Islamic Prudential Banking Concept to Reduce Non Performing Financing

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Abstract

This paper aims to develop the concept of prudential banking based on principles to minimize non-performing financing in Indonesia. This desk research was based on many relevant studies advanced in the literature. The review was particularly focus on Sharia Banking Law, Indonesian Banking Regulations, and Financial Services Authority Regulations. A secondary data published by the Indonesian Central Bank on Shariah Banking Statistics for 2014-2018 was used to sharpen the analysis. In addition, many previous studies on Sharia Banking conducted in other countries (e.g. Malaysia, Pakistan and other European countries) were discussed in order to widen the importance of shariah banking in those countries. The findings of this study include as follows. First, the development of the concept of Islamic prudential banking in the operations of Islamic banks need to give attention towards business risk and the certainty of the implementation of Islamic principles. Second, the operational of Islamic banks need to consider the important of sharia human resources, sharia product, shariah process (marketing, management, and standard operational procedure (SOP)) as well. The Practical implication is that Islamic prudential banking should be implemented in accordance with the Islamic concept in its operations so that it is truly able to minimize non performing financing. This study can also be used for policy instruments to improve Islamic Prudential Banking in Indonesia which is not yet available.Also, it can be implemented by other stakeholders of Islamic Banking. The social implication of this study to increase work motivation and raises honesty in work, in accordance with the objectives of Islamic banks.

Keywords:
Islamic prudential banking, Non performing financing.

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INTRODUCTION

Islamic banking in maintaining its activities requires a trustworthy attitude. The concept of trust in Islam is the implementation of duties while still paying attention to Islamic rules and norms for human life. The norm and rules of human life in Islam are identical with *Rahman* and *Rahimah* Allah. The norm and rules are expected to provide safety and falah as an implementation of faith in God. (Mamadolimova, Ambiah and Lukose, 2011; Kheirabadi, 2004; Barus, 2016)

The rapid economic mobility has triggered Islamic banks to take on the role of advancing the economy through shariah-based financing. Shariah principles according to Jan (2018) include *istihsan (*looking for easy ones that are shariah compliant), benefit, *raf al haraj* (eliminating difficulties), *daruriyat*.

Management of customer funds in several Islamic banks has experienced difficulties. Funds *funding* managed by existing experiencing congestion. Even though the shariah principle with its mandate is expected to realize the stability of Islamic banks. (Hafnida and Maamor, 2016) These bottlenecks can have implications for the income of Islamic banks, profit sharing for depositors and shareholders.

Non Performing Financing (NPF) of Islamic banks throughout 2018 experienced relatively high fluctuations. Bad debt financing ranges from 3.96% to 5.21% between January and August 2018 (Islamic banking statistics August 2018). Becoming a phenomenon is that even though prudential rules have been established, the impact is not only on congestion, but on performance. The advantages of Islamic banks which are proxied from *return on assets* have fluctuated. Return on Asset (ROA) of shariah commercial banks ranges from 0.42%, up to 1.35% in January to August 2018 (Islamic banking statistics August 2018).

Paper Mais and Sari (2015), which evaluates the soundness of shariah banks in Indonesia and Malaysia, produces that good corporate governance factors are considered “healthy”, meaning that the company has implemented good governance. Profit factor or profitability *Return on Assets* (ROA) “Fairly Healthy” with *Return On Assets* below 1.25%. In this condition the role of prudential management in financing management is needed so as to increase profits.

The low profit of Islamic banks is due to non performing financing. Non performing financing is that Islamic banks are required to set aside financial reserves in the form of Allowance for Earning Assets (PPAP). PPAP on current financing is 1% of total current financing (not including Bank Indonesia Wadi'ah Certificate (SWBI) and debt of government). Whereas special reserves of 5% of earning assets in the category of special attention, 15% of earning assets in the category of substandard after deducting collateral, 50% of earning assets in the doubtful category after deducting collateral, and 100% of earning assets in the category of non-performing financing after deducting collateral (Article 2 PBI no. 5/9 / PBI / 2003). The impact of the imposition of high PPAP caused losses to Islamic banks. This means that high non-performing financing has an impact on the ability of Islamic Banks to comply with PPAP rules. This results in the acquisition of earnings for the year to be backed up so that profits are reduced, and even to minus.

Non performing financing in Islamic banks as a result of not managing *Islamic prudential banking*. *Prudential the banking* presence is separate from compliance (*shariah compliance)*. This is evident in theprovisions *prudential Commercial banking banking* includes:

> "Core capital, Minimum Capital Adequacy Requirement (KPMM), Capital Adequacy Ratio taking into account market risk, Net Open Position (NOP), Legal Lending Limit (LLL), Asset Quality, Asset Allowance, Reset Structure Financing, Statutory Reserves (GWM), the application of the principle of knowing customers, transparency to bank finance, transparency of bank product information and the use of personal data of customers, the principle of prudence in capital investment activities of commercial banks, the principle of prudence in asset securitization activities for commercial banks ".(Rivai, Veithzal and Idroes 2017).

Islamic principles in practice are emphasized in the Shariah Supervisory Board (DPS). The task of the DPS according to the Islamic banking law is "to provide advice and advice to the directors and to oversee the activities of the bank in accordance with shariah principles" (Article 32 paragraph 3 of Law No. 21 of 2008). The shariah principle referred to in the circular letter of Bank Indonesia is that all businesses to raise funds, financing and services do not contain elements of riba, *maisir, gharar, haram* and.(SE- BI no 15/22/DPbS). Advice and suggestions are non-binding, meaning that what is suggested by the DPS may be followed or not followed.

Implementation of compliance with shariah principles according to Financial service authority regulations (POJK) must be evaluated by DPS based on shariah compliance principles and policies based on new products and / or bank activities. (Article 5 and 6 POJK no 24 / POJK.03 / 2015)

DPS is appointed by the Commissioner, together with the general meeting of shareholders. This has the potential for DPS's attitudes and actions to merely support the business, while shariah principles do not become an emphasis on business operations. The role of DPS is not as a referee for shariah business, but rather functions as a business partner.

Najib and Rini (2016) revealed that the Bank Syariah Mandiri Case which channeled fictitious financing to the Bogor of BSM Branch of 102 billion to 197 fictional customers. In addition, there are complaints from BRI Syariah customers and Mega Syariah Bank who feel disadvantaged by shariah gold pawning products. Dubai Islamic Bank which suffered a loss of approximately $ 300 billion due to improper financial statements. This incident is a portrait of the prudence of Islamic banking that does not work with shariah principles. The mandate of each officer and the control that is not executed.

Islamic banks should function as the opinion of Wang and Jin-Chuan (2001) banks perform their functions as: *First*, mobilize savings to save excess public funds and provide liquidity for those who need, *Second*, facilitate transactions by providing various facilities, *Third*, help break down risks into a variety of different portfolios, and the *Fourth*, reduce costs by providing service convenience. Banking efforts in running the business due respect to prudence *(prudential banking)* so as not to harm the customer. When Islamic banks experience risk pressures, according to Yazid, *et al.* (2018) Islamic banks are encouraged to transfer risk. These various backgrounds emphasize that shariah prudence and compliance are equally important so that shariah compliance should really be inherent in business risk.

Departing from the various explanations above, there is the potential for the operation of Islamic banks to be not optimal and the emergence of non performing financing. Related to that needed a solution to ensure the operations of Islamic banks are run by shariah are supported with the rules of prudence based on the principles of shariah *(islamic prudential* banking),human resources have the ability of shariah, managerial Islamic banking is executed based on the management of shariah, marketing of shariah and guaranteed carried out both by the manager and the supervisory board.

LITERATURE REVIEW

Prudential banking is defined by the Hulters and Montes Negret (2015) as a framework that encourages banks to operate in a safe and wise manner. The aim of the microprudential (prudential) rule is to maintain the security and health of Islamic banking, reducing the risk of systemic financial instability that affects other banks. The microprudential regulation according to Wall (2015) is intended to maintain the security and health of each institution and is an appropriate response to the threat of failure so as to create financial stability. Valascas and Kassey (2012) argue that in order to maintain the strength of banking stability, it is necessary to limit size and reduce risk. Whereas according to William (2014) bank risk will be low if the role of the government is of high quality. That is, the government has a role to maintain monetary stability that is directly related to Islamic banking.

Prudence in Islamic banking is built on the reality of the economy and the belief in future conditions. According to Welfens (2008) prudence in banking is built on the basis of: *First*, competition and private ownership in the field of Islamic banking, which causes the need for product innovation. *Second*, collateral for deposits of customer money. A big danger in managing public money is if aoccurs *bank runs* . Massive withdrawals of money are anticipated by creating a sense of security for the customer's money by providing guarantee protection to the relevant parties. *Third*, Profit as a bank buffer, it needs to be conveyed to customers in the form of financial report publications. *Fourth*, the central bank has the authority to provide the last loan to meet bank liquidity. *Fifth;* all actors; compliance supervisors, the Central Bank and the government must be cooperative in handling the crisis.

Prudence in banking as a manifestation of shariah banking risk management. Risk management is a series of methodologies and procedures used to identify, measure, monitor, and control risks arising from all activities caused by the bank. Risk management according to POJK the implementation of risk management for shariah commercial banks and shariah business units in question includes credit risk, market risk, liquidity risk, operational risk, legal risk, reputation risk, strategic risk, compliance risk, yield risk and investment risk. (Article 5 POJK no 65 / POJK.03 / 2016) Liquidity risk according to POJK regarding the obligation to meet liquidity adequacy ratios, for example banks must provide a *liquidity coverage ratio,* namely the ratio of *High Quality Liquid Assets* with a net 30 day minimum cash outflow of at least 100 percent.(Article 1 and 2 POJK no 42 / POJK.03 / 2015) Whereas to minimize credit risk, according to Trad, Trabelsi, and Goux (2016), the bank size must be large.

Financing in maintaining prudence is carried out by adhering to the 5 C principles (*Character, Capacity, Capital, Collateral and Condition*). This is regulated in the Islamic Banking Act which reads:

> “Shariah Banks and Shariah Business Units must have confidence in the willingness and ability of prospective recipient customers to pay off all obligations in time, before Islamic banks and / or UUS channel funds to facility recipients . To obtain this belief, Islamic banks and / or UUS are required to carry out a careful assessment of the character, ability of capital, collateral and business prospects of prospective recipient customers ... “(Law No. 21 of 2008 article 23)

Sorkhou (2006) states that Conventional banks channel credit with regard to controlling tools, namely *credit risk units, credit risk, credit ratings* and *credit monitoring processes*. This is what has been done by Islamic banks in conducting business. Things that concern monitoring are a little weak because they are monitored after non performing financing occurs. Shariah that is carried out concerns the products being distributed. While the process input and output are not a push point, no rules can be found.

RESEARCH METHOD

This paper is written based on a descriptive approach and a type of qualitative research. Qualitative research was carried out with various literature review. The review was conducted by reviewing the Shariah Banking Law, Indonesian Banking Regulations, Financial Services Authority Regulations, Indonesian Shariah Banking Statistics for 2014-2018, previous research out side Indonesia taken from such as Malaysia, Pakistan and Eropa.

RESULT AND DISCUSSION

Management of Islamic bank financing is faced with the risk of Non Performing Financing. The results of the study indicate that Islamic banks NPF throughout 2018 experienced relatively high fluctuations. The average non-performing financing in 2014 was 4.06%, 2015 was 5.29%, 2016 was 5.26%, 2017 was 4.71% and 2018 was 4.28%. The data can be proxied from the NPF that occurs every month, including:

Tabel 1 Monthly NPF data 2014 – 2018
Shariah Commercial Bank and Shariah Business Unit

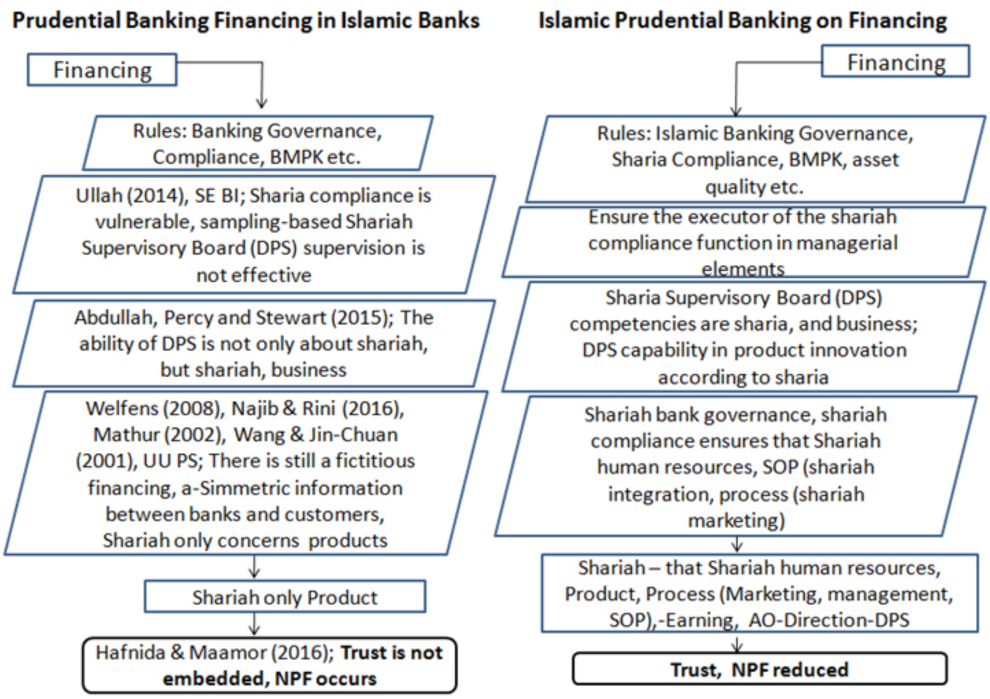
	NPF data on Shariah Commercial Banks & Shariah Business Units (Monthly in%)											
Year/ Month	1	2	3	4	5	6	7	8	9	10	11	12
2014	3.01	3.53	3.22	3.49	4.02	3.90	4.30	4.58	4.67	4.75	4.86	4.33
2015	5.56	5.83	5.49	5.20	5.44	5.09	5.30	5.30	5.14	5.16	5.13	4.84
2016	5.46	5.59	5.35	5.48	6.17	5.68	5.32	5.55	4.67	4.80	4.68	4.42
2017	4.72	4.78	4.61	4.82	4.75	4.47	4.50	4.49	4.41	4.91	5.27	4.77
2018	5.21	5.21	4.56	4.84	4,86	3.83	3.92	3.95	3.82	3.95	3.93	3.26

Source: Processed from Shariah Banking Statistics for 2014 - 2018 accessed through http; // ojk.go.id

The impact of NPF makes the average ROA in 2014 amounted to 0.85%, 2015 at 0.59%, 2016 at 0.66%, 2017 at 0.96% and 2018 at 1.18%. (Islamic banking statistics 2014-2018). If banks continue to experience problems, according to Goodhart and Segoviano (2017) recovery and resolution needs to be done. The level of non-performing financing already exceeds the limit (the threshold of bad financing is greater than 5%. (PBI no. 11/17 / PBI / 2015) Findings from this paper, as the rules in the review literature show that even though prudential rules have been set in various rules both the functions of banking governance, the banking compliance function in which there is a function of shariah bank governance, the shariah compliance function, but the impact on troubled financing is approaching the upper threshold. Islamic rules *prudential banking* are general. in the DPS supervisory function, while the implementers of Islamic bank governance, the shariah compliance function, make risk the dominant thing, while shariah is applied when the first product is launched, while in the process of travel, the DPS supervision is sampling, while the DPS function is not binding, namely just give advice on the supervision that is on do it. Several previous studies have shown that there is fictitious financing, the role of DPS is not optimal, dps competencies are only related to shariah without accounting capabilities, the existence of a-simmetric information between banks and customers and so on.

The development offer in this case is that the prudential rules of Islamic banks include shariah in their operational processes, from *prudential banking* to *Islamic prudential banking*. The rules of prudence in shariah banking make shariah an operational process. Shariah does not only run when new products are launched, but all management is based on shariah. Input, process and output must be based on shariah and set forth in the rules. Islamic banks are proposed to have a function of shariah bank governance, a separate shariah compliance function that is separate from conventional so that rules can be ascertained to be shariah-compliant and easily implemented into the operational standards of shariah bank procedures.

Chart 1 Islamic Prudential Banking Solution



Impact on non-massive prudential rules contributing to the emergence of NPF. With shariah principles, ensuring the NPF will be reduced, due to the awareness that arises for every banking agent and customer the profits obtained are halal. In addition the government as the holder of the regulations set various rules of prudence *(prudential banking)* which make the guidelines for the implementation of Islamic banks. The trust principle is the basis for the operational management of Islamic banks so that banks must meet *Islam prudential banking*.

Prudence is expected based on shariah principles and guaranteed by all managers. While supervision is carried out by DPS. DPS was appointed at the General Meeting of Shareholders (RUPS) by commissioners and shareholders, resulting in DPS obligations evaluating shariah principles as a rule of the shariah financial services authority is less than optimal so that it does not give effect to changes in financing performance. Shariah principles supervision is carried out by the Shariah Supervisory Board according to BI circular letter regarding Shariah Rural Bank (BPRS), DPS guidelines and duties at least once a month.(SE BI no 15/22 / DPbS) This relatively short time is only able to monitor financing operations within sample limits . This has a big chance.

Carefulness in banking is closely related to regulations financial issued by the Financial Services Authority and supervision of Islamic banks. This is intended to limit the risk to every Islamic bank so that Islamic banks can develop. The regulation of the financial services authority regarding the implementation of the compliance function of the commercial bank explains that the compliance function is intended as a preventive effort in risk mitigation of the bank's business (POJK no 46 / POJK.03 / 2017). Compliance with shariah principles is included in article 3 of the POJK which reads:

> "Ensure that policies, provisions, systems and procedures as well as business activities carried out by banks are in accordance with the provisions of the Financial Services Authority and statutory provisions, including shariah principles for commercial banks shariah and shariah business units ... "(POJK no 46 / POJK.03 / 2017)

There are no other provisions in POJK that explain shariah provisions that must be followed, thus creating understanding and implementation of shariah differently. For example, with murabahah products, certainty about the implementation of buying and selling products is not ascertained. So that what happens in recording in the right contract that the financing for the purchase of goods, but the certainty of goods purchased and all funding funds used in accordance with the contract not delivered. So that it distorts that Islamic finance is tantamount to credit at conventional banks. While conventional banks benefit from cheaper loans. So the selling value of financing in Islamic banks has no meaning before customers. Customers easily choose credit at conventional banks. Shariah principles should be emphasized that shariah commercial banks and Shariah Business Units must ensure that all banking operations comply with and implement products, marketing, management, and business processes carried out using shariah principles. Shariah becomes the operational spirit of the business, not just a product so that business awareness is guided and accounted for in addition to the supervisor (Directors) but in front of the creator, Allah SWT.

According to Khann and Bhatti (2008) that the development of Islamic banks in Asia is indicated by the presence and interest of regulators towards Islamic banks. In Indonesia special regulations concerning Islamic banks are regulated in the Shariah banking law, financial service authority regulations, circulars etc. This regulation is part of the efforts of regulators to prepare Islamic banks *prudent*. Caution that must be maintained in every banking institution according to Acharya (2013) is *first*, banks are funded by customers so that attention to the health of the bank is the main thing. Regulators can represent depositors and resolve their collective action problems in monitoring and supervising banks by placing several obstacles in risk taking. *Second*, because the government guarantees deposits up to a certain threshold to reduce problems, the government has an interest in minimizing risks. *Third*, in many countries - especially in emerging markets - banks are state-owned, making the government a direct stakeholder in the financial sector. Micro prudential regulations are part of the overall governance structure of individual financial companies. According to Frecaut (2017) caution in an effort to avoid banking from a severe crisis. According Pambuko and Ichsan (2018) synergy between macro experts and financial experts is needed in islamic banking stability .

Encouragement for banking institutions to operate safely and wisely materialized on the basis of a built-in compliance culture. The compliance culture referred to is the values, behavior and actions that support the creation of compliance with financial service authority regulations and statutory provisions including shariah principles for shariah commercial banks and shariah business units.

Shariah commercial banks in Indonesia receive funds *funding* with shariah principles (ie *wadiah* and *Mudharabah*) offers *funding* large often require fixed profits each month. In this situation the manager must be brave to refuse. Courage does not appear in financial ratios, but the process of financial ratios is formed from the profits promised by Islamic banks to customers. In working capital financing, the contract used is acontract *mudharabah*. With acontract *mudharabah*, the profits obtained by shariah commercial banks are equal to the profit sharing ratio agreed upon by the Islamic bank and the customer obtained from the customer's business income. However, shariah commercial banks often project that the profit sharing ratio is equivalent to conventional bank interest, so Islamic banks set a certain profit target for customers, which under this target contract must be met. In such conditions, Islamic banks must consistently receive fluctuating profits from the income obtained by the customer. If Islamic banks want customer profits to be linear and increase continuously, then the process of monitoring customer business must be carried out, so that customers do not experience a decline in profits, and Islamic banks are not affected.

Compliance with shariah principles does not become an operational risk, because shariah compliance only appears in the issuance of new products. In existing regulations, it does not bring up the financing process to be a part that must be examined by its shariah element. This condition also occurs in Bangladesh. According to Ullah (2014) that the status of shariah compliance from Islamic banks in Bangladesh is in a vulnerable condition, the status of shariah compliance varies greatly among Islamic banks, and Shariah violations are high in investment activities due to lack of knowledge, lack of sincerity in fulfilling Shariah, poor attention in the Shariah audit and Shariah research as well as the lack of a strong shariah supervisory board consisting of full-time skilled members. Compliance with the prudence in providing financing in the form of 5 C according to Abubakar and Handayani (2017) is to ensure that banks fulfill their obligations to pay their obligations. In various banks, the culture of risk compliance according to Carretta, Farina and Schwizer (2017) still has a distance, because every decision made by banks is full of risks. In this case shariah principles must be a part of prudence that can be implemented in providing financing.

Carefully managed risks, shariah becomes a written rule and is implemented, it will have a positive impact on healthy banks, problematic financing is reduced. The fragility of banking institutions because one of the intermediary functions does not run optimally. As in *financing*, Mathur (2002) that financing will be guaranteed smoothly if there is no *a-simmetric information* between the customer and the bank. Caution over this is the management role in managing information so that both parties are open, so that business certainty can be accepted by both customers and banks. The thing that is needed by banks and customers in services is *trust*.

Prudence in shariah commercial bank relates to compliance with shariah principles. This compliance according to Ashraf, Robson and Sekhon (2015) contains elements of trust in both individuals and institutions and beliefs influence the decision to choose Islamic banks in Pakistan. Good trust in a person is related to interpersonal relationships, while trust in the institution concerns its relationship with the bank. Trust and confidence are part of a unity in upholding the universal principles of Islam. Prudence in compliance with shariah principles according to Mamadolimova, Ambiah and Lukose (2011) is carried out by applying a transaction model that is in accordance with the contract. The *contract is in* accordance with the DPS fatwa and the rules stipulated by the Financial Services Authority.

Ullah, Harwood and Jamali (2016) mention the main role of managers and scholars (National Shariah Council) is very dominant in achieving compliance with shariah principles. However, often the control authority is not played maximally by managers or scholars. This means that because it pursues a profit target, compliance with shariah principles is less enforced. In Alsaadi, Ebrahim and Jaafar (2017) research, compliance with shariah principles will increase profits. Compliance with shariah principles means the institution complies with Islamic ethics in managing its company.

The spirit of prudence carried out by banks is expected to be able to connect between banks and stakeholders. As in the *Signaling theory, it is* expected that *prudential banking* and compliance with shariah principles can describe (signal) to customers and shareholders. With a mandate signal built by Islamic banks, the customer will be trustworthy on the funding he receives. Kabir *et al.* (2015) which examines credit risk in Islamic banks and conventional banks. The results show that Islamic banks have lower financing than conventional banks. It has a background that the use of accounting reports alone to assess financing is very misleading. So with shariah that is understood by the customer, it will make the customer appear aware of returning the funds on time.

Nicolo *et al.* (2014); Hermanto (2018); Abozaid (2016) analyzes the quantitative impact of bank regulations regarding microprudential on loans and the Indonesian Religious Nation Shariah Council Leader (MUI DSN) does not ensure that every shariah financial institution implements shariah compliance so it requires a solution. According to Nicolo, Gamba and Lucchett (2014) bank regulations regarding microprudential loans give rise to an inverse relationship between bank loans, welfare, and capital requirements, liquidity requirements clearly reduce loans, efficiency, and welfare, and resolution policies that depend on observed capital. On that basis, as revealed by Abozaid (2016), Islamic finance faces internal challenges, namely shariah governance and shariah audit. It is anticipated that Islamic banks do not lose their Islamic spirit so that they remain unique and choices in choosing Islamic banks.

CONCLUSION

The risk of shariah bank financing is non performing financing. The high level of non performing financing is due to the rules of prudence that have not yet been specific to shariah. The function of shariah bank governance, the shariah compliance function is in the conventional rules, so it is general.

This is supported by shariah compliance implementers not ensuring shariah as an operational basis and emphasizing the soundness of Islamic banks in terms of risk. Shariah compliance is supervised by the DPS which in its implementation is only limited to advice on supervision carried out. The function of implementing shariah compliance is needed on managerial elements. DPS competency is to have Islamic competence and business so that it can support product innovation in accordance with shariah. The solution to this is *Islamic prudential banking,banking* which is that prudence based on shariah principles must be available. Islamic banks must be ensured to have rules for the functions of Islamic bank governance, shariah compliance functions that are separate from conventional banks. These rules must ensure the existence of Shariah Human Resources, Operations are carried out according to Islamic management and Islamic marketing. According to Rahmawaty and Rokhman (2018) that shariah marketing has a positive and signifcant influence on customer satisfaction. Thus *Islamic Prudential Banking* can be ascertained to be comprehensive both input - process and output in accordance with sharia principles contained in the rules. The noble goal of implementing prudence based on shariah principles is to raise awareness for managers and customers for the funds channeled. This can reduce problem financing and towards shariah and healthy Islamic banks.

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