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Islamic Corporate Governance and The Performance of Sharia Banks

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Abstract

This study analyzes the influence of Islamic Corporate Governance (ICG) on the performance of sharia banks. This study uses a panel data regression analysis tool. The research sample includes 12 Islamic banks from 2009 to 2019. Based on the 2020 Islamic banking statistics, the number of sharia banks is 12. The sampling technique used is the convenience sampling method. The results showed that Islamic corporate governance has a positive effect on the performance of sharia banks. ICG has a positive effect on financial performance and managerial behavior. Reporting quality and profits are better after implementing strict ICG. Similarly, the size of the bank as a control variable has a positive effect on the performance of Islamic banks.

Keywords: *Islamic corporate governance, performance, sharia*

INTRODUCTION

Corporate governance is the system used to direct and control the organization, which includes the relationship between the organization's stakeholders, accountability, laws, policies, procedures, practices, standards, and principles that provide direction and control of the organization. It also includes organizational practices and policies related to ethical standards and principles, as well as organizational compliance with ethical codes (Cadbury, 1992). According to Lewis (2005), corporate governance based on Islamic values is known as Islamic Corporate Governance (ICG). ICG seeks to design economic actors and corporate governance based on moral and social values based on sharia or the Islamic paradigm, with the aim of achieving individual and community welfare (Hasan, 2011).

Islamic banks have an ICG model with a high level of accountability in protecting and safeguarding the rights and interests of stakeholders because the ICG framework for Islamic banks is unique, in addition to following a set of principles based on the Quran and Hadith, which contains the principles of justice and accountability but also must follow the regulations set by the government (Sairally, 2013). Islamic banks face strong pressure to maintain profitability as well as social responsibility because, in essence, Islamic banks do not only focus on economic benefits but also must be responsible and care about social problems in their business activities (Malik & Nadeem, 2014).

The social functions of Islamic banks, including concern for the environment, are the hallmarks of Islamic banks (Law of the Republic of Indonesia Number 21 of 2008). The social function shows its contribution to the welfare of society as well as helping Muslims fulfill their religious obligations (Maali, Casson, & Napier, 2006). Social and environmental responsibility is the responsibility of stakeholders who aim to protect their rights and interests, both horizontally and vertically or to Allah SWT. The

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understanding that places Allah SWT as the main stakeholder develops in the stakeholder theory from an Islamic perspective developed by Iqbal and Mirakhor (2004).

Islamic banks must have a good sharia compliance structure to increase stakeholder trust and ensure all operations and services are sharia compliant (Srairi, 2015). Sharia compliance refers to operations, products, and services that must be free from elements of sinful activities, sharia risks, exploitation, and have real economic goals to finance socially productive sectors in the economy (Mohamed, 2005). Sharia bank operations and services must also have social functions implemented in corporate social responsibility and concern for the environment or Corporate Social Responsibility (CSR). Based on this, Lanis (2011) states that Islamic banks which are the implementation of the ICG concept must be committed to CSR.

Operations and services by Islamic banks must be in accordance with the principles of accountability and transparency (Tapanjeh, 2009). Accountability and transparency of operations and services can be disclosed in the annual report; accurate and adequate disclosure of information must be freely available to all stakeholders. Therefore, Islamic banks are expected to be able to disclose the characteristics of their corporate governance and all their activities to stakeholders so that they can assess how the bank is regulated and managed (Darmadi, 2013). The benefits of this disclosure can improve supervision and internal control and maintain public trust so that in the long term, it will improve the performance of Islamic banks (Patel, Balic, & Bwakira, 2002; Hossain, 2008; Platanova, Asutay, Dixon, & Mohammad, 2018).

LITERATURE REVIEW

The development of a new research framework by including the mediation variable ICSR disclosure on the influence of ICG on the performance of Islamic banks is very important to do because research so far on this relationship results in inconsistent results both at home and abroad. The solution to the inconsistency of the research results is to include an intermediate variable (Wu and Zambo, 2008), while the intermediate variable can be used in moderation or mediation (MacKennon, 2012).

The results of previous studies that show the inconsistency of these results are: for research showing that ICG affects the performance of Islamic banks conducted by Dalwai, Prasad, and Mohamadi (2014), Muttakin and Ullah (2012), Hoque, Islam, and Ahmed (2012), Al-Baidhani (2013), Hussain (2009), Rehman and Mangla (2010), Ado, Shafie, and Goni (2017), Hamza (2013), Quttainah (2012), Tamimi (2012), and Yaghoobnezhad, Nikoomaram, and Salteh (2012). For research showing that ICG has no effect on the performance of Islamic banks, Manaseer, Hindawi, Dahiyat, & Sartawi (2012), Chalaki, Didar, & Riahinezhad (2012), Adalayeen (2017), Muhamaad, Mangawing, & Salsabilla (2020), Riyadi and Santosa (2018), and Eksandy (2018).

Another reason for the need to include ICSR disclosure mediation on the influence of ICG on the performance of Islamic banks is that because Islamic banks are implementing ICG with social functions, they are obliged to carry out social activities in the form of ICSR, and if Islamic banks disclose it transparently, accurately, and adequately in the annual report will have an impact on the creation of a reputation, good image and trust from the public (Tapanjeh, 2009; and Mallin, Farag, and Yong, 2014). The creation of this reputation, image, and trust has a positive impact on the performance of Islamic banks (Lanis, 2005; Hossain, 2008; and Platanova et al., 2018). Thus, it can be implicitly concluded that ICSR disclosure mediates the effect of ICG on the performance of Islamic banks.

This research was conducted based on stakeholder theory which was later developed into stakeholder theory from an Islamic perspective (Iqbal & Mirakhor, 2004). The contribution of this research is to strengthen the construction of stakeholder theory development in the Islamic perspective, which currently has been widely conducted research to strengthen the position of the theory in the field of Islamic accounting. The methodological contribution of this study reaffirms and develops a new research framework on the relationship between ICG and Islamic bank performance with ICSR as a mediating variable. These contributions are expected to be useful in developing knowledge, as well as increasing the awareness of Islamic banks towards social and environmental activities, which are one of their functions. Thus, the novelty of this study is to build a new model of the relationship between ICG and Islamic bank performance by including ICSR as mediation and using stakeholder theory from an Islamic perspective as a grand theory.

The ICG is unique governance in Islamic banks because ICG must also ensure all operations comply with ethics and morality as outlined by Islam (Choudhury & Hoque, 2006). This uniqueness enables the achievement of competitive advantage with high performance, and this uniqueness lies in the role of the structure of the Sharia Supervisory Board (DPS) (Farook et al., 2011). Mollah and Zaman (2015) found the role and influence of DPS in improving financial performance in Islamic banks. ICG in Islamic banks is an implementation of stakeholder theory in an Islamic perspective because the management of Islamic banks is responsible not only to those who relate explicitly stated in contracts or transactions, but also parties who are implicitly related to company activities which are the main stakeholders of Islamic banks, namely Allah. SWT, because when humans are born on earth, they automatically become caliphs who have an implicit contract with God in every activity (Iqbal & Mirakhor, 2004).

Research on the effect of ICG on bank performance can be found in several previous studies. These studies include Dalwai, Prasad, and Mohamadi (2014), revealing evidence that ICG can increase a company's competitiveness and lead to good performance. Muttakin and Ullah (2012) found that the number of directors had a positive effect on performance. Hoque, Islam, and Ahmed (2012) found that the number of directors and the number of audit committee meetings had a positive effect on performance. Hussain (2009) found that there is an influence between an efficient ICG structure on financial performance. Rehman and Mangla (2010) found that there is an influence of ICG on the financial performance of conventional banks and Islamic banks.

RESEARCH METHOD

The population of this study consisted of Islamic commercial banks and Islamic public financial banks. Based on Islamic Banking Statistics 2020, the number of Islamic commercial banks is 12, and Islamic finance banks are 165, so the population of this study is 177. The sampling technique used is a non-probability sampling method, namely convenience sampling (Sekaran and Bougie, 2016). From the existing population, only Islamic commercial banks provide complete and easy information, so the sample of this study is 12 Islamic commercial banks. Observations for 12 years until 2019 (or from 2008 to 2019) to strengthen the generalizability of the research results. Islamic commercial banks that are not yet 12 years old or in 2008 have not been established, observations from their establishment until 2019. The results of the observations were obtained as many as 121 observations (unbalance), while the data source is the Annual Report of Islamic banks in Indonesia which can be obtained on the official website of the Islamic bank concerned.

The dependent variable of this study is the performance of Islamic banks. The performance of Islamic banks used is productivity as measured by total operating income divided by total assets. This ratio measures the company's ability to generate income with its assets. The high value of this ratio indicates the high productivity of banks in utilizing their assets (Widagdo and Ika, 2008).

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The ICG as an independent variable is measured based on the composite predicate scale resulting from the ICG self-assessment, as done by Asrori (2014), which consists of eleven dimensions, namely (1). Implementation of the duties and responsibilities of the board of commissioners, (2). Implementation of the duties and responsibilities of the board of directors, (3). Completeness and implementation of committee duties, (4). Implementation of the duties and responsibilities of DPS, (5). Application of sharia principles in the activities of raising funds and distributing funds and services, (6). Handling conflicts of interest, (7). Implementation of the bank compliance function, (8). Implementation of the internal audit function, (9). Implementation of the external audit function, (10). The maximum limit for disbursement of funds, and (11). Transparency of financial and non-financial conditions, GCG implementation reports, and internal reporting. Then, the model is stated in the following equation

KBSit : $a_0 + a_1 \, ICG_{1it} + a_2(Size)_{2it} + e_{it}$
$\alpha 0$: constant
ICG : Islamic Corporate Governance
KBS : Performance of sharia bank
Size : Size sharia bank
e : error

FINDINGS AND DISCUSSION

The Hausman test results show a value of 17,323 and indicate that the more appropriate model is the Fixed Effect. The value of the coefficient of determination (R2) is estimated at 0.5278, indicating that 52.78 percent of the variation in Islamic bank performance can be explained by variations in the dependent variable, while the remaining 47.22 is explained by residuals. Meanwhile, a high F value of 11.165 and significantly reflects that the composite predicate scale and the size of the sharia bank simultaneously affect the performance of the sharia bank.

Table 1. The Result of Estimation (Fixed Effects)

No.	Variable	Coefficient Value	t statistic
1	Islamic Corporate Governance	0.005	1.968*
2	Size of sharia bank	0.167	9.249*
3	Constant	-0.610	-0.275

Dependent variable: performance of sharia bank R2 = 52.78
* Significant at (α=5%)

The statistically significant t value indicates that the composite predicate scale has a positive effect on the performance of Islamic banks. This means that the increase in the composite predicate scale is followed by an increase in the performance of Islamic banks. The existence of ICG in Islamic banks ensures that all operations comply with ethics and morality as outlined by sharia. The ideal sharia corporate governance according to Islamic economic principles is developed by accommodating the interests of all company stakeholders fairly, based on sharia rules in accordance with ownership rights and agreements. DPS, which is the main organ of ICG, is responsible for supervising and supervising sharia compliance and is obliged to ensure compliance with sharia bank management with sharia principles and bind stakeholders in fulfilling obligations and obtaining rights.

The ICG obliges all suppliers, customers, employees, and society to fulfill their spiritual and physical needs. Thus, ICG shows the responsibilities and obligations both at the corporate level and at the individual level. The foundation of Islamic banking is rooted in Islamic law and adheres to the principle that contracts that are exploitative, uncertain, or contain risk or speculation cannot be executed by Islamic banks. Financial transactions based on Islamic law teach financial operations and products that generate reasonable profits and provide added socio-economic value to society.

A high ICG shows responsibility and attention to the wishes of all parties and ensures the company's accountability to all stakeholders. There is clear relevance in the conception of ICG and stakeholders view business as a complex and interconnected network that contributes to the value of the company. ICG relies on the strengths of transparency, accountability, and honesty. ICG makes the company progress and will gain public trust. ICSR disclosure maximizes trust and maintains good relations with stakeholders. ICG has a positive effect on financial performance and managerial behavior. Reporting quality and profits are better after implementing strict ICG. The results of the study support the findings of Disaster and Alfattani (2014) that the implementation of ICG affects the implementation of corporate social responsibility.

Moreover, the statistically significant t value indicates that the bank size scale has a positive effect on the performance of sharia banks. This means that the increase in bank size is followed by an increase in the performance of sharia banks. In general, company size is related to efficiency. Larger company size is followed by a greater level of efficiency. Companies that have large total assets indicate that the company is relatively stable and able to generate large profits. Large companies have a wider stakeholder base, so that the company's policies have a greater impact on the public interest than small companies.

Firm size is suspected of having a positive effect on firm performance. Company size describes the size of a company which can be expressed by total assets. This shows that the large size of the company indicates that the company is experiencing good development in the future so that it can affect public perception of the company so that the community responds positively. The larger the size of the company, the more it will be known to the public, which means it is easier to get information that can improve performance. Thus the size of the bank has a positive effect on the performance of sharia banks.

CONCLUSION AND FUTURE RESEARCH

The Islamic corporate governance (ICG) has a positive effect on the performance of sharia banks. ICG has a positive impact on financial performance and managerial behavior. Reporting quality and profits are better after implementing strict ICG. A high ICG shows responsibility and attention to the wishes of all parties and ensures the company's accountability to all stakeholders so that the bank's performance increases. Similarly, the size of the bank as a control variable has a positive effect on the performance of sharia banks. The bigger the bank, the more well-known the public. The greater sharia banks are easier to get information that can improve performance.

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