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The Impact of COVID-19 on Islamic Rural Banks' Profitability and Capital Adequacy Ratio

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Abstract

Purpose – This study aims to analyze the impact of the COVID-19 pandemic on the financial performance of Islamic Rural Banks (IRB) in the Banten region, focusing on profitability and capital adequacy ratios as indicators of financial soundness.

Methodology – The research employs a quantitative approach, utilizing descriptive and comparative methods. Data from eight IRB institutions in Banten were collected and assessed using the Financial Services Authority Regulation (POJK) No. 3 of 2022 to evaluate the soundness of the IRB. The Paired Sample T-Test was used to analyze four key financial ratios: Return on Assets (ROA), Operating Expenses to Operating Income (BOPO), Capital Adequacy Ratio (KPMM), and Core Capital to Non-Performing Productive Assets (MIAPB).

Findings – After the pandemic, profitability declined significantly, with average ratings falling from 3 (moderately adequate) to 4 (less adequate). This decline was evident in lower ROA and higher BOPO, reflecting reduced operational efficiency and profit margins. Capital adequacy remained stable at 2 (adequate), unaffected by the pandemic.

Implications – These findings demonstrate the vulnerability of Islamic microfinance institutions to profitability during crises, while also highlighting their resilient capital structures. Policymakers and banking practitioners can utilize these insights to develop adaptive strategies that enhance operational efficiency and crisis preparedness in Islamic banking.

Originality – This study contributes to the limited empirical research on the post-COVID-19 financial health of IRB in Indonesia, particularly in Banten province. It uniquely applies the updated POJK No. 3/2022 and integrates profitability and capital indicators to evaluate the resilience of Islamic rural banks during a global health crisis.

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1. Introduction

The spread of the SARS-CoV-2 coronavirus, or COVID-19, which was declared a global pandemic by the World Health Organization (WHO), has had a profound impact on nearly all sectors of the economy, including the financial institutions sector (World Bank, 2020). The pandemic disrupted global supply chains, leading to a decline in foreign direct investment in

Indonesia. As a result, Indonesia's economic growth slowed from 5.02 percent in 2019 to just 2.97 percent in 2020 (BPS, 2021).

This economic slowdown was accompanied by a rise in unemployment, which, according to the World Bank, increased from 5.28 percent in 2019 to 7.07 percent in 2020 (World Bank, 2021). As financial intermediaries that collect and distribute public funds, banks were not immune to the domino effect of the COVID-19 pandemic. Communities, as both depositors and financing recipients, experienced financial pressure that could lead to the withdrawal of third-party funds and an increase in non-performing financing risks, ultimately affecting bank liquidity and profitability (Ismail, 2018).

Although COVID-19 was officially declared to have ended as a pandemic through Presidential Decree No. 17 of 2023—changing its status to endemic as of June 30, 2023—the economic impact did not cease immediately, especially in the banking sector, which is highly dependent on the performance of the real sector (Keputusan Presiden Nomor 17 Tahun 2023 Tentang Penetapan Berakhirnya Pandemi COVID-19 Di Indonesia, 2023). Previous studies by Tiono and Djajang identified significant differences in banking performance based on NPL, ROA, and LDR ratios before and after the pandemic. Similarly, research by Rudy and Endang concluded that the pandemic had a real adverse effect on the profitability of rural banks (Rudy & Endang, 2022). This is further supported by the fact that several rural banks and IRB were declared bankrupt after the pandemic. In 2023, four IRBs had their licenses revoked, and by the first semester of 2024, the Financial Services Authority (OJK) had revoked permits for 12 more institutions—10 conventional BPRs and 2 Islamic rural banks (Otoritas Jasa Keuangan, 2024).

This development is of grave concern to all stakeholders, including rural bank management, academics, and customers alike. Considering that Islamic banking is part of the muamalah (transactional) system in Islam, its existence must be preserved as a sharia-compliant financial system free from usurious practices (Antonio, 2011). To strengthen the rural bank industry, OJK issued Regulation No. 28/POJK.03/2023 as a refinement of Regulation No. 32/POJK.03/2019, governing the status and follow-up supervision of rural banks and IRB. This includes new provisions regarding fund placement mechanisms by the Deposit Insurance Corporation (LPS) and supervision of three leading indicators: Cash Ratio, Capital Adequacy Ratio (KPMM), and Soundness Level (POJK No. 28/POJK.03/2023).

Furthermore, Law No. 21 of 2008 concerning Islamic Banking mandates that Islamic banks and Islamic business units must maintain soundness through financial aspects (capital, asset quality, profitability, liquidity, and solvency), as well as management and compliance with Sharia principles (UU No. 21 Tahun 2008 Tentang Perbankan Syariah, 2008). Additionally, the OJK has issued Regulation No. 3/POJK.03/2022, effective for reporting as of December 2023, replacing Regulation No. 20/POJK.03/2019. The new regulation transitions the bank health assessment from the CAMEL approach (Capital, Asset, Management, Earning, Liquidity) to a risk-based approach, known as RBBR (Risk-Based Bank Rating), which assesses the risk profile, governance, profitability, and capital (POJK No. 3/POJK.03/2022).

A sound banking system is a key pillar in maintaining national financial stability. Bank health is a primary concern for owners, management, regulators, and the public. Banks that can carry out their intermediation function effectively are better positioned to maintain public trust and support the smooth operation of the national payment system (Van Greuning & Bratanovic, 2009). As a buffer region for the capital city, Banten Province—with a Muslim-majority population of 94.16%—has significant potential for the development of Islamic rural banks. Therefore, evaluating the soundness level of the IRB in Banten in the post-pandemic period is essential to understand how effectively these institutions have adapted.

Banten is a strategically located region, home to the ports of Merak and Bojonegara, which connect Sumatra and Jakarta. It comprises four regencies (Pandeglang, Lebak, Serang, Tangerang) and four cities (Tangerang, Cilegon, Serang, and South Tangerang). Out of its 10,637,089 inhabitants, 10,016,177 (94.16%) identify as Muslim. In the post-pandemic economic context, it is crucial to assess how well IRB in Banten has adapted to market and liquidity changes. This study aims to analyze profitability and capital adequacy ratios by determining the ranking of these indicators in the IRB in Banten after the COVID-19 pandemic.

Previous studies have examined the impacts of the COVID-19 pandemic on IRB from various perspectives. Hosen et al. (2021) found a decline in profitability due to restrictions on economic activity, while Sari et al. (2022) reported a decrease in operational efficiency linked to rising non-performing financing. Rachmawati and Firmansyah (2022) highlighted the importance of capital resilience in withstanding economic pressures during the pandemic. Dewi and Putra (2021) emphasized the need for strategic business adjustments to maintain profitability in the post-pandemic era. Fauziah et al. (2023) analyzed the capital structure of Islamic banks, including IRB, though without a specific focus on financial soundness ratios. Similarly, Wijayanti and Saputra (2022) noted a deterioration in the quality of productive assets as non-performing financing increased. Purnomo and Ramdani (2021) discussed the impact of disrupted financing distribution on profits in urban IRB. Rahmawati (2022) explored financial resilience during crises but did not detail the updated POJK soundness framework. Fitriana and Nurdin (2023) emphasized the importance of profitability evaluations in enhancing risk management strategies following the COVID-19 pandemic. Meanwhile, Anwar et al. (2022) researched microfinance practices in IRB but did not explicitly connect profitability ratios to post-pandemic health levels.

However, previous studies on IRB in Banten have yet to specifically examine financial ratios in relation to the health level of these institutions after the pandemic. Therefore, this research aims to fill that gap by analyzing the post-pandemic health status of the IRB in Banten, with the hope that its findings will contribute to policy development by stakeholders, academics, and the local government. Unfortunately, specific studies examining financial ratios and the health level of the IRB in Banten after the COVID-19 pandemic remain very limited. Hence, this study aims to analyze profitability and capital adequacy ratios as part of the IRB health indicators in the Banten region, with the expectation that its findings will offer meaningful contributions to regulators, banking practitioners, and scholars in formulating policies and strategies to strengthen local Islamic banking.

2. Literature Review

2.1 The Financial Ratio Theory

The theory of financial ratios is one of the primary approaches used to analyze the performance and soundness of financial institutions, including Islamic banks. Financial ratios are utilized to interpret the relationships among items in financial statements, providing a deeper understanding of an institution's effectiveness, efficiency, and financial stability. In this context, financial ratios serve as quantitative measurement tools that assist internal management, regulators, and external parties such as investors and depositors in evaluating performance and making data-driven decisions (Harahap, 2011). Ratio analysis also aligns with the principles of transparency and accountability in the Islamic financial system, which emphasizes the importance of managing entrusted resources in a professional and just manner.

In this study, the financial ratio theory is applied to assess two key aspects: profitability and capital adequacy. Profitability is measured through two leading indicators. First, Return on Assets (ROA), which reflects how effectively a bank's assets are used to generate profit. ROA is a critical indicator of asset management efficiency and the bank's ability to generate income from its total resources (Munawir, 2014). Second, the BOPO ratio (Operating Expenses to Operating Income), which measures operational efficiency. This ratio shows the proportion of operational costs incurred to generate income; thus, the lower the BOPO value, the more efficient the bank's operations (Kasmir, 2010).

On the other hand, capital adequacy is assessed through two key ratios. The first is the Capital Adequacy Ratio (CAR), which indicates the extent to which a bank has sufficient capital to cover potential risks, including credit, operational, and market risk. This ratio is a primary tool used by regulators to evaluate a bank's resilience to financial shocks (Van Greuning & Bratanovic, 2009). The second is MIAPB (Core Capital to Non-Performing Productive Assets), which measures explicitly a bank's ability to absorb potential losses from non-performing financing. A higher

MIAPB ratio indicates a stronger capital structure to withstand financing risks. Thus, financial ratio theory functions not only as a technical analytical tool but also as an essential instrument in strategic decision-making for Islamic banking. It reflects both prudential principles and Shariah values, such as justice, transparency, and sustainability, in fund management.

2.2 Theory of Bank Soundness Analysis

Bank soundness assessment is a critical approach to evaluating the extent to which a bank, including Islamic Rural Banks (BPR Syariah), can effectively perform its intermediation function, maintain financial stability, and manage potential risks. This assessment is particularly relevant because BPR Syariah functions as a financial institution that collects funds from the public and channels them to productive sectors based on sharia principles, thus requiring strict supervision and performance evaluation. Bank soundness assessment also serves as an essential instrument for the Financial Services Authority (OJK) to issue early warnings when signs of performance deterioration or potential problems that could threaten the bank's continuity are detected (Ismail, 2018).

Since 2022, the assessment of IRB soundness in Indonesia has been based on OJK Regulation No. 3/POJK.03/2022. This regulation introduces a new framework known as the Risk-Based Bank Rating (RBBR) approach, which replaces the previous CAMELS-based method. RBBR aims to provide a more comprehensive evaluation of a bank's condition by not only relying on financial ratios but also examining risk profiles and the effectiveness of risk management. Through this approach, bank soundness assessments become more dynamic and responsive to changes in the business environment, and better equipped to anticipate future risks (POJK No. 3/POJK.03/2022).

RBBR consists of four core components: risk profile, good corporate governance (GCG), earnings, and capital. The risk profile assesses how effectively a bank identifies and manages key risks, including credit risk, liquidity risk, operational risk, and legal risk. The GCG component evaluates the bank's management's adherence to sound governance principles, including the roles of the Board of Commissioners, the Board of Directors, and the Sharia Supervisory Board. The earnings component measures the bank's ability to generate profits through indicators such as Return on Assets (ROA) and the Operating Expenses to Operating Income (BOPO) ratio. Meanwhile, the capital component evaluates the adequacy of the bank's capital to absorb potential losses, typically through the Capital Adequacy Ratio (CAR) and assessments of capital structure concerning risk exposures (Faturohman & Pratama, 2023).

Compared to the CAMELS approach, which primarily focuses on historical data and financial reports, RBBR is considered more comprehensive as it includes managerial aspects and forward-looking risk management strategies. Consequently, this approach is more adaptable to the growing complexity of the Islamic banking industry, especially in the context of increasing digitalization and emerging risks, such as technological and reputational risks. RBBR encourages BPR Syariah to improve not only their financial performance but also to strengthen their foundations in risk management, corporate governance, and long-term strategic planning (Antonio, 2011).

As an official regulatory reference, this approach is governed by POJK No. 3/POJK.03/2022 issued by OJK. Furthermore, various literature, such as Antonio (2011) and Sutedi (2011), as well as numerous academic journals on Islamic finance, discuss the effectiveness of RBBR implementation in maintaining the soundness and stability of Islamic banks. This approach is expected to foster a resilient and healthy Islamic rural banking industry that supports the development of a sharia-based economy in Indonesia (Sutedi, 2011).

2.3. Islamic Finance Theory

Islamic finance theory is a normative framework that situates financial activities within the boundaries of Shariah values. It does not merely pursue profit but also seeks to uphold social justice, ethics, and sustainability. From this perspective, financial transactions must be free from prohibited elements such as *riba* (interest), *gharar* (excessive uncertainty), *maysir* (speculation), and any form of *zulm* (injustice) that may harm one party. Conversely, transactions are encouraged to be based on mutual consent (*taradhi*), transparency, and social responsibility. Shariah financial ethics require that every transaction not only be legally valid but also aligned with the maqasid al-shariah—the higher objectives of Islamic law, namely the protection of religion, life, intellect, lineage, and wealth (Chapra, 2000).

In this paper, the ethical foundation of Islamic finance is evaluated through five core shariah principles that form the moral and philosophical basis of the Islamic financial system: *ukhuwah* (brotherhood), '*adl* (justice), *maslahah* (public interest), *tawazun* (balance), and *syumuliyah* (universality). The principle of *ukhuwah* emphasizes social solidarity in economic transactions, whereby profit should not be gained at the expense of others. The principle of *'adalah* demands fairness in risk sharing, profit distribution, and equal treatment among contracting parties. *Maslahah* refers to promoting collective benefits and preventing social harm through an inclusive and responsible financial system (Dusuki et al., 2007).

Furthermore, the principle of *tawazun* underscores the importance of maintaining balance between individual and societal interests, between material and spiritual dimensions, and between economic growth and environmental preservation. The principle of *syumuliyah,* or universality, affirms that Islamic values are comprehensive and applicable to all areas of life, including modern financial systems, without compromising relevance or fairness. Hence, the Islamic financial system is designed not only for Muslims but also as a blueprint for a just, stable, and sustainable economic order for all of humanity (Siddiqi, 2001).

Islamic finance theory is not merely an alternative to the conventional system; instead, it offers an ethical paradigm that places spiritual and humanistic values at the core of financial system design and evaluation. These principles serve as benchmarks to assess whether a financial product aligns with Shariah objectives or deviates from the moral values of Islam.

2.3 Risk Theory in Banking

Risk theory in banking is an analytical approach used to identify, measure, monitor, and control potential losses that may arise from banking activities. In this context, banks, as financial intermediaries, are exposed to various types of risks stemming from changes in macroeconomic conditions, financial markets, customer behavior, internal policies, and legal or compliance factors. Therefore, risk management is an integral part of the banking supervision system, both internally and externally, including oversight by regulatory authorities such as the Financial Services Authority (OJK) (Hull, 2018).

In modern banking practices, including Islamic banking systems, risk profile assessment encompasses several key risk dimensions. First, credit risk refers to the possibility that a borrower may fail to meet their obligations. Second, liquidity risk refers to the risk that a bank may be unable to meet its short-term obligations due to a lack of readily available funds. Third, operational risk, which includes failures in internal processes, technological systems, or human errors that may result in financial loss (Van Greuning & Bratanovic, 2009).

Additionally, there is a compliance risk that arises from failure to adhere to legal regulations, including Sharia principles in Islamic banking. Strategic risk refers to losses resulting from flawed strategic decisions or misalignment of the bank's policies with market dynamics. Market risk refers to fluctuations in market variables, such as interest rates, exchange rates, or commodity prices, that may affect the bank's financial position. Reputational risk involves damage to public trust caused by legal issues, social controversies, or service failures. Lastly, the rate of return and investment risk is a specific risk in Islamic banking, arising from a mismatch between customer profit expectations and the actual investment returns generated by the bank (Iqbal & Mirakhor, 2011).

Assessment of the full spectrum of these risks aims to determine the bank's capacity and resilience in facing potential losses, both from internal and external sources. Therefore, sound risk management involves the formulation of policies, internal control systems, risk mitigation strategies, and measurable risk reporting mechanisms. Under the regulatory framework of OJK and the Risk-Based Bank Rating (RBBR) approach, risk management systems serve as one of the key benchmarks for determining a bank's soundness and business sustainability (POJK No. 3/POJK.03/2022).

2.5 Signaling Theory

Signaling theory, developed by Michael Spence (1973) in the context of information economics, is widely used to explain how parties with more information (typically business actors) can send signals to those with less information (such as investors, consumers, or regulators). In the context of banking—especially Islamic Rural Banks (IRB)—signaling theory suggests that financial reports and key financial ratios serve as crucial signals that reveal the internal condition of a bank to external parties who lack direct access to such information (Spence, 1973).

Financial ratios such as Return on Assets (ROA), Operating Efficiency Ratio (BOPO), Non-Performing Financing (NPF), Capital Adequacy Ratio (CAR), along with liquidity and financing ratios, provide indications of IRB performance, profitability, and financial stability. According to signaling theory, strong ratios act as positive signals that enhance the perception of investors, regulators, and the public regarding the bank's credibility and long-term prospects. Conversely, weak financial ratios may serve as early warning signals of potential risks, which could reduce public trust and lead to increased regulatory scrutiny (Ross et al., 2008).

The theory also underscores the importance of transparency and accountability in financial reporting as a form of honest communication between internal and external stakeholders. In the context of limited public access to a bank's internal operations, financial statements become the primary tools for building trust and maintaining institutional reputation. In Islamic banking, the signals sent through financial reports not only reflect financial soundness but also demonstrate a commitment to Shariah principles such as justice (*'adl*), public interest (*maslahah*), and trust (*amanah*). Therefore, the financial reports of IRB are not merely administrative instruments, but also a part of morally and socially responsible financial communication strategies (Iqbal & Mirakhor, 2011).

Signaling theory thus provides a theoretical foundation for understanding why regular, accurate, and reliable disclosure of financial information is crucial in Islamic banking. On the one hand, such disclosures affirm the institution's stability and integrity; on the other hand, they serve as a market monitoring tool and as a determinant of public trust in an ethical and sustainable Islamic financial system.

3. Research Methods

This study employs a quantitative approach combining descriptive and comparative methods. The quantitative method was chosen to objectively measure and analyze numerical data (Sugiyono, 2018), while the descriptive method systematically illustrates the financial condition of Islamic Rural Banks (IRB) in Banten (Nazir, 2011). The comparative method is applied to examine differences in economic performance before and after the COVID-19 pandemic (Kasmir, 2010).

The population for this study comprises all BPR Syariah institutions operating in Banten Province, with eight institutions selected as the sample based on the availability of complete financial reports. The sample was drawn using purposive sampling, targeting those banks that consistently published financial statements for both the pre-pandemic and post-pandemic periods. The data analyzed are secondary data taken from audited financial reports of these eight IRB, focusing on four key financial ratios: Return on Assets (ROA), Operating Expenses to Operating Income (BOPO), Minimum Capital Adequacy Requirement (KPMM), and Core Capital to Non-Performing Productive Assets (MIAPB), in line with standard references (Kasmir, 2010).

The analysis refers to the assessment standards of Financial Services Authority Regulation (POJK) Number 3 of 2022 concerning the soundness level of IRB (OJK, 2022). To test for significant differences between the pre-pandemic and post-pandemic conditions, the Paired Sample T-Test was applied, as this technique is appropriate for comparing two directly related samples over different periods (Ghazali, 2018). The analysis was performed using statistical software (such as SPSS) to ensure accurate and reliable results.

Table 1. Variable Measurement

Variable	Indicator	Scale	Source
Profitability (ROA)	Net profit after tax divided by total assets	Ratio	Kasmir (2010), POJK No.3/2022
Operational Efficiency (BOPO)	Operating expenses divided by operating income	Ratio	Kasmir (2010), POJK No.3/2022
Capital Adequacy (KPMM)	Capital divided by risk-weighted assets	Ratio	POJK No.3/2022
Core Capital to Non-Performing Productive Assets (MIAPB)	Core capital divided by non-performing productive assets	Ratio	POJK No.3/2022

4. Results and Discussion

The research findings indicate that the profitability aspect of IRB in the Banten region experienced a significant decline following the COVID-19 pandemic. Descriptively, the average profitability rating dropped from level 3 (fairly adequate) to level 4 (less adequate), based on indicators such as Return on Assets (ROA) and the Operating Expenses to Operating Income ratio (BOPO). The decline in ROA reflects a decrease in net income relative to total assets, while the increase in BOPO indicates reduced operational efficiency and rising cost burdens. These findings demonstrate that the COVID-19 pandemic hurt the financial performance of IRB, particularly in terms of generating profits and managing operating expenses (Ilhami & Thamrin, 2021). The pandemic led to a rise in non-performing financing risks and a contraction in public economic activity, directly lowering the operating income of Islamic rural banks.

Conversely, the research findings on capital adequacy show a relatively stable condition. Both before and after the pandemic, the capital rating of IRB consistently remained at level 2 (adequate), as indicated by the Capital Adequacy Ratio (KPMM) and the Core Capital to Non-Performing Productive Assets Ratio (MIAPB). This result suggests that the IRB in Banten maintained a sufficiently strong capital structure to absorb potential losses arising from the pandemic's economic impact. Such stability aligns with risk profile theory, which states that financial institutions with conservative risk management and relatively safe asset portfolios are better able to withstand shocks (Rose & Hudgins, 2013). Furthermore, the resilience of capital adequacy may also have been supported by policy measures, such as government credit restructuring programs and temporary regulatory relief issued by the OJK during the pandemic (OJK, 2021), which helped to avoid a sudden erosion of capital buffers. The consistency of capital soundness supports the view that IRB adheres to prudent financial management practices to safeguard depositor funds (Kadir & Rahman, 2021).

Statistical testing using the Paired Sample T-Test strengthens the descriptive analysis. The test results confirm a significant difference in profitability before and after the pandemic, with a p-value below 0.05, indicating that the COVID-19 pandemic had a statistically significant adverse effect on IRB profitability. In contrast, no significant difference was found for capital adequacy, meaning that the banks' capital positions remained robust throughout the observed period.

This is consistent with Widyaningtyas and Dura (2021), who noted that during economic crises, capital tends to be more resilient to shocks than profitability. These findings are crucial for policymakers and bank managers, suggesting that post-pandemic recovery strategies should prioritize efforts to restore profitability through improved operational efficiency and innovation, while still preserving the banks' relatively strong capital structures to remain resilient in the face of future crises.

5. Conclusion

This study aimed to examine the impact of the COVID-19 pandemic on the financial soundness of Islamic Rural Banks (IRB) in Banten Province, with a specific focus on profitability and capital adequacy ratios. The objective was to assess how the pandemic influenced the financial performance of IRB and to evaluate the resilience of these institutions in maintaining capital stability during economic disruptions.

The findings indicate that profitability experienced a statistically significant decline post-pandemic, as reflected in the drop from a fairly adequate to a less adequate rating. This was evidenced by a decrease in Return on Assets (ROA) and an increase in the BOPO ratio, highlighting reduced operational efficiency and income generation. In contrast, capital adequacy—measured through KPMM and MIAPB—remained consistently stable at an adequate level, showing no significant change between the pre- and post-pandemic periods. These results suggest that while IRB faced pressure in maintaining profitability, their capital base remained resilient against external shocks.

These findings provide valuable insights for regulators, policymakers, and bank managers. The decline in profitability signals the need for more adaptive operational strategies, particularly in enhancing efficiency and diversifying revenue streams. Meanwhile, capital stability underscores the importance of prudent risk management and regulatory frameworks, such as POJK No. 3/2022, in preserving financial resilience. Post-pandemic recovery policies should prioritize restoring profitability while maintaining capital adequacy as a foundation for economic stability.

This study is limited by its focus on a specific region (Banten Province) and a relatively small sample size of eight BPR Syariah. Future research could expand the geographic scope and incorporate qualitative insights from bank management to gain a deeper understanding of internal strategic responses. Further studies may also investigate the long-term effects of government stimulus programs and regulatory interventions on the performance of Islamic rural banks beyond the immediate post-pandemic period.

Author Contributions

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