

The Role of Compliance Risk Management in Improving the Sustainability of Islamic Banks

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Abstract

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This study focuses on the importance of compliance risk management in maintaining the operational conformity of Islamic banks with sharia principles and applicable regulations, as well as its impact on the sustainability and stability of banks. In facing regulatory challenges and operational risks, Islamic banks require an effective risk management system to avoid potential financial losses and reputational damage. This study uses a qualitative approach with a case study design. Data were collected through case study examinations and review of related documents, including annual reports and applicable regulations. Another method of data collection is a literature review, which involves collecting, reading, and processing various relevant literature sources. The research findings indicate that compliance risk management implemented in banks is effective in identifying, evaluating, and mitigating risks related to non-compliance with sharia principles and laws and regulations. This contributes to the sustainability of bank operations, increasing customer trust, and reducing potential losses caused by reputational and legal risks. However, challenges related to regulatory changes and limited human resources remain obstacles to more optimal implementation.

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1. Introduction

Islamic banks are financial institutions that operate based on Islamic principles, which serve as the foundation for all their activities. As intermediary institutions, their main function is to collect and distribute public funds while adhering to applicable Islamic regulations. Compliance with Islamic principles is not only essential to align business activities with religious norms but also to ensure operational sustainability and maintain the bank's reputation (Elgharbawy, 2020). In this regard, compliance risk management plays a crucial role in supporting the survival of Islamic banks amidst various challenges. This system is designed to identify, assess, and manage risks arising from non-compliance with laws and Islamic principles. Without effective risk management, Islamic banks may face negative financial, operational, and reputational consequences that can threaten long-term sustainability.

As financial institutions based on Islamic law, these banks must comply with national legal frameworks while ensuring alignment with prohibitions such as *riba*, *gharar*, and *maysir*. Failure to comply can lead to financial losses and damage to reputation, eroding public trust, a critical element for survival. Compliance risk management ensures that every business decision aligns with established Islamic guidelines and legal requirements (Jan et al., 2019). According to Novita (2019), effective compliance risk management enables Islamic banks to identify and mitigate risks threatening sustainability. One of the most significant risks is reputation risk, which may arise from violations of Islamic principles or regulations. Such risks can damage the public image of a bank and affect customers' trust when choosing where

to place their funds. Conversely, banks that consistently demonstrate compliance earn stronger reputations and greater customer loyalty, allowing them to attract and retain clients (Elamer et al., 2020). However, scandals or violations can quickly erode trust, jeopardizing financial stability.

Compliance risk management also helps Islamic banks adapt to economic challenges and regulatory changes while managing other risks, such as market, credit, and operational risks. A robust risk management framework allows institutions to anticipate shifts in the environment and develop strategies to ensure continuity. Financing is one critical area, as it represents a major product for Islamic banks and has a direct impact on sustainability (Shad et al., 2019). Financing carries inherent risks, and banks must ensure every transaction complies with Islamic principles, avoiding *riba*, *gharar*, and *maysir*. Proper financing risk management also reduces exposure to high-risk ventures, such as businesses with unclear prospects or clients with weak credit histories (Jan et al., 2021).

The ability of Islamic banks to manage risks directly affects their competitiveness. Institutions with strong risk management can maintain stability, avoid losses, and adapt to market changes more effectively. Effective risk management not only supports operational continuity but also fosters long-term growth by encouraging process improvements and organizational resilience (Alhammadi et al., 2020). A strong compliance risk management system further ensures adherence to laws and Islamic principles, safeguarding both short-term performance and long-term viability. Ultimately, the sustainability of Islamic banks depends not only on financial performance but also on their ability to maintain

compliance. Institutions that effectively manage compliance risks will be better equipped to survive challenges and sustain growth. This includes maintaining financial stability, ensuring operational continuity, preserving reputation, and strengthening public trust.

As Mustapha et al. (2021) argue, compliance risk management by monitoring and addressing risks tied to Islamic principles and regulations is a key factor for long-term survival and growth. The purpose of this study is to analyze the role of compliance risk management in enhancing the sustainability and stability of Islamic banks. It explores how compliance systems help identify, mitigate, and manage risks such as reputation, legal, and operational risks. Furthermore, the study examines how compliance strengthens trust among customers and the public, which is vital for long-term success. The research seeks to contribute both to managerial practices and regulatory policy. For Islamic banks, it offers insights into the importance of implementing robust compliance systems to maintain stability and reputation. For regulators, it provides recommendations for frameworks that support compliance risk management and encourage sustainable growth in Indonesia's Islamic banking sector.

2. Methods

This research employs a qualitative approach with a case study design to examine the role of compliance risk management in enhancing the sustainability and stability of Islamic banks, with a specific focus on Bank Muamalat Indonesia. The case study approach was selected because it provides the opportunity to explore

complex phenomena within their real-life context, offering a deeper and more holistic understanding of how compliance risk management is implemented in practice. Unlike purely quantitative approaches, a case study allows researchers to capture the nuances of organizational behavior, internal processes, and contextual challenges that influence the success of compliance efforts.

Data collection was carried out through two primary methods: direct case study examination and a comprehensive review of relevant documents. The case study examination involved analyzing how Bank Muamalat Indonesia applies compliance risk management in its operational activities, the strategies used to identify and mitigate risks, and the impact of these practices on the bank's long-term stability and sustainability. In parallel, a document review was undertaken by gathering and analyzing various sources such as annual reports, internal policies, compliance guidelines, and regulatory frameworks that govern Islamic banking practices in Indonesia.

To strengthen the analysis, a literature review was also conducted. This process included identifying, reading, and synthesizing information from books, peer-reviewed journal articles, and other credible internet-based resources. The purpose of this literature review is threefold: first, to clarify and frame the research problem; second, to build a strong theoretical foundation regarding compliance risk management and Islamic banking sustainability; and third, to support and validate the findings derived from the case study. Through this integrated approach, the study aims to generate a comprehensive understanding of how compliance risk

management contributes to sustaining Islamic banks in an increasingly competitive financial environment.

3. Results

Compliance risk management plays a crucial role in enhancing the sustainability and stability of Islamic Banks, particularly at Bank Muamalat Indonesia. Based on the case study conducted, it can be concluded that the implementation of effective compliance risk management at Bank Muamalat Indonesia has a significant impact on the operational sustainability of the bank, both in financial and reputational aspects. As the first Islamic bank in Indonesia, established in 1991, Bank Muamalat has long served as a pioneer in the development of Islamic banking in the country (Bayinah et al., 2021). Its existence has not only inspired the growth of other Islamic financial institutions but also created a benchmark for compliance with Islamic principles in financial services. Because of this pioneering role, the expectations placed upon Bank Muamalat are particularly high, and the need to implement a strong compliance risk management framework becomes all the more essential.

Bank Muamalat Indonesia faces significant challenges in ensuring that all of its operational activities comply with Islamic principles and applicable regulations. Unlike conventional banks that only need to follow national banking regulations, Islamic banks must adhere to both sharia regulations and the legal frameworks established by financial authorities such as Bank Indonesia and the *Otoritas Jasa Keuangan* (OJK) (Nastiti & Kasri, 2019). This dual requirement means that risk

management practices must be designed not only to address financial and operational risks but also to safeguard adherence to Islamic values. One of the key findings of this study is that the compliance risk management implemented by Bank Muamalat focuses on identifying, evaluating, and mitigating risks related to non-compliance with Islamic regulations and laws (Hanefah et al., 2020). For instance, the bank has a strict system in place to ensure that the products offered, such as financing and savings, are in accordance with Islamic principles and comply with the provisions of the National Sharia Council – Indonesian Ulema Council (DSN-MUI) and Islamic banking regulations set by regulators.

In practice, compliance risk management at Bank Muamalat Indonesia also includes the implementation of stringent internal procedures to monitor operational activities continuously. Every product offered by the bank is required to undergo an internal audit and careful sharia review to ensure there are no violations of Islamic principles. These internal audits are not merely administrative checks; they involve a thorough examination of contracts, financial flows, and the underlying business activities being financed (Vezenkoska et al., 2017). For example, when extending financing to a corporate client, Bank Muamalat must ensure that the project financed does not involve prohibited elements such as alcohol, gambling, or speculative activities. This detailed oversight demonstrates the depth of compliance risk management within the institution.

Additionally, the bank regularly conducts training and updates for all employees regarding the importance of compliance with Islamic principles and applicable regulations (Ullah et al., 2018). These training programs are aimed at

enhancing employees' understanding of sharia values and equipping them with the knowledge to recognize potential compliance risks in their daily tasks. By doing so, the bank attempts to cultivate a culture of compliance across all organizational levels. Furthermore, periodic refresher seminars ensure that staff members remain updated on the latest regulatory changes and developments in Islamic finance practices.

The implementation of proper compliance risk management allows Bank Muamalat Indonesia to avoid potential losses that may occur due to non-compliance with Islamic principles, such as legal sanctions, loss of customer trust, or operational disruptions. In particular, reputation risk emerges as one of the most significant factors that could harm Islamic banks, and it becomes a major focus in compliance risk management (Grassa et al., 2021). This study found that by maintaining strict compliance with Islamic principles, Bank Muamalat has been able to maintain its reputation as a trusted Islamic bank, which is crucial in maintaining customer loyalty and attracting new customers. In the context of Islamic finance, reputation is not only tied to service quality but also directly to the perception of the bank's adherence to sharia principles. Any violation could quickly erode decades of credibility, making compliance risk management indispensable for long-term sustainability.

Moreover, effective compliance risk management also impacts the financial sustainability of Bank Muamalat Indonesia. By minimizing potential legal and reputational risks, the bank can maintain financial stability and improve its competitiveness in the market. Products that are fully aligned with Islamic principles and meet regulatory standards attract more customers who value both ethical considerations and sustainable financial practices. For instance, customers seeking

sharia-compliant mortgages or investment products prefer institutions like Bank Muamalat, which demonstrate strong compliance systems. This alignment between compliance and customer expectations allows the bank to strengthen its market position.

Bank Muamalat Indonesia also benefits from good risk management in terms of its ability to plan business strategies more effectively and make the right decisions when facing market changes and evolving regulations (Hamidi & Worthington, 2021). From an operational perspective, this study shows that the compliance risk management system implemented by the bank also includes the improvement of internal processes, such as periodic internal audits and the adoption of more advanced information technology systems to monitor every transaction. These technologies help automate compliance checks, reduce human error, and ensure that irregularities are detected in real time. By integrating IT into compliance monitoring, the bank increases its efficiency while strengthening oversight. This enables the institution to take corrective actions before potential issues escalate into larger problems.

However, this study also found challenges faced by Bank Muamalat Indonesia in implementing comprehensive compliance risk management. One of the main challenges is the frequent regulatory changes, both nationally and internationally, that require continuous adjustments in operational procedures and risk management policies (Kotsanopoulos & Arvanitoyannis, 2017). For example, global standards in Islamic finance issued by bodies such as AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) and IFSB (Islamic Financial Services

Board) continue to evolve, influencing how banks in Indonesia must adjust their practices. Therefore, the bank must constantly adapt to regulatory developments and ensure that every policy and procedure applied is always up-to-date and compliant with the applicable rules.

Furthermore, the limited number of human resources specifically trained in sharia matters also poses a challenge in implementing more optimal compliance risk management. While the bank has sharia supervisory boards and trained compliance officers, there remains a shortage of professionals with deep expertise in both Islamic jurisprudence and modern financial practices. This shortage can hinder the efficiency of compliance monitoring and decision-making. Although Bank Muamalat Indonesia has made various efforts to improve employees' knowledge and skills through training, workshops, and seminars, challenges persist in ensuring that all employees fully understand and apply Islamic principles in every business decision.

In addition, competition within the Indonesian banking industry places further pressure on Islamic banks like Bank Muamalat to remain innovative while strictly adhering to compliance frameworks (Lui et al., 2021). Balancing the need for product innovation such as introducing digital banking solutions or fintech collaborations with the obligation to comply with Islamic principles is not always straightforward. Each new product or service must undergo rigorous compliance assessment, which can sometimes slow down innovation compared to conventional banks. Despite these challenges, the study emphasizes that the benefits of compliance risk management far outweigh the difficulties. Effective compliance

frameworks not only shield the bank from risks but also enhance its long-term resilience. For instance, by demonstrating strong compliance, Bank Muamalat can secure greater investor confidence, attract international partners, and build stronger relationships with regulators. In the long run, these advantages contribute significantly to the sustainability and growth of the institution.

In conclusion, the case study of Bank Muamalat Indonesia illustrates that compliance risk management is not merely an administrative requirement but a strategic necessity for Islamic banks. It safeguards the bank's reputation, ensures financial stability, and strengthens competitiveness in an increasingly dynamic financial landscape. At the same time, continuous efforts are needed to address challenges such as regulatory changes and the shortage of skilled human resources. By investing in employee training, enhancing IT systems, and maintaining strong engagement with regulatory bodies, Bank Muamalat can further refine its compliance practices. Ultimately, the sustainability of Islamic banks like Bank Muamalat depends on their ability to integrate compliance risk management into every aspect of their operations, ensuring that they remain trustworthy, stable, and resilient in serving both their customers and the broader Islamic finance industry.

4. Conclusion

Compliance risk management plays a crucial role in enhancing the sustainability and stability of Islamic Banks, particularly at Bank Muamalat Indonesia. The implementation of effective compliance risk management enables the bank to maintain the alignment of all its operational activities with Islamic

principles and applicable regulations. Thus, Bank Muamalat Indonesia can avoid various risks that could potentially be detrimental, such as reputation risk, legal risk, and operational risk, which could threaten the bank's operational continuity and sustainability. This study found that Bank Muamalat Indonesia has implemented a compliance risk management system that includes the identification, evaluation, and mitigation of risks related to non-compliance with Islamic principles and existing regulations. Strict monitoring and internal auditing processes ensure that every product and service offered is in accordance with Islamic principles, which in turn enhances customer trust and maintains the bank's reputation as a trusted Islamic financial institution. In addition, good compliance risk management also contributes to the bank's financial stability, as it minimizes potential losses and increases competitiveness in the market.

However, this study also identified several challenges in the implementation of compliance risk management. One of them is the frequent regulatory changes that often require quick adjustments in the policies and procedures applied by the bank. Bank Muamalat Indonesia needs to continuously adapt to the evolving regulatory dynamics to ensure it can still meet the standards set by regulators and the National Sharia Council-Indonesian Ulema Council (DSN-MUI). Furthermore, the limited number of human resources trained in sharia matters is a challenge in maintaining the quality and effectiveness of compliance risk management implementation. Overall, this study shows that good compliance risk management is a key factor in maintaining the sustainability and stability of Islamic banks.

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