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QUALITY OF SHARIA GOVERNANCE STRUCTURE ON SOCIAL PERFORMANCE IN INDONESIAN ISLAMIC BANKING

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Abstract. This research aimed to examine empirically the effect of the performance of Islamic Bank on sharia governance in Indonesia. The social performance of the Islamic Bank was measured by qordhul hasan and micro finance, and sharia governance (SG) was measured by the proportion of the independent board of commissioners, board size, audit committee and sharia supervisory board. The data in this study were secondary data from Islamic Banking Financial Report (IBFR) of 2012-2016. This research applied quantitative approach with the panels of data regression using E-views 9.0 software. Data analysis was conducted by using factor analysis. The test result showed that the direct effect of SG on performance was 0.323 significant because it had a value of t count of 11.96 or a value of probability of (0,000) < alpha 5%. The positive coefficient showed that SG was able to improve performance while the highest loading values that reflected SG (TKS) was X3 (number of KA members) of 0.934, and X4 (number of KA meetings in a year) of 0.880. The loading value of X5 was the number of DPS of 0.445 while the value of loading X2 (the number of DK meetings in 1 year) was 0.319

Keywords: performance of islamic banking; board size; audit committee; sharia supervisory board

I. INTRODUCTION

The current global financial crisis occurs as a repetition of the first financial crisis in England in 1825. These financial crises have reappeared with higher frequencies and wider impacts since the collapse of the last gold standard in 1971, which recorded the occurrence of 431 financial crises, including 147 banking crises, 218 currency crises and 66 foreign debt crises, including 68 twin-crises and 8 triplet-crises [1].

Based on previous studies, Islamic economics and finance experts agree with the fundamental causes of the financial crisis i.e. the violation of God's provisions in financial activities, especially in the violations of the pillars of the economic system and Islamic finance, such as the prohibition of usury, *maysir* and *gharar* in various complex forms.

In addition, according to [2] in line with the results of ANP analysis, the main causes of the financial crisis can be classified into five groups, namely: 1) instability and injustice in the monetary/financial system (24.8%) including the interest system, paper money, fractional reserve based banking system, leverage system, derivation of financial products and credit creation through credit cards; 2) governance weaknesses in government and private institutions (20.5%) including administrative weaknesses, corruption, price controls, regulatory weaknesses, lack of openness and misplaced personnel; 3) deviant behavior of economic actors (19.7%) including greed, individualism, hedonism, speculation, criminal acts and expectations. Experts believe that monetary system instability and governance weaknesses are the primary causes. Cases of misconduct of corporate governance practices also occur in Islamic banking, namely, the case of derivative transactions (including *gharar*) conducted by the Sharia Business Unit of Bank Danamon Tbk. Derivative transaction is forbidden according to Islamic principles because of its speculative aspects. Another case was carried out by Bank *Syariah* Mandiri, Bogor Branch Office, which carried out a fictitious credit mode in financing *Al-murabahah* [3]. The facts clearly show that PT BSM and PT Danamon Sharia Business Unit Division had conducted transactions not in accordance with Sharia principles.

Due to this phenomenon of Islamic banks not fulfilling sharia principles, Bank Indonesia and Islamic economic scholars must conduct the purification of sharia principles in the practice of Islamic banking. Therefore, guarantees regarding the sharia compliance of all customer fund management activities by Islamic banks are very important in the business activities of Islamic banks.

This research examined the effects of sharia governance through its structure on the quality of Islamic banking performance. The sharia governance structures referred to in this research included the Board of Commissioners, the Audit Committee, and the Sharia Supervisory Board carrying out their duties at the Islamic banks. These three parts of the board conduct the monitoring of the functions of the company. The function of the monitoring is aimed at ensuring that the company runs its business in accordance with the interests of the owner. The sharia governance structures examined in this research included the proportion of Independent Commissioners, number of Board of Commissioners meetings, size of the Audit Committee, number of Audit Committee meetings, size of the Sharia Supervisory Board, educational

Volume 04, Number 01, Maret 2020, Page 57 - 61
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background of the Sharia Supervisory Board members, and number of sharia Supervisory Board meetings.

The social performance of Islamic banking in this research was still limited i.e. realizing justice. Islamic banks must ensure honesty and fairness in all transactions and business activities: the distribution functions of qardh hasan and micro finance bank products.

Sharia governance is a concept emerged in the nineteenth century after the birth of Islamic banking and Islamic finance [4]. Sharia governance is a unique characteristic of corporate governance in the financial architecture and is related to religious aspects, Islamic activities, and their implementation at Islamic Financial Institutions (IFIs) [5]. Furthermore, [6] define corporate governance as a series of relationships among the company management, board of directors, shareholders and other stakeholders.

To date, the Financial Accounting Standards (Accounting and Auditing Organization for Islamic Financial Institutions/AAOIFI) have developed a comprehensive framework for corporate governance of IFIs consisting of 7 (seven) governance standards. This standard covers different areas: (a) SSB composition, report and appointment; (b) sharia reviews; (c) internal sharia reviews; (d) audit and governance committee for IFI; (e) independence of the sharia supervisory board; (f) statement of the governance principles for IFI; and (g) corporate social responsibility, implementation, and disclosure of IFIs.

Choudhury & Alam [7] showed the results of imperfections in applying corporate governance in Islamic banks. These must be reformed, removed, and replaced by complementarities between entities. They considered that Maqasid as Sharia in sharia governance does not accept ethical deviations.

In implementing sharia governance, there are a number of things that must be considered by Islamic banks to improve their reputation and trust including (a) increasing the professionalism and capability of Sharia Supervisory Board (DPS) in carrying out the task of maintaining compliance with sharia; (b) increasing responsibility; (c) increasing fairness; and (d) increasing transparency and accountability (Wardayati, [8]). Based on some perspectives expressed by previous researchers [7], [9]–[11], it can be concluded that there is an effect of sharia governance on Islamic banking performance in terms of its application

II. RESEARCH METHODS

Islamic banks, namely, Sharia Commercial Banks (BUS) registered in Bank Indonesia. The data used in this research were the annual financial report data of Islamic banking registered in Bank Indonesia during 2012-2016.

The objects in this research were all Islamic commercial banks totaling 13 Islamic banks registered in Bank Indonesia during the 2012-2016 fiscal year. All data obtained through the directory of financial statements published by Bank Indonesia, and Sharia Governance implementation reports obtained directly from each bank.

Table 1. Criteria of Research Objects

Criteria	**BUS**
Registered in Bank Indonesia	13
Financial Statements of Islamic Commercial Bank did not have sufficient data relevant to the research, and the data were not available until the 3rd quarter proportional to the total assets, because only one bank was in operation in January 2016. (5)	(5)
Total object	8
Total object	8
Total object in 5 year observation	40

The dependent variable in this research was the quality of performance in enforcing justice (*iqamah al-'adl*). The definition of Sharia Banking performance is a manifestation in realizing benefits related to the public interest, and as a way to achieve goals through the establishment of sharia law. The context of upholding justice (*iqamah al-'adl*) includes the maintenance of equality of rights between Islamic banking and customers. Islamic banking must ensure honesty and fairness in all transactions and business activities [12], [13], [22], [14]–[21]. Dimension of quality performance in upholding justice (iqamah al-'adl) is a function of the distribution of qardh hasan and micro finance bank products.

The independent variables in this research include the proportion of Independent Commissioners, number of Board of Commissioners meetings, size of Audit Committee, number of Audit Committee meetings, size of Sharia Supervisory Board, educational background of Sharia Supervisory Board, and number of Sharia Supervisory Board meetings.

Data analysis method was used through several stages; the first stage used factor analysis to reduce indicators that did not validly measure each of the latent variables. In the second stage, after the loading value meeting the valid requirements was obtained, the factor analysis produced a factor score on each latent variable. Results of factor score on Sharia Governance (SG) and Performance variables were further analysed by panel data regression.
Structural Equation Model in this research:
First Equation:

$$Y\ (\eta_1) = \gamma X + \delta \qquad (1)$$

Table 2. Measurement Model

Exogenous Concept	Endogenous Concept
Syariah Governance (X)	Performance (Y)
$X_1 = \lambda_{X1}\xi_1 + \delta_1$	$Y_1 = \lambda_{Y1}\eta_1 + \varepsilon_1$
$X_2 = \lambda_{X2}\xi 2 + \delta_2$	$Y_2 = \lambda_{Y2}\eta_1 + \varepsilon_2$
$X_3 = \lambda_{X3}\xi_3 + \delta_3$	
$X_4 = \lambda_{X4}\xi_4 + \delta_4$	
$X_5 = \lambda_{X5}\xi_5 + \delta_5$	
$X_6 = \lambda_{X6}\xi_6 + \delta_6$	
$X_7 = \lambda_{X7}\xi_7 + \delta_7$	

III. RESULTS AND DISCUSSION

Analysis Stages

The first stage applied Factor Analysis to reduce indicators on Performance and Governance variables. After

Volume 04, Number 01, Maret 2020, Page 57 - 61
e-ISSN: 2598-120X; p-ISSN: 2598-117X

obtaining the loading value that met the requirements, the next step was to calculate the performance and governance scores to be processed by panel regression.

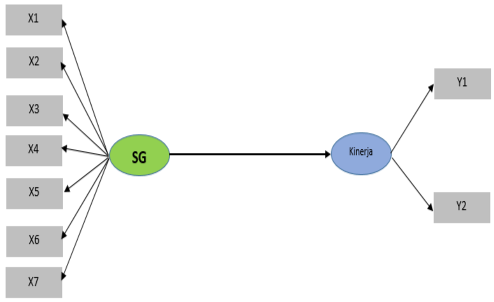

Figure 1. Types of panel data: 8 Sharia Commercial Banks in the 2012-2016 period

Stage 1. Results of Factor Analysis on Sharia Governance Variable (SG)

Communalities

	Initial	Extraction
X1	1,000	,472
X2	1,000	,740
X3	1,000	,840
X4	1,000	,828
X5	1,000	,853
X6	1,000	,609
X7	1,000	,647

Extraction Method: Principal Component Analysis.

Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	2,146	30,657	30,657	2,146	30,657	30,657	1,988	28,400	28,400
2	1,480	21,148	51,805	1,480	21,148	51,805	1,539	21,983	50,384
3	1,363	19,469	71,274	1,363	19,469	71,274	1,462	20,890	71,274
4	,960	13,712	84,986						
5	,696	9,941	94,927						
6	,223	3,186	98,112						
7	,132	1,888	100,000						

Extraction Method: Principal Component Analysis.

Component Matrix[a]

	Component	
	1	2
X2	,220	,901
X3	,924	,145
X4	,878	,067
X5	,531	-,736

Extraction Method: Principal Component Analysis.

a. 2 components extracted.

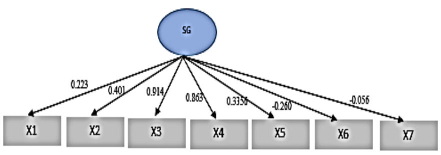

Figure 2. Result of Phase 1 factor analysis on Sharia Governance variable (SG)

The results of phase 1 factor analysis showed that there were three indicators that had to be dropped as they had a loading value of less than 0.3 i.e. X1, X6 and X7 so that the results of stage 2 after being reduced could produce a loading value > 0.3 and a governance score.

Communalities

	Initial	Extraction
X2	1,000	,861
X3	1,000	,875
X4	1,000	,775
X5	1,000	,824

Extraction Method: Principal Component Analysis.

Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	1,955	48,870	48,870	1,955	48,870	48,870	1,948	48,691	48,691
2	1,380	34,494	83,364	1,380	34,494	83,364	1,387	34,673	83,364
3	,448	11,195	94,559						
4	,218	5,441	100,000						

Extraction Method: Principal Component Analysis.

Rotated Component Matrix[a]

	Component	
	1	2
X2	,319	,871
X3	,934	,041
X4	,880	-,031
X5	,445	-,791

Rotated Component Matrix[a]

	Component		
	1	2	3
X1	,223	-,016	,649
X2	,401	,760	-,044
X3	,914	-,013	-,064
X4	,863	-,047	,286
X5	,356	-,845	,109
X6	-,260	,416	,607
X7	-,056	,269	-,756

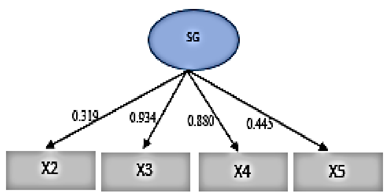

Figure 3. Result of Phase 2 factor analysis on Sharia Governance variable (SG)

The results of the phase 2 factor analysis showed that there were four indicators, namely, the number of meetings of the Board of Commissioners, size of the audit committee, number of meetings of the Audit Committee, and size of the Sharia Supervisory Board. After being reduced, this phase could produce a loading value > 0.3 from the Sharia governance score.

Volume 04, Number 01, Maret 2020, Page 57 - 61
e-ISSN: 2598-120X; p-ISSN: 2598-117X

Stage 2. Results of Factor Analysis on Social Performance Variable of Islamic Banking

Communalities

	Initial	Extraction
Y1	1,000	,661
Y2	1,000	,661

Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	1,322	66,108	66,108	1,322	66,108	66,108
2	,678	33,892	100,000			

Component Matrix[a]

	Component
	1
Y1	,813
Y2	,813

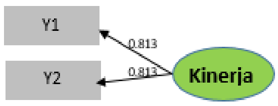

Figure 4. Results of the phase 1 factor analysis on Social Performance variable.

Based on the results of the factor analysis in phase 1, the indicator dropped was Y2 (Micro Financing) because it had a loading value of less than 0.3.

Stage 3. Results of Panel Regression Processing

Dependent Variable: KINERJA
Method: Panel EGLS (Cross-section weights)
Date: 05/10/19 Time: 08:12
Sample: 2012 2016
Periods included: 5
Cross-sections included: 8
Total panel (balanced) observations: 40
Linear estimation after one-step weighting matrix
White cross-section standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
SG	0.342567	0.028583	11.98509	0.0000
C	-0.303776	0.015336	-19.80838	0.0000

Weighted Statistics			
R-squared	0.328777	Mean dependent var	-0.795738
Adjusted R-squared	0.311113	S.D. dependent var	1.408523
S.E. of regression	0.708269	Sum squared resid	19.06252
F-statistic	18.61304	Durbin-Watson stat	0.313163
Prob(F-statistic)	0.000110		

Unweighted Statistics			
R-squared	0.158606	Mean dependent var	-2.50E-07
Sum squared resid	32.81439	Durbin-Watson stat	0.127824

The direct effect of Sharia Governance on Performance was significant by 0.323 because it had a t value of 11.96 or a probability value of (0,000) < alpha 5%. A positive coefficient indicates that an increase in Sharia Governance will be able to improve performance. Meanwhile, the highest loading values refelecting the Sharia Governance were X3 (number of Audit Committee members) by 0.934 and X4 (number of Audit Committee meetings in a year) by 0.880. The loading value of X5 was the number of Sharia Supervisory Boards by 0.445, and the loading value of X2 was the number of the Board of Commissioner meetings in 1 year by 0.319.

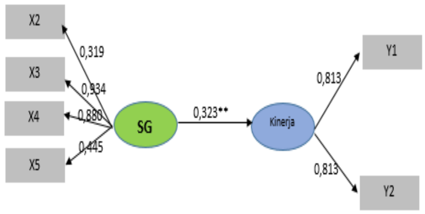

Figure 5. Results of regression processing.

This research examined the effect of Sharia Governance implementation on Islamic banks that strengthened the Social Performance. Islamic Banking is proven to have an effect on monitoring operations, thereby improving the quality of implementing Islamic ethical values in Islamic banks by implementing and managing Qordhul Hasan and Micro Financing. This finding supports the results of previous studies (Ascarya; Iryani, LD, et al.; Yadiati, et al.; Ghayad; and Ghaffar).

IV. CONCLUSION

Based on the results of this research, sharia governance has direct effects on social performance at Islamic Commercial Banks. Nonetheless, better implementation of sharia governance will improve the ability of social performance. Although the role of Sharia Supervisory Board (DPS) is still relatively low, it is proven to provide a controlling role. This research still has some limitations because it has not included all indicators of social performance aspects in Islamic banking. This will be an interesting discussion as research that integrates sharia maqasid values starts to emerge. Moreover, the objectives of Islamic banking support the implementation of national development to improve justice, togetherness, and equal distribution of people's welfare.

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Volume 04, Number 01, Maret 2020, Page 57 - 61
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