk Management For Sharia Commercial Banks and Sharia Business Units, there are 10 (ten) risks that banks must manage. The ten types of risk are credit risk, market risk, operational risk, liquidity risk, compliance risk, legal risk, reputation risk, strategic risk, return risk, and investment risk (Bank Indonesia Regulation No. 13/23/PBI/2011 concerning Implementation of Risk Management for Sharia Commercial Banks and Sharia Business Units).

1. Financing/Credit Risk Management

The main cause of credit risk is that it is too easy for banks to provide loans or make investments because they are too required to utilize excess liquidity, so that credit assessments are less careful in anticipating various possible risks of the business being financed (Arifin, 2009). This risk can be reduced by limiting the credit decision authority for each credit institution, based on its capabilities (*authorize limit*) and limits on the amount of credit that can be given to businesses or

specific company (*credit line limit*), as well as diversifying (Arifin, 2013). To minimize the possibility of financing losses, the following techniques are needed: (a) Rating model for individual financing; (b) Financing portfolio management; (c) Collateral; (d) Cash flow monitoring; (e) Recovery management; (f) Insurance (Rianto, 2013).

2. Market Risk Management

The risk of loss occurring in the portfolio owned by the bank due to movements in market variables (*Adverse movement*) in the form of exchange rates and interest rates. Foreign exchange rate risk can be reduced by limiting or reducing positions, or can even be avoided altogether if banks always take positions*squaire*. Meanwhile, interest rate risk in sharia banking will not have an effect, because sharia banking does not deal with interest rates (Arifin, 2013).

Islamic banks must establish a sound and comprehensive market risk management process and information system which includes, among other things, the following:

1) A conceptual framework to drive identification of underlying market risks;
2) Guidelines for managing risk-taking activities in different portfolios with limited investments and market risk limits;
3) Framework for appropriate pricing, valuation and revenue recognition;
4) A strong management information system (MIS) for controlling, monitoring and reporting market risk exposure and senior management performance (Rianto, 2013).

3. Operational Risk Management

Operational risk is a risk caused by inadequacy or non-functioning of internal processes,*human error*, system failure or affecting bank operations. There are three factors that are the main causes of this risk, namely: Infrastructure such as technology, policy, environment, security, disputes, and so on; Process; and Resources (Karim, 2013)

4. Liquidity Risk Management

The risk is caused, among other things, by the bank's inability to fulfill its obligations when they fall due. The available liquidity must be sufficient, not too much
small so that it interferes with daily operational needs, but it should not be too large because it will reduce efficiency and result in low levels of profitability. In order to carry out the liquidity risk control function, banks must implement the assets and liability management (ALMA) function (Arifin, 2013). The aim of liquidity risk management is to maintain sufficient bank liquidity so that at any time it is able to fulfill the bank's maturing obligations, maintain the level of customer confidence in the banking system, maintain sufficient bank liquidity to support sustainable bank assets (Rianto, 2013).

5. Compliance Risk Management

Risks caused by non-compliance with existing provisions, both internal and external, are as follows:

1) Requirements for Minimum Statutory Reserves, Net Open Position, Non-Performing Financing, and Maximum Limits for Providing Financing;
2) Conditions for providing products;
3) Provisions for providing financing;
4) Provisions for reporting, whether internal reports, reports to Bank Indonesia or reports to other third parties;
5) Tax provisions;
6) Provisions in the contract agreement;
7) National Sharia Council Fatwa (Karim, 2013).

Compliance risks can originate, among other things, from behavior at least bank activities that deviate or violate statutory provisions or regulations (Rianto, 2013). Failure to manage compliance risk can lead to massive withdrawals of third party funds, give rise to liquidity problems, bank closures by the authorities, and even bankruptcy. Therefore, the main objective of risk management for compliance risk is to ensure that the risk management process can minimize the possibility of negative impacts from sharia bank behavior that violates generally accepted standards, provisions, and/or applicable laws and regulations (Rianto, 2013).

6. Legal Risk Management

Risks caused by weaknesses in juridical aspects, such as: legal claims, absence of supporting legislation or weaknesses in agreements such as failure to fulfill the conditions for the validity of a contract or incomplete binding of collateral (Rianto, 2013). The main objective of legal risk management is to ensure that the risk management process can minimize the possibility of negative impacts from weaknesses in juridical aspects, absence of, and/or changes in statutory regulations.

7. Strategic Risk Management

Risks are caused, among other things, by the implementation and implementation of bank strategies that are not appropriate, making inappropriate business decisions or the bank not complying with/not implementing changes to legislation and other applicable provisions. Compliance risk management is carried out through consistent implementation of an internal control system. An indication of the risk of this strategy can be seen from the failure to achieve the business targets that have been set, both financial and non-financial targets (Karim, 2013).

Strategic risks can originate from, among other things, weaknesses in the strategy formulation process and inaccuracies in strategy formulation, inadequate management information systems (MIS), inadequate results of internal and external environmental analysis, overly aggressive strategic goal setting, inaccuracies in strategy implementation, and failure to anticipate changes in the business environment (Rianto, 2013).

8. Risk Management

Reputation Reputation risk is caused by negative publications related to bank activities or negative perceptions of the bank. Failure to manage reputation risk can lead to massive withdrawals of third party funds, give rise to liquidity problems, bank closures by the authorities, and even bankruptcy. Therefore, the main objective of reputation risk management is to anticipate and minimize the impact of losses from reputation risk of Islamic banks. Reputational risks in business can originate from various sharia bank business activities (Rianto, 2013).

If management in the view of stakeholders is considered good then the reputation risk is low, likewise if the company is owned by strong shareholders then the reputation risk is low. In terms of service, if the service is not good then the reputation risk is high. In implementing sharia principles, they must be implemented properly
consistent so as not to give rise to a negative assessment of the implementation of the sharia system which could result in negative publications thereby increasing the level of reputation risk (Karim, 2013).

9. Return Risk

Risk due to changes in the level of returns paid to customers due to changes in the level of returns received by the bank from disbursing funds, which can influence the behavior of bank third party fund customers due to changes in expectations of the level of returns received from sharia banks. Changes in expectations can be caused by internal factors such as a decrease in the value of bank assets or external factors such as increases in returns offered by other banks (Rianto, 2013:)

In yield risk management, Islamic banks must have an appropriate system for identifying and measuring factors that can increase the yield risk.

10. Investment Risk

Investment risk is the risk resulting from the bank sharing in the customer's business losses financed in profit sharing based financing. This risk arises if the bank provides profit sharing based financing to customers where the bank shares the risk of losses of the financed customer (*profit and loss sharing*).

Implementation of Risk Management in Sharia Banking

Risk management is decision making that contributes to achieving company goals by applying it both at the individual activity level and in functional areas (Henz and Berg, 2010). Thus, risk management is an important element whose implementation really needs attention, especially in banks as a financial institution (*financial institution*) (Umam, 2013).

Implementation of risk management can improve*shareholder value*, provide an overview to bank managers regarding the possibility of bank losses in the future, improve systematic decision-making methods and processes based on the availability of information, which is used as a basis for more accurate measurement of bank performance, and create a solid risk management

infrastructure in order to improve bank competitiveness (Rivai and Arifin, 2013: 941). For banking it can improve*share value*, giving an overview to bank managers about
the possibility of bank losses in the future, improving systematic decision-making methods and processes based on the availability of information, used as a basis for more accurate measurement of bank performance, used to assess the risks inherent in relatively complex bank instruments or business activities and creating management infrastructure solid risk in order to increase bank competitiveness (Yulianti, 2009).

Risk management practices in banking can use various alternative risk profile assessments. Basel II standards use several alternative approaches to various types of risk in calculating capital requirements in accordance with the bank's risk profile. Through the implementation of Basel II, Bank Indonesia is expected to be able to improve aspects of risk management so that banks become more resistant to changes that occur both domestically, regionally and internationally (Goyal, 2010).

The implementation of risk management in Islamic banks must be adjusted to the objectives, business policies, size and complexity of the business as well as the bank's capabilities. Business complexity is the diversity in types of business network product/service transactions. Meanwhile, bank capabilities include financial capabilities, supporting infrastructure and human resource capabilities (Rianto, 2013).

The application of risk management at least includes: (1) Application of risk management in general; (2) Implementation of risk management for each risk, which includes 8 (eight) risks, namely credit risk, market risk, liquidity risk, operational risk, legal risk, strategic risk, compliance risk and reputation risk; (3) Risk profile assessment (Indonesian Bankers Association: 342).

In its implementation, the process of identifying, measuring, monitoring and controlling risks takes into account the following matters:

1) Risk identification is carried out by analyzing: (a) Characteristics of risks inherent in functional activities; (b) Risks from products and business activities.
2) Risk measurement is carried out by carrying out: (a) Periodic evaluation of the suitability of assumptions, data sources and procedures used to measure risk; (b) Improvements to the risk measurement system if there are changes in business activities, products, transactions and material risk factors.
3) Risk monitoring is carried out by: (a) Evaluation of risk exposure; (b) Improving the reporting process if there are changes in business activities,
4) products, transactions, risk factors, information technology and material risk management information systems.
5) Implementation of the risk control process, used to manage certain risks that can endanger the sustainability of the bank (Karim, 2013).

The quality of implementing risk management includes:

1) Risk management (*risk governance*). Risk management (*risk governance*) includes active surveillance (*management oversight*) Board of Commissioners and Directors, as well as*risk appetite*.
2) Risk management framework (*risk management framework*). Risk management framework (*risk management framework*) includes the adequacy of policies,

procedures and limit determination.

3) Adequacy of the risk management process. The risk management process consists of the process of identification, assessment, control (*risk mitigation*), as well as a risk management information system.

4) Comprehensive internal control system (Indonesian Bankers Association: 347).

Conclusion

Implementation of Risk Management for Sharia Commercial Banks and Sharia Business Units, there are ten risks that banks must manage, namely credit risk, market risk, operational risk, liquidity risk, compliance risk, legal risk, reputation risk, strategic risk, return risk, and investment risks. The application of risk management can increase shareholder value, provide bank managers with an idea of the bank's possible losses in the future, improve systematic decision-making methods and processes based on the availability of information, which is used as a basis for more accurate measurement of bank performance, and create infrastructure. Strong risk management in order to increase bank competitiveness. The implementation of risk management in Islamic banks must be adjusted to the objectives, business policies, size and complexity of the business as well as the bank's capabilities. Business complexity is the diversity in types of business network product/service transactions. Meanwhile, bank capabilities include financial capabilities, supporting infrastructure and human resource capabilities.

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