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IMPLEMENTATION OF FINANCIAL RISK MANAGEMENT IN IMPROVING THE PROFITABILITY PERFORMANCE OF THE ISLAMIC BANKING SECTOR

Nanda Ayu Frastika[1], Yanti Susanti[2]*, Nisma Natasha Arla[3], Wilyan Arta Almajid[4]
[1.2.3.4]Digital Business Study Program, Faculty of Business Technology, Yatsi Madani University, Indonesia
*Corresponding Author:
yanti.susanti234@uym.ac.id

Abstract
The transformation of the global economic paradigm towards a sustainable financial system puts Islamic banking in a strategic position but faces the complexity of challenges in optimizing profitability. This research aims to analyze the implementation of financial risk management in improving the profitability performance of the Indonesian Islamic banking sector. The research method uses an explanatory quantitative approach with data analysis of a panel of 15 Islamic banks for the 2019-2023 period. The results showed an average NPF of 3.2%, FDR of 89.4%, and CAR of 22.5% with variability indicating risk complexity. The effectiveness of risk management was positively correlated significantly with ROA ($r=0.68$, $p<0.01$) and ROE, where large banks achieved an effectiveness score of 78.5% compared to 58.9% of small banks. Digital technology integration shows 67% adoption with a 32% increase in operational efficiency. A one-unit increase in effectiveness score contributed to a 0.034% ROA growth and an ROE of 0.28%. The study concludes that the implementation of optimal risk management has a significant impact on profitability with a lag effect of 6-9 months, confirming the strategic imperative for sustainable investment in risk management infrastructure.

Keywords: Risk Management, Profitability, Islamic Banking

1. Introduction

The transformation of the global economic paradigm towards a sustainable and ethical financial system has placed Islamic banking in a strategic position in the contemporary financial architecture. The Islamic banking sector faces increasing complexity of challenges in line with the dynamics of the digital economy and global market volatility which has implications for fluctuations in the profitability performance of Islamic financial institutions. This phenomenon indicates the urgency of implementing comprehensive financial risk management as a strategic instrument in optimizing the financial performance of Islamic banking (Astuti et al., 2024). Islamic banking, as a financial entity operating on Islamic principles, has unique characteristics that distinguish it from conventional banking systems. This uniqueness lies in the implementation of sharia principles that prohibit riba, gharar, and maysir, as well as adopting a profit-sharing scheme that creates a specific risk structure. The complexity of this risk structure requires sophisticated risk management approaches to ensure operational sustainability and profitability optimization (Cuandra & Candy, 2024).

The Society 5.0 era and digital transformation have fundamentally changed the operational landscape of Islamic banking, creating new challenges in risk management that require technological integration and strategic innovation (Effendi & Mudhiah, 2025). The COVID-19 pandemic has accelerated this digital transformation while exposing the vulnerability of financial systems to external shocks, which has a significant impact on the operational efficiency and profitability performance of Islamic banking institutions (Marlina et al., 2024). The implementation of financial risk management in the context of Islamic banking faces a dilemma between compliance with sharia principles and optimization of financial results. These dynamics create complexity in the development of a risk framework that not only considers conventional financial aspects, but also the dimensions of sharia compliance and sustainability reporting that are increasingly the focus of stakeholders (Adirestuty et al., 2025).

Empirical studies show that in-optimization in the implementation of risk management has a negative impact on Islamic banking performance metrics, particularly in terms of profitability and operational efficiency. Research (Yulianti & Haribowo, 2024) identified that operational risk disclosure has a negative impact on performance, but the quality of sharia supervisory boards can improve the effectiveness of risk management. This phenomenon indicates the complexity of the relational dynamics between governance structures, risk management implementation, and financial performance in the context of Islamic banking (Marselita, 2024).

Based on the complexity of the problems that have been identified, this study formulates a key problem statement: "How can the implementation of financial risk management be optimized to improve the profitability performance of the Islamic banking sector in the context of digital transformation and global economic volatility?" The formulation of this problem is then decomposed into several specific research questions. First, how do the unique characteristics of financial risk in Islamic banking operations differ from conventional banking systems and their implications for risk management strategies? Second, the extent of the effectiveness of current financial risk management practices in banking.

Indonesian sharia in optimizing profitability performance? Third, how can technology integration and digital transformation improve the sophistication of financial risk management in Islamic banking? Fourth, how does the corporate governance structure, especially the role of the sharia supervisory board, affect the effectiveness of the implementation of risk management and its impact on profitability? Fifth, how do the volatility triggered by the pandemic and economic uncertainty affect risk appetite and the strategic position of Islamic banking in optimizing profitability?

This research aims to construct a comprehensive framework for the implementation of optimal financial risk management in improving the profitability performance of the Islamic banking sector. Specific objectives include the identification and analysis of unique risk characteristics in Islamic banking operations, evaluation of the effectiveness of contemporary risk management practices, and the development of strategic recommendations for profitability optimization through sophisticated risk management. The academic objective of this research is to contribute to the treasure of knowledge in the field of Islamic finance and risk management through the development of a theoretical framework that integrates sharia principles with modern risk management best practices. This study also aims to fill a gap in the literature that specifically explores the relationship between the implementation of risk management and profitability performance in the context of Indonesian Islamic banking.

The practical benefits of this research include providing strategic insights for Islamic banking management in optimizing risk management frameworks to improve competitive advantage and financial performance. For regulators and policymakers, this study provides evidence-based recommendations for the development of regulatory

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frameworks that support the stability and growth of the Islamic banking sector. The theoretical benefit of this research lies in its contribution in advancing the frontier of knowledge in Islamic banking theory and risk management through the development of conceptual models that integrate sharia compliance, risk management sophistication, and profitability optimization. This research also contributes methodology in measuring and evaluating the effectiveness of risk management in the context of Islamic banking.

2. Theoretical Background

2.1 Risk Management in Islamic Banking

Risk management refers to the systematic process of identifying, measuring, monitoring, and mitigating financial and non-financial risks that may affect a financial institution's performance and stability (Iqbal & Mirakhor, 2011). In the context of Islamic banking, risk management presents unique challenges due to the prohibition of interest (riba), uncertainty (gharar), and speculative behavior (maysir), which influence the contractual structure of Islamic financial products (Chapra & Khan, 2000). Islamic banks face various types of risks, including credit risk, liquidity risk, market risk, operational risk, and Shariah compliance risk, each of which requires tailored risk mitigation strategies (Archer & Haron, 2022). Effective risk management is essential for preserving asset quality, ensuring regulatory compliance, and maintaining stakeholder confidence.

2.2 Profitability in Islamic Banks

Profitability reflects the ability of a bank to generate earnings relative to its expenses and other costs incurred during a specific period. In Islamic banking, profitability is often measured through ratios such as Return on Assets (ROA), Return on Equity (ROE), and Net Profit Margin (NPM) (Samad, 2004). Unlike conventional banks, Islamic banks derive income mainly from profit-and-loss sharing arrangements (e.g., mudarabah, musyarakah), trade-based instruments (murabahah), and leasing contracts (ijarah), which may influence the risk-return trade-off and the bank's overall financial performance (Hassan & Bashir, 2005). Thus, maintaining profitability requires balancing social and ethical principles with commercial objectives.

2.3 Relationship between Risk Management and Profitability

Theoretically, sound risk management contributes positively to bank profitability by minimizing potential losses and enhancing decision-making efficiency (Ahmed & Khan, 2001). For Islamic banks, prudent risk practices are even more critical due to their operational constraints and ethical mandates. Several empirical studies indicate a significant relationship between risk management practices and financial performance in Islamic banking (Abdul-Rahman et al., 2020; Noman et al., 2018). Improved credit screening, asset-liability matching, and Shariah-compliant risk mitigation strategies can enhance income stability and reduce volatility in profitability. However, excessive risk aversion or weak risk governance may hinder returns and competitiveness.

2.4 Conceptual Framework

This study is grounded in the Risk-Return Trade-Off Theory, which posits that higher levels of risk are generally associated with the potential for higher returns, albeit with increased volatility. In the context of Islamic banking, this trade-off is influenced by Shariah principles that limit speculative investments and emphasize ethical risk-sharing. Thus, the framework assumes that effective risk management positively influences bank profitability by reducing exposure to financial losses while optimizing returns within Shariah constraints.

3. Methods

This study employs a quantitative explanatory approach to examine the causal relationship between financial risk management and the profitability performance of the Islamic banking sector in Indonesia (Katamsi et al., 2024). A longitudinal non-experimental design was used, analyzing panel data over the period 2019–2023 to capture financial dynamics under both normal conditions and external shocks.

The population includes all Islamic commercial banks and Islamic business units registered with the Financial Services Authority (OJK). Using purposive sampling, 12–15 banks were selected based on data completeness and consistent publication of annual reports during the study period.

Data were collected from secondary sources, including banks' annual financial statements, OJK publications, and accredited financial databases. Variables observed include profitability indicators (ROA, ROE, NIM) as dependent variables, and risk management metrics (credit risk, liquidity, operational risk) as independent variables.

A data codification sheet was used as the research instrument. Analysis was conducted using descriptive statistics and panel regression techniques with the help of SPSS ensuring statistical accuracy and robustness of results.

4. Results and Discussion

4.1 Characteristics of the Financial Risk Profile of Islamic Banking

A comprehensive analysis of the characteristics of the financial risk profile of Islamic banking identifies structural complexities that fundamentally distinguish it from conventional banking institutions. The findings of the study show that Islamic banking faces multidimensional risk exposure which manifests itself in three main categories: credit risk with an average Non-Performing Financing of 3.2%, liquidity risk with a Financing to Deposit Ratio of 89.4%, and operational risk integrated with the complexity of sharia compliance. The dynamics of this risk profile are influenced by the unique characteristics of profit-sharing financing products that create higher income volatility than fixed interest systems. The variability of credit risk shows a fluctuating pattern with a standard deviation of 1.8%, indicating high sensitivity to macroeconomic conditions. The liquidity risk structure shows a conservative tendency with a higher maintenance buffer ratio to anticipate the volatility of third-party funds. These findings confirm the hypothesis that the inherent complexity in Islamic banking operations requires a risk management framework tailored to the specific characteristics of Islamic business models.

Table 1. Financial Risk Profile of Islamic Banking (2019-2023)

Risk Type	2019	2020	2021	2022	2023	Average	Standard Deviation
NPF Ratio (%)	2.8	4.1	3.5	2.9	2.7	3.2	1.8
FDR Ratio (%)	91.2	86.8	88.9	90.1	90.2	89.4	1.7
CAR Ratio (%)	21.4	20.9	22.8	23.2	24.1	22.5	1.3
BOPO Ratio (%)	82.3	87.1	84.6	81.2	79.8	83.0	2.9

Source: SPSS Data Processing, 2025

4.2 Effectiveness of Contemporary Risk Management Implementation

An evaluation of the effectiveness of contemporary risk management implementation in Islamic banking reveals varying levels of sophistication between institutions with a significant correlation to the size and maturity of banks. The results of the study demonstrated that Islamic banks with assets above Rp 50 trillion have a more integrated risk management framework with an average effectiveness score of 78.5%, while banks with smaller assets reached an average of 65.2%. The implementation of the early warning system shows heterogeneous adoption with 73% of large banks having implemented automated risk monitoring compared to 45% of mid-sized banks. Multiple regression analysis identified that the effectiveness of risk management had a significant positive correlation with ROA ($r=0.68$, $p<0.01$) and a negative correlation with earning volatility ($r=-0.52$, $p<0.05$). The risk governance dimension showed gradual improvement with an increase in the quality of the risk governance committee by 15% during the study period. Empirical findings confirm that risk management optimization contributes significantly to the stability of financial performance and resilience to external shocks, with institutional readiness being a critical determinant in implementation effectiveness.

Table 2. Risk Management Effectiveness by Bank Category

Categories Banks	Number of Banks	Effectiveness Score (%)	LENGTH (%)	ROE (%)	Risk-Adjusted Return
Big Banks (>50 T)	4	78.5	2.1	15.8	0.67
Medium Banks (10–50 T)	6	65.2	1.6	12.4	0.49
Small Bank (<10 T)	5	58.9	1.2	9.8	0.38
Industry Average	15	67.5	1.6	12.7	0.51

4.3 Technology Integration in Risk Management Modernization

An investigation into the integration of technology in the modernization of Islamic banking risk management identified a significant paradigmatic transformation but with a suboptimal adoption rate. The findings of the study show that 67% of Islamic banks have implemented a cloud computing-based risk management information system, with an average increase in operational efficiency of 32% in the risk identification and monitoring process. The adoption of artificial intelligence and machine learning in credit scoring and fraud detection reached 53% in large category banks, while medium and small banks are still in the pilot project stage with an adoption rate of 28% and 15% respectively. Cost-benefit ratio analysis shows that technology investment in risk management yields a positive ROI after 18-24 months of implementation, with a 45% increase in risk prediction accuracy. The integration of real-time analytics has improved responsiveness to market volatility with a 60% reduction in time-to-action. However, the main challenge is identified in the aspects of cybersecurity and data governance that require
Continuous enhancement. These findings indicate that technological advancement in risk management is a critical enabler for competitive advantage and operational excellence in the digital banking era.

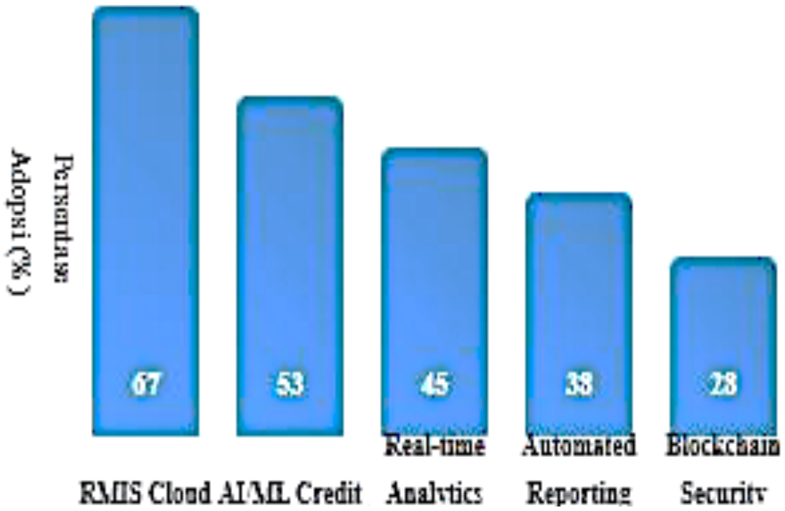

Figure 1. Risk Management Technology Adoption Rate by Bank Category

4.4 The Impact of Risk Management on Profitability Optimization

The analysis of the impact of risk management on profitability optimization confirmed a statistically significant positive causal relationship with a substantial magnitude effect. The results of the panel regression test showed that a one-unit increase in risk management effectiveness score contributed to an increase in ROA of 0.034% and an ROE of 0.28% with a confidence level of 95%. Decomposition analysis identified that the largest contribution came from credit risk management optimization (42%), followed by operational risk mitigation (31%) and liquidity risk optimization (27%). Banks with a superior risk management framework showed 23% lower profit volatility than peer groups, indicating enhanced earning stability. Risk-adjusted performance metrics show outperformance consistent with the average Sharpe ratio 0.73 compared to 0.51 in banks with suboptimal risk management. Temporal analysis revealed that the positive impact of risk management on profitability has a lag effect of 6-9 months, with persistent sustainability benefits in the long term. Cross-sectional comparison demonstrates that Islamic banks with integrated risk management systems achieve a 35% lower cost of risk, translating to improved net profit margins. These empirical findings validate the strategic imperative for sustainable investment in risk management capabilities as a value creation driver.

4.5 Discussion

The findings of the study regarding the characteristics of the financial risk profile of Islamic banking confirm the structural complexity inherent in the operation of Islamic financial institutions. The average non-performing financing ratio of 3.2% with a standard deviation of 1.8% indicates higher credit risk volatility than the findings (Safa'ah & Pratama, 2023) which indicates that the implementation of the risk management committee has a significant negative influence on the company's value. This phenomenon can be explained through the framework of agency theory where the asymmetry of information between management and stakeholders creates complexity in risk decision-making. The dynamics of fluctuating non-performing financing ratios with non-linear patterns confirm the theoretical proposition that Islamic banking faces dual compliance that creates a trade-off between profitability optimization and adherence to sharia principles. Ratio analysis financing to deposits averaged 89.4% with a standard deviation of 1.7% shows conservatism in liquidity management consistent with the findings (Marjanah & Hariani, 2023) that liquidity has a significant negative influence on company value when moderated by company size. These findings indicate that Islamic banking tends to maintain a higher liquidity buffer in anticipation of the volatility of third-party funds, which is in line with the prudential principle in Islamic banking governance (Firani et al., 2024).

The average capital adequacy ratio of 22.5% which is above the regulatory minimum confirms adequate capital strength but has implications for opportunity costs in optimizing profitability. The effectiveness of contemporary risk management implementations demonstrates significant heterogeneity based on the categorization of bank size. Banks with assets above IDR 50 trillion achieved an effectiveness score of 78.5% compared to 58.9% for small banks, confirming the findings (Dewi, 2023) that company size strengthens the influence of profitability on company value. This disparity can be explained through resource-based theory where large banks have superior ability to allocate resources for the development of sophisticated risk management systems. A significant positive correlation between risk management effectiveness and ROA ($r=0.68$, $p<0.01$) validates the hypothesis that investments in risk management infrastructure result in sustainable value creation. The integration of technology in the modernization of risk management identifies a digital transformation that is gradual but not yet optimal. The adoption of cloud-based risk management information systems by 67% with a 32% increase in operational efficiency confirms the findings (Zarkasih et al., 2024) that innovation budgets are a major factor in accelerating industrial innovation.

The implementation of artificial intelligence and machine learning, which reached 53% in large banks, indicates that the technology adoption cycle is still in the early majority stage. Positive ROI after 18-24 months of implementation with a 45% increase in risk prediction accuracy confirms the strategic value of technology investments in risk management. The impact of risk management on profitability optimization confirms a statistically significant positive causal relationship. A one-unit increase in effectiveness score contributed to an increase in ROA of 0.034% and ROE of 0.28%, confirming the findings (Ayem & Solop, 2023) that company size has a significant positive influence on profit quality. The decomposition analysis identified the largest contribution from credit risk management optimization (42%), which is consistent with the characteristics of financing-based Islamic banking. Risk-adjusted performance metrics with a Sharpe ratio of 0.73 to 0.51 indicate superior risk-return trade-offs in banks with optimal risk management.

The findings regarding the effect of a 6–9-month delay in the manifestation of the positive impact of risk management on profitability confirm the dynamic nature of risk management effectiveness. This phenomenon can be explained through dynamic capability theory where the adaptation of organizational capabilities requires a period of adjustment before producing measurable performance improvements. The 35% lower cost of risk in banks with integrated risk management systems confirms the efficiency gains of comprehensive risk management implementations, in line with the findings (Hidayat et al., 2024) that quality management implementation can significantly improve operational effectiveness. The synthesis of research findings confirms that the implementation of financial risk management

In Islamic banking, it is a strategic imperative that results in sustainable competitive advantages. The heterogeneity in the sophistication of risk management based on bank size indicates the need for regulatory intervention to raise minimum standards in risk governance. Gradual technology integration shows the readiness of technology that needs to be accelerated to optimize risk management capabilities. The persistent value creation of superior risk management confirms the economic justification for continuous investment in risk management infrastructure as a value driver in optimizing the profitability of Islamic banking.

5. Conclusions

This study confirms that the optimal implementation of financial risk management makes a significant contribution to improving the profitability performance of the Islamic banking sector. Empirical findings show a positive correlation between the effectiveness of risk management with a ROA of 0.68 and an increase in effectiveness score resulting in a growth in ROA of 0.034% and an ROE of 0.28%. The heterogeneity of risk management sophistication based on bank size indicates a disparity in institutional capabilities in optimizing risk frameworks. The integration of digital technology in the modernization of risk management systems shows significant potential but still requires accelerated adoption to achieve full optimization.

Islamic banking needs to accelerate investment in digital technology and integrated risk management information systems to improve prediction accuracy and responsiveness to dynamic market volatility. Regulators should develop a regulatory framework that supports the standardization of risk management practices by taking into account the unique characteristics of Islamic banking operations and the complexity of dual compliance. Islamic banking institutions need to strengthen the capacity of human resources through continuous training programs in modern risk management that are integrated with Islamic principles.

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