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The Empirical Testing of Risk Management on Profitability Growth of Sharia Rural Banks in Indonesia

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Abstract:- This study aims to analyze the effect of risk management as measured by operational risk, liquidity risk and credit risk on financial performance in Islamic rural banks (BPRS) in Indonesia. This study used a quantitative approach. This research was in the type of explanatory research. Methods of data analysis used path analysis. The research data is obtained from the statistics of Indonesian banks and the Financial Services Authority (OJK). The independent variables included financing risk (NPF) and operational risk (BOPO). The dependent variable was ROA. This study showed that NPF had negative and significant effect on financial performance. BOPO had a significant effect on financial performance.

Keywords:- *Risk Management, Operational Risk, Credit Risk, Liquidity Risk and Financial Performance.*

I. INTRODUCTION

Islamic banking or known as sharia banking with sharia principles originating from the Al-Qur'an and Al-Hadith. Sharia People's Financing Banks in the general sense are not only to avoid interest based on transactions, but also to avoid Gharar (Fraud), as well as prohibitions contained in Islamic sharia and some practices that are not in accordance with ethics and to participate in achieving economic goals Islam. The difference between the activities of Sharia bank and commercial banks is based on the rewards provided not with an interest system but a profit sharing system according to Islamic law.

Sharia Bank in Indonesia was first born in 1992 with the start of operation of Bank Muamalat Indonesia. Sharia Banks continue to experience development. Based on statistical data released by the Financial Services Authority, by the end of 2021 there will already be 13 Islamic Commercial Banks (BUS) with 21 Islamic Business Units (UUS) and 659 Sharia People’s Financing Banks (BPRS) in Indonesia. The development of sharia bank has also become a phenomenon that has attracted the attention of both academics and practitioners in the last 20 years. (OJK, 2022).

The sharia banking industry in Indonesia has experienced rapid growth throughout 2022. As reported by the Financial Services Authority (OJK) noted sharia bank assets amounting to IDR 686.29 trillion in April 2022. This realization grew 12.71 percent year on year. The market share of sharia bank has also increased quite rapidly. This figure is projected to increase considering that the West Nusa Tenggara BPD is still in the conversion process and there are several other BPDs that have the potential to convert to sharia BPDs.

This rapid growth, according to the Secretary General of the Association of Indonesian Sharia Banks was not only supported by conversions, but also due to the growth in the placement of haj funds and sharia campaigns. The sharia campaign which has recently been intensified by the government has had a positive impact on the development of sharia banking in Indonesia. The formation of the National Islamic Finance Committee also implies that the Government also has good faith regarding the Islamic economic sector in Indonesia.

The increase in the number of banks and offices has an impact on the development of Sharia bank. This makes it easier for people to feel the services of Sharia bank. Apart from having a significant effect on profitability growth, the number of banks. A part from having a significant effect on profitability growth, the increase in the number of sharia bank and bank offices also has a significant effect on the growth of sharia bank temporary syirkah funds (Khazanah, 2012). When compared to what happened to the banking industry as a whole in Indonesia, both of them experienced very significant growth with an average annual growth of 25%.

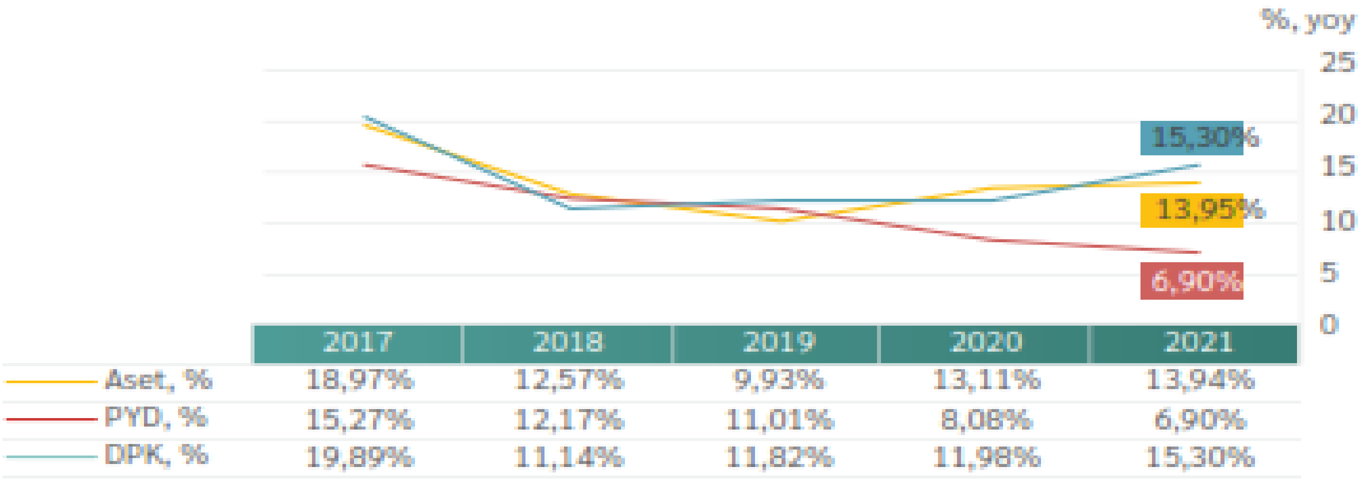

Fig 1 Growth of Sharia Bank in Indonesia
Source: OJK, 2022

Table 1 shows that in the last five years the Islamic banking industry has always experienced positive growth, both in assets, collection of DPK and distribution of financing. High third party funds mean that the funds owned by Sharia bank in carrying out the intermediary function are getting better. Meanwhile, higher Islamic bank financing explains that the circulation of loan funds to the community is also higher so that the intermediary function is getting better. This development is also indicated by the number of offices, assets, PYD and DPK as follows.

Table 1 Development of Sharia Bank

Banking Industry	**Number of Institutions**	**Number of offices**	**Assets (TrillionRp)**	**PYD (Trillion IDR)**	**Third Party Funds (Trillion Rp)**
BUS	12	2035	441.79	256,22	365,42
UUS	21	444	234.95	153.66	171.57
BPRS	164	649	17.06	11.98	11.59
Total	197	3.128	693,80	421.86	548.58

Source: OJK, 2022

Table 1 describes the development of sharia banks in the number of institutions, number of offices, assets, PYD and DPK. Based on this, the number of institutions is the most, but the value of assets, BPRS and DPK has the lowest value. The development of BPRS in Indonesia based on several aspects is explained in Table 2.

Table 2 Number of Sharia BPRS

Province / Provinces	**2018**	**2019**	**2020**	**2021**	**2022**			
					Jan	Feb	Mar	Apr
Amount	167	164	164	164	164	164	165	165

Source: OJK, 2022

Table 2 explains that the development of the number of sharia BPRS in Indonesia has not developed significantly in Indonesia. This shows that the BPRS business movement cannot be said to have increased. Based on the financial performance of the BPRS as shown in Table 3.

Table 3 BPRS by Assets

Total Assets (Rp)	**2018**	**2019**	**2020**	**2021**	**2022**			
					Jan	Feb	Mar	Apr
< 1 Billion / < 1 Billion	1	12	1	1	1	1	1	1
1 to 5 Billion / 1 up to 5 Billion	7	4	3	3	2	2	-	1
> 5 to 10 Billion / > 5 up to 10 Billion	13	9	9	7	7	7	9	9
> 10 Billion / > 10 Billion	146	139	150	153	154	154	155	154
Total	167	164	163	164	164	164	165	165

Source: OJK (2022)

Table 3 describes the number of BPRS from the value of assets which explains the highest number of BPRS with total assets of more than 10 billion compared to BPRS which have total assets below 10 billion. This shows that the BPRS has nominally large assets. Based on these asset values, the achievement of BPRS performance is presented in Table 4.

Table 4 Financial Performance of BPRS in Indonesia (%)

No	Ratio	2018	2019	2020	2021	2022			
						Jan	Feb	Mar	Apr
1	CAR	19.33	17.99	28,60	23.79	25,14	25.93	24.09	23,92
2	ROA	1.87	2.61	2.01	1.73	1.99	1.79	1.74	1.63
3	ROE	12.86	27.30	20,29	16,27	18,41	16,48	16.03	14.91
4	NPF	9.30	7.05	7,24	6.95	7,25	7,27	7.05	7,19
5	FDR	111.67	113.59	108.78	103,38	103.85	106,88	108.98	110.08
6	BOPO	87,66	84,12	87,62	87.63	85,69	86,43	86.03	87,16

Source: OJK (2022)

Table 4 shows that BPRS in Indonesia from 2016 to 2022 in April experienced fluctuating developments. In general, from every aspect of financial performance, the ratios of CAR, ROA, ROE tend to decrease. While the aspect ratios of NPF, FDR and BOPO tend to increase. The performance of BPRS from 2016 to April 2022 for several periods, this cannot be separated from the obstacles that often occur in national BPRS in Indonesia, including first, the regulatory framework for Islamic financial institutions is incomplete and in accordance with the unique characteristics of the banking industry; second, the limited number of human resources who have the competence and integrity that meet the needs of the industry; third, the knowledge and understanding of the community is relatively low, even though the market potential is relatively large; fourth, incomplete regulations, infrastructure and supporting institutions; fifth, education and training institutions are not sufficient enough to provide human resources needed by the industry; sixth, competition in the midst of globalization and seventh, a limited office network that limits Islamic financial institutions' access to potential customers.

Bank performance is measured by the profitability ratio proxied by Return on Assets (ROA). Yudiana (2013) explains ROA is the ability to earn profits from assets at the bank. Increasing profit is also inseparable from the application of risk management to avoid losses. Risk management is important because risk uncertainty will exist with increasing competition from other banks. Banks need to implement risk management so that bank performance also increases. Risk management is an effort to find out and analyze risk controls for banking activities so that effectiveness and efficiency are higher (Darmawi, 2016). Bank Indonesia explained that risk management is a procedure for identifying, measuring and controlling risks in a bank's business.

Application of risk management is beneficial for banking. The application of risk management increases shareholder value and results in losses in the future. Improving systematic decision-making methods and processes as the basis for precise measurements of performance in the banking world. In addition, risk management is a determinant of stock value (Sensarma and Jayadev, 2009). The application of risk management in Sharia bank is adjusted to the ability of banks, Bank Indonesia establishes this risk management rule as a minimum standard for Sharia General Affairs (BUS) and Islamic Business Units (UUS) to fulfill. General provisions regarding the implementation of Islamic banking risk management are contained in BI provisions Number 13/23/PBI/2011 dated 2 November 2011 concerning the application of risk management for BUS and UUS (Rustam, 2013). There are several indicators that can be measured from such risk management such as risk credit, market risk, liquidity risk and operational risk.

Financial performance is measured by ROA which compares the profits earned with the assets received. The bank earns profit from managing its assets. If there are more and more bank loans that are bad, the credit quality gets worse (Burton, et.al. 2002). ROA is the ability to increase company profits (Yanikkaya et.al, 2018; Qayyum and Noreen, 2019; Muhammad et.al, 2016). ROA shows the success of a bank in obtaining profits (Nguyen and Nguyen, 2020). ROA is used to predict future profits (Erasmus, 2010; Arquisola et.al, 2018). ROA is a measure of net income compared to total assets after tax (McGowan and Stambaugh, 2012). Return on assets in measuring the effectiveness to gain profit through assets. (McGowan and Stambaugh, 2012).

Bad credit is a condition where customers are unable to pay debts after being made a bank (Harianto, 2017; Messai and Jouini, 2013). Bad loans are classified into collectibility levels, namely substandard, doubtful, and loss (Saba et.al, 2012). Non Performing Loan indicates a problem with the bank if it is not followed up it will harm the bank. The problem credit factor is seen from various aspects such as customer aspects (Kencana et.al, 2016), management (Haneef et al., 2012), operations (Adeyemi, 2011), as well as external aspects such as economic and bank conditions (Abid et.al, 2014). Credit risk is proxied by Non Performing Loans (NPL) where the ratio of total non-performing loans to all loans extended. If the NPL ratio is higher, the bank's performance will be worse (Ikhsan et al. 2022). Banks that have problem loans exceed the limit and cause losses. NPL risk has a significant effect on bank assets (Haneef et al., 2012; Cucinelli, 2015). The cause of the Non-Performing Loan ratio, namely the debtor's ability to pay off the principal and interest on the loan, does not mean that there is no ability and good faith on the part of the borrower or debtor, so that many installments are defaulted, resulting in higher NPLs. In addition, operational costs cause risks with the bank's internal

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process malfunctions, system failures and external problems. Operational risk is caused by the functioning of the bank's internal processes, human errors, technological system failures and external problems.

The measure of operational risk uses BOPO with the ability of bank management in operational costs to operating income. Attar (2014) explains that BOPO has a negative effect on financial performance as measured by ROA. BOPO indicates higher operating expenses which indicates that if operating expenses exceed operating income, it can reduce bank profits so that ROA decreases. This study aims to analyze the effect of risk management on credit risk, operational risk and liquidity risk on financial performance in Islamic rural banks in Indonesia.

II. LITERATURE REVIEW AND HYPOTHESES

➢ *Risk Management*

Risk management is organizational management in mapping with existing problems in placing a comprehensive management approach (Fahmi, 2011). Risk management emphasizes the adequacy of procedures in risk management so that the bank's business is controlled within limits that remain profitable for the bank. Sharia Bank is an investment and banking institution that operates according to sharia principles. The source of funds obtained must be in accordance with sharia and the allocation of investments made aims to grow the economy and social community. Iqbal and Mirakhor (2018) see the risks faced by Sharia Bank are grouped into four classifications including the first, financial (financial) risks that have a direct impact on the assets and liabilities of a bank. This financial risk itself is divided into three parts including credit risk, market risk, and equity investment risk (specifically for non-bank financing). Second, business risk, which is related to bank competition and prospects for bank success in market changes. Business risk includes return risk and withdrawal risk. Third, treasury risk includes risks originating from institutional financial resource management in terms of cash management, equity management, short-term liquidity management and asset liability management (MAL). Fourth, government risk which includes operational risk, transparency risk, sharia risk and reputation risk.

➢ *Financial Performance*

Performance is the result in a certain period which is influenced by operational activities in utilizing the resources they have (Srimindarti, 2014). Performance is an organizational activity in one period with reference to standards on past costs with management accountability (Srimindo, 2014). Performance appraisal is something that is very important in the era of global competition as it is today. One of the important company performance measurement tools is that company performance measurement tools are used by management as a basis for making decisions and evaluating the performance of related units within the company's organizational environment. Appraisals provide an important mechanism for management to use in clarifying performance goals and standards to motivate individual performance in the future.

According to Kasmir (2015), a bank's financial performance is a measure of success for the bank's directors, so if the bank is bad it is impossible for these directors to be replaced. Financial performance is work performance that has been achieved by the company in a certain period and is stated in the financial statements of the company concerned. According to Bastian (2016), financial performance can be measured using profitability ratios consisting of ROA and ROE. ROA is the ratio used to measure a bank's management ability to make a profit by utilizing its total assets and ROE is used to measure a bank's ability to gain net profit using its own capital.

In this study, ROA is used as an indicator of bank performance. ROA shows the company's effectiveness in generating profits by optimizing its assets. The higher the ROA, the more effective the company is, because the amount of ROA is influenced by the amount of profit generated by the company. Information about performance is very useful for users of financial reports. For groups of investors, creditors and the general public who want their investment invested in banks, it is necessary to know the performance of the bank. Return on capital investment is useful for management evaluation, profitability analysis, profit forecasting, and planning and control. The rate of return on capital investment for this purpose requires an in-depth understanding of this measure of return. Because the measure of return includes components that have the potential to contribute to understanding company performance (Wild, Subramanyam, Halsey, 2005).

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➢ *Effect of Risk Management On Financial Performance*

Based on Bank Indonesia Regulation No. 13/23/PBI/2011 concerning the application of risk management for Islamic Commercial Banks and Islamic Business Units, risk is the potential loss due to the occurrence of a certain event. Inconsistent application of risk management results in Islamic banks facing a financial crisis.

The results of research by Attar and Islahuddin (2015) show that the application of risk management simultaneously affects banking financial performance. Meanwhile, only partially implementing liquidity risk management has no effect on banking financial performance. Meanwhile, research conducted by Andersen, (2018) conducted a study showing a relationship between the effectiveness of risk management

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and company performance. Meanwhile, research conducted by Andersen, (2018) conducted a study showing a relationship between the effectiveness of risk management and company performance. Jafari et.al (2011) found that risk management affects company performance. Based on the description above, the researcher tries to formulate the hypothesis as follows:

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✓ H1: NPF has a significant effect on the financial performance of BPRS in Indonesia
✓ H2: BOPO has a significant effect on the financial performance of BPRS in Indonesia

III. METHODS

The approach used in this research was a quantitative approach. This type of research was explanatory research. This study used secondary data types taken from Sharia People's Financing Banks in Indonesia. The type of data used is pooled data. The data used in the form of annual report data from Bank Indonesia. To obtain up to date data, annual banking report data was taken from BI for 2017-2021. The data was obtained from the annual reports of Sharia People's Financing Banks in Indonesia. The data were obtained from the Directory of Bank Indonesia and the financial services authority (www.ojk.go.id) or sample corporate bank websites.

The type of data that the authors used in this study is secondary data, namely data obtained from the processing of second parties (external data). This research was an explanatory research that describes a causal relationship between the independent variables and the dependent variable. The sampling method used purposive sampling was selected in selecting the sample for this study, so the sample taken in this study was Sharia People's Financing Banks in Indonesia. The criteria for Sharia People's Financing Banks (BPRS) which will be the sample in this study are as follows:

➢ *The BPRS is registered at Bank Indonesia and at the Financial Services Authority (OJK).*
➢ *BPRS which have complete data based on the variables used for research during the period 2017 to 2021 which are presented in the financial statements of each sample of the sample BPRS financial statements that have been sampled have been audited so that the data taken is unlikely to change.*

The variables in this study include risk management independent variables as measured by NPF and operational risk by BOPO. While the dependent variable is measured by ROA. The analysis used in this study is multiple regression analysis, because there is more than one independent variable. In order to know the intensity of the relationship between the dependent variable and the independent variable, the regression model used can be formulated as follows:

$$Y = bo + b_1X1 + b2\ X\ 2 + e$$

Where:
Y =ROA
X1 X2 = independent variable
X1 =NPF
X2 = BOPO
bo =*intercepts*
b1 b2 b3 b4 b4 = independent variable regression coefficient
e = confounding variable

Partial testing (t-test), namely testing the regression coefficients individually by determining the statistical formula to be tested, the t test as a test for each variable of a regression equation based on the tcount value (Sugiyono, 2017). The test criteria include a) t count > t table Ho is rejected and Ha is accepted, meaning that there is an influence between the independent variables on the dependent variable with the degree of confidence used of $\alpha = 5\%$; b) t count < t table Ho is accepted and Ha is rejected,

IV. RESULT

Before testing the relationship between variables, it is important to present data that describes the bank's financial condition. The data to be presented is the result of processed data based on time series and cross section data for the last six years.*Non Performing financing*(NPF) or non-performing financing is one of the risks that always arises in the banking world both from external factors and from internal factors. External factors come from outside the bank, while internal factors come from the bank.BThe following is data on the development of NPF at BPRS in Indonesia for the period January 2021 to January 2022 in Figure 2.

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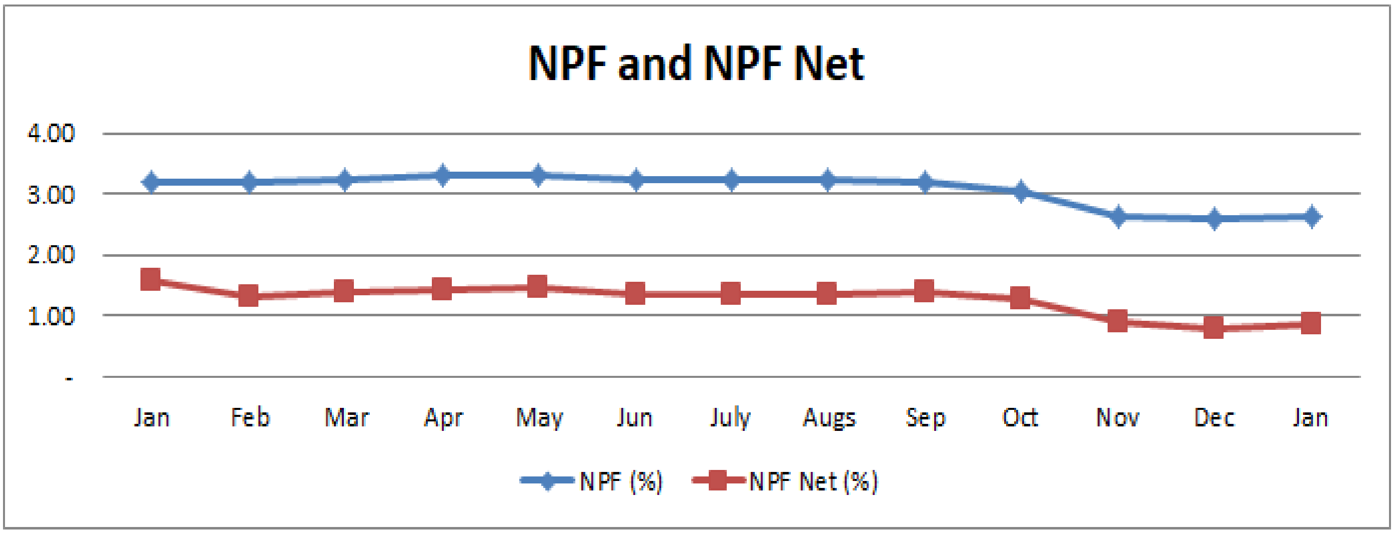

Fig 2 Development of NPF of Sharia People's Financing Banks in Indonesia from January 2021 to January 2022

Based on Figure 2 it can be concluded that the NPF reached a peak of 3.30% in May 2021, then continued to experience fluctuating developments until January 2022, the NPF experienced a fairly good decline with a lowest point of 2.64% in January 2022. The higher the value The NPF of a bank can reflect the poor quality of bank credit which causes the number of non-performing loans to increase, so the possibility of a bank in a troubled condition increases. For the next period, it is expected that sharia people's financing banks will be more careful in selecting prospective customers who will be given financing

The ratio of Operating Expenses to Operating Income (BOPO) is a comparison between operating costs and operating income. The operational cost ratio is used to measure the level of efficiency and ability of a bank to carry out its operational activities. (Dendawijaya, 2015) The higher the BOPO ratio, the quality of financing will be reduced, so this can also lead to an increase in the non-performing financing ratio due to reduced total financing.

Return on Assets (ROA) is an indicator that measures whether a bank is healthy or not in utilizing its assets to generate profits. Quality assets will certainly support the performance of Sharia Bank in generating profit for the continuation of banking performance in subsequent periods. An overview of the development of ROA from 2021 to 2022 is in Figure 3 below.

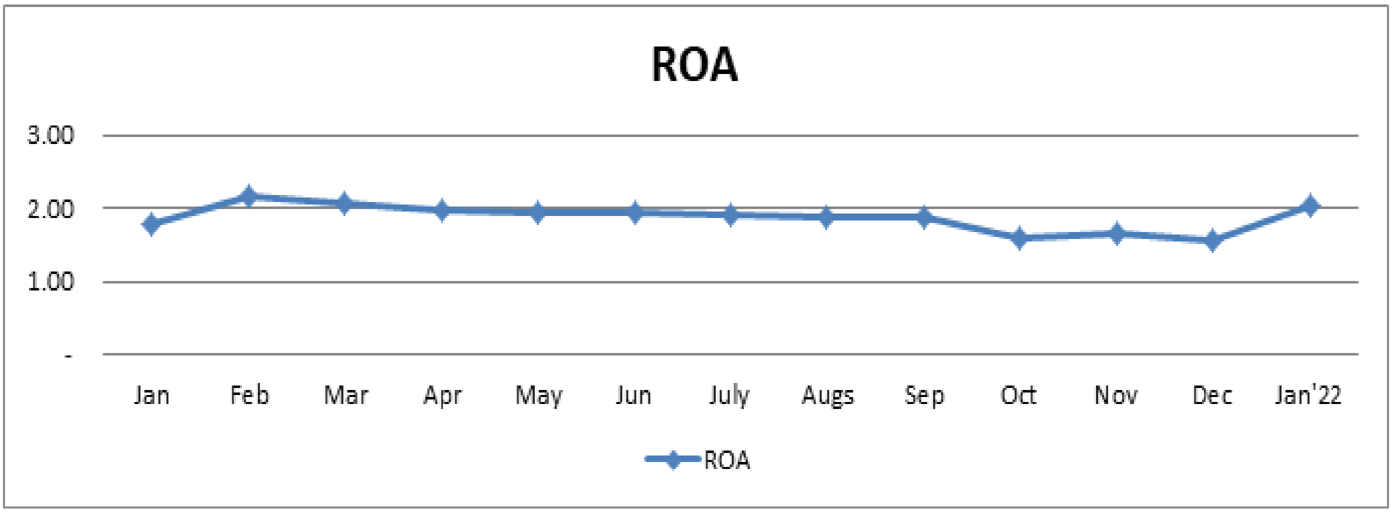

Fig 3 Development of ROA of Sharia People's Financing Banks in IndonesiaPerperiod January 2021 to January 2022

Based on Figure 2, it can be concluded that ROA reached its highest point in February 2021 around 2.15%. ROA has decreased from December 2021 to 1.55%. Then it rose to 2.03% in January 2022.The results of the normality test show that the variables NPF (X1), BOPO (X2), and ROA (Y) are normally distributed. It can be seen that the results of the Kolmogorov Smirnov Test calculations have shown a normal distribution of all variables (significance value > 0.05). The results of the multicollinearity test show that there is no multicollinearity between the independent variables because the VIF value is less than 5, meaning that there is no perfect linear relationship between some or all of the independent variables. The results of the hetoakedastisity test showed that the distribution of the data did not form a certain line or was random. This means that the independent variables do not form heteroscedasticity.

Based on the results of Durbin Watson shows a number of 1.895. This shows that according to the criteria for DW numbers below -2 to +2, it means that there is no autocorrelation. This means that the multiple linear regression model used is free from autocorrelation. Based on these results, it is known that the magnitude of the direct effect and the total effect of NPF and BOPO as independent variables on ROA as the dependent variable. The results of multiple linear regression and hypothesis testing are described in Table 5.

Table 5 Path Coefficient Values and Hypothesis Testing

Hypothesis	**Variable Free**	**Variable Bound**	**Beta (β)**	**t-count**	***ρ-values***
1	NPF	ROA	-0.266	-4,193	0.024
2	BOPO	ROA	0.344	2,308	0.001

Description: ** = Significant at α = 5%

The results of testing the hypotheses proposed in this study were obtained based on testing the path coefficients in the multiple linear regression model in Table 5. The hypothesis testing is seen from the p value of each path. If the p value is less than 0.05 then the relationship between variables is significant.Conversely, ifthe p value is greater than 0.05, the relationship between variables is not significant. The results of hypothesis testing are explained as follows:

Testing the first hypothesis seen from the beta coefficient (β) of -0.266 with a ρ-value of 0.024. Hypothesis one is proven to be accepted because the ρ-value <αor 0.024 <0.05. This shows that the hypothesis that NPF has a negative and significant effect on financial performance (ROA) is accepted. Testing the effect of BOPO on financial performance (ROA) is indicated by a beta coefficient (β) of 0.344 with a ρ-value of 0.001. Because the ρ-value <αor 0.001 <0.005, then H2 is accepted. Thus the hypothesis that BOPO has a significant effect on financial performance (ROA) is accepted.

V. DISCUSSION

The results of hypothesis testing indicate that simultaneously the application of risk management (financial and operational) has an effect on financial performance (ROA). This indicates that banks have successfully implemented risk management. The success of Islamic People's Funding Banks in implementing risk management affects their financial performance, indicated by the value of ROA. The positive value shown by ROA means that Sharia People’s Financing Banks are able to generate profit in their operational activities so that it places the bank in a good rating based on the criteria in assessing the level of banking soundness.

The magnitude of the influence of the rate of return on credit on banking performance requires active supervision by the board of commissioners and directors in terms of segregation of duties between the functions of analyzing credit applications, giving credit approval and reviewing credit. In extending credit, the bank must also conduct an analysis of the debtor's ability to fulfill obligations. Banks must review, assess and bind collateral to minimize credit risk or debtor default.

The results of this study support the results of the studyAttar and Islahuddin (2015) show that the application of risk management simultaneously influences banking financial performance. Meanwhile, only partially implementing liquidity risk management has no effect on banking financial performance. The research results are consistent with Andersen (2008) which shows a relationship between the effectiveness of risk management and firm performance. Jafari et.al (2011) suggests that there is a positive and significant relationship between risk management and company performance.

VI. CONCLUSIONS AND RECOMMENDATIONS

The results of the study can be concluded that risk management which is proxied by financing risk or NPF and operational risk (BOPO) has an effect on financial performance. NPF has a negative and significant effect on financial performance (ROA). BOPO has a significant effect on financial performance (ROA).

Based on the research results, there are several suggestions that the author can put forward as follows a) For Sharia People’s Financing Banks, the banking world cannot be separated from bad credit, but this can be minimized. Sharia People’s Financing Banks should be stricter in carrying out their 5C principles before extending credit. Sharia People's Financing Banks should always maintain their capital level, so that it will improve the financial performance of the Sharia People's Financing Banks; b) For further research, it is hoped that they can examine variables outside of this variable in order to obtain more varied results which can describe what things can affect Return on Assets (ROA) and for customers, the community or depositors should follow developments in the soundness level of BPRS. The people of Sharia People’s Financing Banks who have healthy financial ratios such as CAR above 8% and avoid Sharia People’s Financing Banks whose capital ratio continues to decline and avoid Sharia People’s Financing Banks that have problem loans or NPF above 5

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