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UNIVERSITAS ISLAM INDONESIA YOGYAKARTA FAKULTAS BISNIS DAN EKONOMIKA

PRO-CYCLICAL RISK OF ISLAMIC BANKING FINANCING IN INDONESIA UNDER THE COVID-19 PANDEMIC

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Abstract

Many studies have proven that Islamic banks around the world are relatively unaffected by the crisis. This also applies when the Covid 19 pandemic hits the world today, where Islamic banking in Indonesia actually shows better performance compared to conventional banks. Currently, almost all business sectors, especially in developing countries, are highly dependent on bank financing as a source of capital financing. The role of banks in lending to increase capital in people who need funds to strengthen their capital structure. However, excessive lending can lead to pro-cyclical problems. So far, there have not been many studies that specifically discuss the pro-cyclical nature of financing in Islamic banks in terms of the type of financing. This study aims to discuss the pro-cyclical risk of financing Islamic banks during the Covid-19 pandemic. The researchers also expand its analysis with other hypotheses, namely; providing loans to Islamic banks that is pro-cyclical in one type of loan pattern, thus worsening the economic situation in difficult times due to defaults with sensitivity to local conditions that occur in Indonesia. The findings of this study are also expected to enrich literacy in Islamic banking which can be a motivation for further researchers, as well as add to the literature on Islamic finance studies. This study uses a literature review method with a literature review. Procyclicality behavior in banking is generally followed by an increase in risk-taking behavior in lending, which can be identified from the risk of an imbalance between lending and the needs of the economy. The precautionary principle in sharia banking is a guideline in the management of banking as well as banks that implement sharia compliance (sharia compliance). The researcher realizes that it is necessary to conduct a more-deep analysis related to the pattern and nature of financing in Islamic banks before giving a pro-cyclical label.

Keywords: Financing, Pro-cyclical Risk, Islamic Bank

Introduction

Bank in the world is affected by the financial crisis, many studies prove that Islamic banks around the world are relatively unaffected by the crisis. Such conditions also apply when the Covid-19 pandemic hit the world today, where Islamic banking in Indonesia actually shows better performance compared to conventional banks. One of the alleged reasons is the management of the provision of financing in a dynamic and more careful Islamic bank. Shariah bank as an intermediary institution has an important role because it is able to provide stimulus to the economy. Islamic bank role also to support economic growth without forgetting the basis of Islamic law attached to its nature and social goals.

At present, almost all business sectors, especially in developing countries, rely heavily on banking financing as a source of capital financing. Parties who have excess funds (capital) will place their funds into financial institutions (as intermediation institutions) which will then be channeled to the business sector that needs financing.

Business turnover is inseparable from the financial cycle that is closely related to banking. In early 2020 the world was horrified by the Covid-19 virus spreading throughout the continent, the Covid-19 virus not only shook the health sector, but also had an impact on the economic sector which resulted in a weakening of the national and global economy. Consumption activities, investment in foreign trade continue to decline quite significantly. Various efforts have been made by the government to increase economic growth so that Indonesia avoids recession.

The role of banks in the distribution of credit to increase capital in communities that require funds in order to strengthen their capital structure. But excessive credit distribution can cause pro-cyclical problems. Pro-cyclical banking is excessive credit distribution so as to accelerate economic growth when the economy is in a condition of expansion and distribution of too little credit, thus slowing economic growth when in the economy in contraction conditions (Bank Indonesia, 2014). Capital adequacy becomes one of the indicators to see and assess the health of the bank. Later in order to remain able to operate the bank must have capital adequacy that has been determined by BI so that banks do not experience liquid when the current crisis causes bad credit numbers to soar (Financial Services Authority, 2020).

The above makes the comparison financing model between conventional banks and Islamic banks both local ownership and private foreign ownership as in the research (Pratami et al., 2021) has compared the behavior between conventional banks and Islamic banks in Indonesia in the decision of granting financing. Research (Pratami et al., 2021), has proven that conventional commercial banks are pro-cyclical which means that financing provided by conventional commercial banks is positively correlated with business turnover, while in Islamic banks more counter-cyclical that occurs not only in times of crisis, but also in various economic conditions. Evidently when Indonesia experienced a monetary crisis in 1998 Islamic banking was able to survive compared to conventional banking.

In the past two decades, according to the Islamic Financial Services Council in 2019, Islamic banking assets have more than doubled in the 10 years (2008-2018) from $660 billion to $1.57 trillion. This is inseparable from the benefits they get from loans that are channeled. Distribution of Islamic bank loans so far as we are familiar with *debt financing* using buying and selling and renting and *equity financing* with revenue sharing agreements. The revenue sharing pattern of Islamic banks (PLS) is to divide the risk between creditors and debtors by agreement at the beginning on the principle of distributive justice, (Beck et al., 2013).

This far there has been no research that specifically discusses the pro-cyclical nature of financing in Islamic banks in terms of the type of financing. The distribution of financing to Islamic banks is divided into two main groups, namely *debt financing* using buying and selling and renting agreements and *equity financing* with revenue sharing agreements. Some literature is also found to review by identifying banks in terms of asset ownership and quality, bank size, and bank reliance on foreign share ownership.

This research aims to discuss the risks of pro-cyclical financing at banks in the Covid-19 pandemic. The main hypothesis of this study is that the provision of financing to Islamic banks is not pro-cyclical, given the important role of Islamic banks in times of economic crisis. The researcher also expanded his analysis with other hypotheses, namely; The provision of loans to Islamic banks that are pro-cyclical in one type of lending pattern, thus worsening the economic situation in difficult times due to default with sensitivity to see local conditions that occur in Indonesia. Of course, the monetary policy of the central bank influences the bank's decision in lending and even credit crisis due to regulatory determination (Akinsola & Ikhide, 2018).

Furthermore, the findings of this study are also expected to enrich the literacy of Islamic banking which can be a motivation for further researchers, as well as add to the literature of Islam financial studies. The role of Islamic banks is considered to reduce the negative impact during the global crisis at that time (Beck et al., 2013; Farooq & Zaheer, 2015; Hasan & Dridi, 2011; Soedarmono et al., 2017).

Literature and Theoretical Review

This study provides an in-depth understanding of the nature of Islamic commercial bank lending patterns that researchers have never discussed before. Research conducted in this study wants to find out which lending patterns play a more positive role in sustainable economic stability, whether the pattern *of debt financing* loans or *equity financing* with its inherent account. Although many pros and cons are questioning again about the ultimate goal of Islamic bank ideals that prioritize social justice over profit. There has been a lot of discussion and literature discussions about the loan cycle of private conventional banks, government banks, banks with foreign ownership, cooperative banks and Islamic banks as stated by (Aysan & Ozturk, 2018) about two banking systems that found that there are similar patterns of Islamic bank lending and pro-cyclical conventional banks in Turkey. This result is due to the tight competition of banking in Turkey, interestingly, customers there can combine between religious rules and free market conditions.

This is contrary to the belief that the involvement of Islamic banks that successfully survive and play a role in controlling economic stability cannot be separated from its social ideals (Mansour et al., 2015) in poverty alleviation, distributive justice outside rather than maximizing profitability (Aysan & Ozturk, 2018; Venardos, 2006). Discussions on profitability in research (Cornett et al., 2010) revealed that profitability obtained by 16 government banks operating in 16 Asian countries is also much less at higher risk than private banks, although this problem recovered after the economic crisis in the Asian region improved. The study is a continuation of previous research with the same finding that the profitability of government banks is not as good as private banks. This is because in India, Pakistan, Brazil and Italy politicians use government loans to provide political protection that has an impact on poor credit allocation and causes a lot of problematic financing in Government Banks (Bertay et al., 2015; Carvalho, 2014; Cole, 2009; Khwaja & Mian, 2005; Sapienza, 2004).

Furthermore, research comparing between two Islamic bank systems in Malaysia and in Indonesia, found differences in results, because in Malaysia proved counter-cyclical, but pro-cyclical in Indonesia (Ascarya et al., 2016; Ibrahim, 2016). Curiosity about the nature of government banks in the business cycle was examined by (Bertay et al., 2015) with a sample of 32 high-income countries from 1999 to 2010 such as the United States, Australia, Austria, Belgium, the Netherlands, Canada, Cyprus, Denmark, Finland, Hong Kong, Iceland, Ireland, The United Kingdom, Israel, Italy, Germany, Japan, Kuwait, Luxembourg, New Zeeland, Norway, France, Portugal, Saudi Arabia, Singapore, Slovenia, Spain, Sweden, Switzerland, UAE, Greece, Qatar, the remaining 79 developing countries including Indonesia with a sample of 1633 banks. Its findings identified that high-income countries were less pro-cyclical, even counter-cyclical in lending. This gives rise to the new fact that government banks can provide stable credit even in unstable financial situations, even though the distribution of credit is not good enough.

Albertazzi &Bottero (2014) provides a variation of another study that tested the resilience of banks in the Lehman collapse period in Italy by comparing cross-border foreign banks with domestic banks. The results of his research proved that Foreign Banks make little contribution and are pro-cyclical. Previously, comparing the capabilities of foreign banks in the pre-Lehman Brothers period, and post Lehman Brothers has been done by Bofondi et al. (2018) with the finding that the increase in credit supply provided by foreign banks is less affected by the shock of financial markets than domestic banks.

Based on some of the explanations of the literature above, the originality of this study lies in the absence of detailed research that specifically discusses the time of the national crisis, the business cycle in Islamic banking financing is disrupted by the high level of bad credit. These evocative researchers to examine more deeply about the pro-cyclical risks that occur in Islamic banking during the covid-19 pandemic. The expected findings in this study do not contradict the fundamentals of Islam's law in practice. The challenges faced in the process of writing this paper are the lack of data, limited time and the amount of literature that counters Islamic commercial banks in practice to run a socially equitable business with partners, not viewing customers as debtors and creditors alone, engaged in a positive business cycle that makes the economy grow.

Research Method

This research uses a method of review literature with literature studies. This research only uses data that focuses on one country, namely Indonesia. As the object of this research is the pro-cyclical risk of Islamic bank financing in the Covid-19 period.

The purpose of this study is to conduct an analysis of financing behavior at Islamic banks when viewed from the type of financing at the time of the Covid-19 pandemic. This is done to find out that Islamic bank is pro-cyclical or counter-cyclical when the crisis due to the covid-19 pandemic causes bad credit numbers to increase. This research uses a qualitative type of descriptive analysis.

Research Results

Credit distribution is influenced by several factors, both internal and external factors. From the internal side, credit distribution is mainly influenced by the bank's ability to collect public funds commonly called Third Party Funds (DPK), *Loan to Deposit Ratio (LDR), Non-Performing Loan (NPL), Return on Assets (ROA), Capital Adequacy Ratio* (*CAR*), Bank Indonesia Certificate (SBI) and interest rate determination. Based on the external side, the distribution of credit from banks is influenced by economic conditions, government regulations, and others as such.

The role of banks in the distribution of credit is to increase capital in communities that need funds in order to strengthen their capital structure. But excessive distribution of credit can cause pro-cyclical problems. Banking pro-cyclicality is the distribution of excessive banking credit so as to accelerate economic growth when the economy is in a state of expansion; and the distribution of credit is (too) little, thus slowing economic growth when in the economy in contraction conditions (Bank Indonesia, 2014). *Countercyclical Capital Buffer* (CCB) is an instrument used to ensure that banks have large capital buffers that allow them to absorb unsullied losses when faced with negative systemic shocks, this is expected not to sacrifice loans to the rill economy (Pratiwik et al., 2021).

Banking pro-cyclical is generally followed by an increase in *risk taking* behavior in credit distribution that can be identified from the risk of imbalance between credit distribution and economic needs. Thus, the problem in procyclicality is based on indicators of economic needs and indicators of imbalance in the distribution of banking credit. Before researching more deeply about the factors that affect pro-cyclicality, we must first identify that in the period of research it is true that pro- cyclical occurs (Borio, Furfine, & Lowe, 2001).

Conclusions

Financing is one of the Islamic banking programs to realize national economic development, which is expected to improve the welfare of the community in accordance with the objectives of Islamic banking. Financing in the business cycle is expected to increase Small and Medium Enterprises (SMEs) actors for national economic drivers. Financing provided by Islamic banks certainly contains risks. As is currently the case due to the covid-19 pandemic some business actors cannot operate because of government policies that implement restrictions on community activities (PPKM) that lead to reduced income. Another effect, to remain operational some business sectors do a lot of Job Relationship Termination (layoffs) on their employees.

The principle of prudence in Islamic banking, is a guideline in the management of the law as well as banks that apply *sharia compliance (shariah compliance*). The quality of a Islamic banking is not determined from *the Capital Adequacy Ratio* (CAR), *Financing to Deposit Ratio* (FDR), *Non Performing Financing* (NPF). But the management of the provision of financing in Islamic banks is dynamic and more prudent, which causes Islamic banks to be more resilient to crises than conventional banks.

The research realized that more in-depth analysis was needed related to the pattern and nature of financing at Islamic banks before labeling pro-cyclical. This is because the proportion *of equity financing* in Islamic banks is smaller when compared to *debt financing.* Therefore, the authors provide recommendations to answer the question by conducting an analysis on the broader Islamic bank objects with ongoing research to support government programs, one of which is by making Indonesia a leader in the progress of the development of a civilized Islamic financial system. For stakeholders, the above research can be one of the considerations that Islamic banking still requires an injection of funds from the government and private sector to stabilize lending when the economy is difficult. In the end, this goal is in line with the mission of

Bank Indonesia in synergy with the National Committee for Islamic Economics and Finance (KNEKS).

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