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A Conceptual Paper: Factors Affecting the Stability of Islamic Banking

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Abstract

This article aims to build a conceptual framework. The main objective of this study is to develop a literature review of the factors that affect the stability of Islamic banking in the GCC countries. The factors used in assessing the stability of Islamic banking are efficiency and financing risk. Islamic banks can obtain stability by managing their costs to remain efficient. By maintaining the stability of Islamic banks, the intermediation function and Islamic banking services can run optimally to contribute to economic growth. This article uses a qualitative approach and the data used is secondary data sourced from literature, books, and research journals. The result of this article is the establishment of a conceptual framework regarding how to maintain the stability of Islamic banking in GCC countries. It is expected that future research will be able to use a quantitative approach with Data Envelopment Analysis (DEA) that can help get the results of efficient and inefficient levels of providing research recommendations.

Keywords: *Islamic Bank, Stability, Efficiency, Financing Risk*

Introduction

Islamic finance is a contributing part of the world's financial sector. Islamic finance is an industry that has grown significantly to date. According to the Global Islamic Financial Report 2022, the Islamic banking sector and Islamic capital markets are the main contributors to the increase in the total value of the global Islamic Financial Services Industry (IFSI). Islamic banking even dominates among other Islamic financial sectors. Based on the Global Islamic Financial Report 2022 by (Azizah, 2023), the contribution of Islamic banking to global Islamic financial assets amounted to 68.7%, followed by sukuk at 25.4%.

The development of world Islamic finance is also supported by the development of Islamic financial assets from various groups of countries in the world. The group of countries members of The Gulf Cooperation Council (GCC) is the largest contributor. The contribution made by the GCC can be seen from the Islamic Financial Services Board report (2022) GCC countries as the largest contributors to Islamic banking, namely USD 1,212.5 billion, Middle Eastern and South Asian countries amounting to USD 477.1 billion, Southeast Asian countries contributed to Islamic banking amounting to USD 287.5 billion, and African countries contributed to Islamic banking amounting to USD 58.2 billion. The GCC, or the Gulf Cooperation Council, was established in 1981 as an organization of Arab governments in the Persian Gulf whose focal point is in the economic and political fields. Saudi Arabia, the United Arab Emirates, Kuwait, Bahrain, Qatar, and Oman are countries that are members of the GCC (Azizah, 2023).

There is a gap in the development of Islamic banking in the GCC group countries because each country has heterogeneity in the quality of their respective developments. Iran and Sudan have the largest Islamic banking assets in the world, which is 100%. Then, Saudi Arabia ranks third at 77.2% among GCC countries. Kuwait ranked 5th at 52%, followed by Qatar in seventh place at 28%, then the UAE ranked tenth at 24%, Bahrain ranked 12th at 21%, and Oman ranked 15th at 15%. Based on this graph, it is clear that the GCC countries contribute the most to Islamic banking in the world. Therefore, deepening the study of Islamic banking in GCC member countries is important as a form of learning.

According to (Miah & Uddin, 2017), regarding stability, a theory states that banks can obtain stability by managing costs incurred to remain efficient. The level of banking stability can be measured using the Z-Score value. Previous research tested stability with the Z-Score method by (Abrar et al., 2018), (Miah & Uddin, 2017), and others. Research on previous Islamic Banking Stability conducted by (Danlami et al., 2022) showed that institutional quality in Islamic banks strengthened the effect of financing risk-sharing on stability. Furthermore, (Rahmayuni & Paminto, 2021) examined the influence of macroeconomics and financial governance on the stability of Islamic banks, proxied by the NPF ratio. The results found that the two independent variables did not affect the stability of Islamic banks.

Regarding efficiency and credit risk, most comparisons are made by comparing efficiency and stability and credit risk in Islamic banks in certain locations. As studied by (Rusydiana, 2018), both compare efficiency and stability in Islamic banks in the ASEAN region. Furthermore, some only compare credit risk, namely (Karini & Filianti, 2018).

The main objective of this study is to develop a literature review on factors affecting the stability of Islamic banking. By conducting this research, adequate knowledge can be generated to fill the existing research gap. In addition, through this research, Islamic banking practitioners and policymakers can gain more insight into enhancing stability and, therefore, take the necessary related actions. Lastly, this research can improve Islamic banking worldwide by improving its stability. This research has several parts: Introduction, Literature Review, Research Method, Result, and Conclusion.

Literature Review

Banking Stability

Stability means balance or stability. In this regard, financial stability, in the view of Bank Indonesia, is a condition in which economic mechanisms function properly and support economic growth in pricing, allocation of funds, and risk management. The banking sector is the dominant financial sector today in Asia and is one of the sectors that supports financial stability.

An Islamic bank that maintains stability is always associated with bank risk management. Banks maintain the continuity of Islamic finance by paying attention to risk management. Therefore, risk management is important for optimizing the stability of Islamic banking. Irfan says risk management manages all potential problems using comprehensive and systematic management. In line with that, it is stated in QS. Taha: 81.

Efficiency

According to Ali, unjust acts and contrary to Islam can occur when a producer minimizes production costs because he wants to get the most profit. Islam teaches that the maximum profit will be obtained when it has made efforts and hard work that uphold the value of justice by sharia. A Muslim who runs a business must be serious and efficient by minimizing costs so that consumers can accept it. Inmaqashid Sharia, efficiency is preserving property (almaal) kamaruddin safa. In line with that, it is stated in QS. Al-Israa': 26-27.

The meaning of 'wasteful' in the verse is the origin of the verbs tabdzir and mubadzir. Imam Shafi'i defines it as using the property owned for something unimportant or not in its way. Mujahid further explained that much money spent in a good way is considered worthwhile. However, even if the wealth is small and needs to beent correctly, it is considered wasteful. Based on this concept, the concept of efficiency in Islam refers to managing resources and costs for optimal results that are still functional, economical, and not wasteful.

Financing Risk

According to (Saputri et al., 2023), credit risk is the failure of the debtor to fulfill his obligations, causing risk or loss to the creditor. In credit, the principle of prudence is prioritized so that there is no default at maturity. To measure the level of credit risk in banking using two approaches. This approach is commonly referred to as a ratio. Consists of Loan Deposit Ratio (LDR), Non-Performing Loan (NPL), and Non-Performing Financing (NPF). According to (Dahlan, 2005), NPF is a ratio that shows the existence of non-performing loans caused by internal and external factors. Internal factors are in the form of deliberation originating from financing customers. External factors are all events that creditor customers cannot control.

Research Method

The data used in this article is secondary data sourced from literature, books, and research journals.

The efficiency variable is used because it is supported by Syafira's research (2021) using the DEA method, which shows that efficiency is one of the determinants of Islamic bank stability, with research results that reveal efficiency has a significant and negative effect on Islamic banking stability. Research on the effect of efficiency on bank stability was also conducted by Nugroho and Anisa (2018). However, efficiency was proxied by the BOPO ratio with measurements using a ratio approach and showed negative and insignificant results. Most researchers use DEA to calculate efficiency, but some use different approaches. Research by (Mufraini et al., 2021) adopted a human resource efficiency approach in measuring the performance of Indonesian Islamic banks using the DEA method.

Meanwhile, the study conducted by Hanum (2018) used DEA with an output approach. In theory, stability will be achieved if a bank has achieved efficiency (Miah & Uddin, 2017). This is why the need to analyze whether efficiency can affect stability, especially in Islamic banks. Researchers are then interested in measuring the efficiency of Islamic banks in the GCC group as the object of research because it consists of large Islamic banks in the world.

Islamic bank products are always followed by credit risk or non-performing financing (Saputri & Ahmadi, 2022). Thus, non-performing loans will certainly affect the state of profit or profit of the bank. Non-performing financing (NPF) can be used to measure non-performing financing (Saputri et al., 2020). NPF illustrates the bank's risk management ability to manage non-performing financing (Prastiwi, 2018). A theory, according to (Amidu & Wolfe, 2013), is that when credit risk decreases, it will lead to stability. From this theory, researchers want to test it on GCC Islamic banking, which has been the best Islamic banking in the world.

This article uses a qualitative approach by reviewing the latest literature to build a conceptual framework for stability in Islamic banks. The literature study related to stability, efficiency, and financing risk. The results of this article formed a model of the concept of Islamic banks' stability that may be affected by efficiency and financing risk.

Result and Discussion

The efficiency level and financing risk can affect Islamic bank stability in this model on the discussion in the previous section that refers to the literature study, the conceptual framework in affecting stability is formulated as follows:

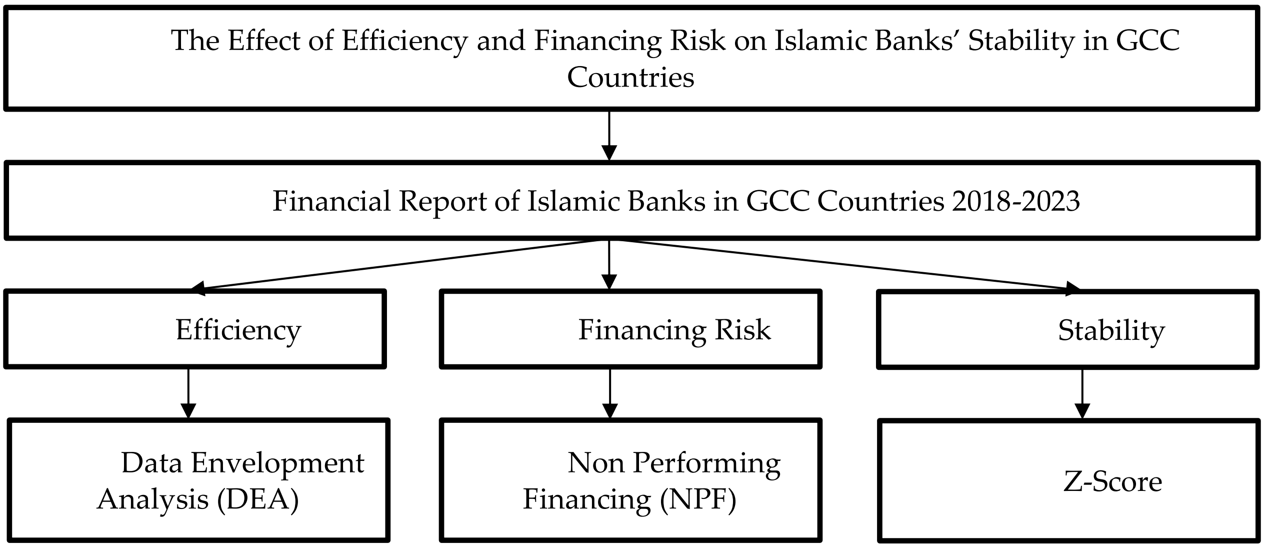

Figure 1. Conceptual Framework - Islamic Banks' Stability

Figure 1. Shows the flow to find the effect of efficiency and financing risk on the stability of Islamic banks in the GCC countries. In addition, the results of this study are also supported by the relationship between efficiency and financing risk with Islamic bank stability.

The Relationship Between Efficiency and Islamic Bank Stability

Efficiency means that any smaller costs incurred by the bank can generate greater profits. The bank's ability to produce maximum output with a certain input or produce certain output with minimum input is the definition of banking efficiency. Islamic banking is said to have good financial performance if the efficiency value is high. Banks must run their business efficiently to compete in the increasingly competitive banking world. In addition, efficiency is also one of the factors that must be considered to explain financial stability because efficiency can encourage financial stability (Dutta & Saha, 2021). So, the efficiency of a bank, especially Islamic banks, is very important to be maintained. This is done for the continuity of the financial institution and to get as much profit as possible. Stability will also be achieved when the bank can profit from its business activities. Related to this, (Dutta & Saha, 2021) research states that efficiency significantly affects bank stability.

The Relationship Between Credit Risk and Islamic Bank Stability

Credit risk is a loss that will arise when banks issue loans or financing to customers. The loss will occur when the customer cannot pay the loan installments when due, commonly referred to as non-performing financing. Non-performing financing can be measured by the NPF ratio (Dahlan, 2005). The higher the NPF ratio, the higher the financing risk and the more it will affect bank stability. This is in line with the empirical study of (renda Gonzalez-Hermosillo, 1999), revealing that the cause of bankruptcy of a bank is a large credit risk. Similarly, (Schinazi, 2006) revealed that financial stability is caused by low credit risk.

The above statement is based on research conducted by (Ahmad Fatoni, 2022), who found that NPF has a positive and significant effect on the stability of Islamic banks. Meanwhile, research conducted by (Dwinanda & Sulistyowati, 2021) found that liquidity risk and credit risk on the stability of Islamic banks have a negative and significant effect.

Conclusion

The main contribution of the study remains in the perspective of Islamic banks towards its stability. The stability of Islamic banks is essential to study, especially when there is a relationship between variables with efficiency and financing risk. The stability maintained by Islamic banks can make Islamic banks sustainable in the long term. Through the discussion above, some important things will help the program to be planned. Future research must validate the measurement of proposed concepts and test conceptual models on empirical data using quantitative methods. Data Envelopment Analysis (DEA) is suitable for further research that can produce efficient and inefficient levels of a study.

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