Determinant of the level of sharia compliance of Islamic banks in Indonesia

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Abstract

This study aims to examine the relationship between SSB remuneration, SSB cross-membership, board independence, audit committee independence, IAH, leverage, profitability, and firm size to the level of sharia compliance of Islamic banks. In this study, sharia compliance is measured by an index compiled in previous studies. The sample used in this study is 10 Islamic banks that have published annual reports on each website with an observation period between 2015-2020. Multiple regression analysis using EViews 10 application. The results of this study indicate that board independence, audit committee independence, firm size, and SSB cross-membership significantly affect sharia compliance. While SSB remuneration, IAH, leverage, and profitability do not affect the level of sharia compliance.

Introduction

Sharia compliance is a sensitive issue faced by Islamic banks. This relates to whether the activities of Islamic banks have complied with Islamic principles or not. For Islamic banks, which have not met sharia compliance, the bank cannot be treated as a sharia bank (Ullah, 2014). From the side of Muslim customers, sharia compliance is very important, because the main preference of Muslims in conducting transactions is based on halal (Saqib et al., 2016; Rashid et al., 2014). Grassa (2013) found that Muslim customers are not only concerned with financial benefits but are very concerned about sharia aspects. They may even cancel profits to maintain the sharia aspect. Furthermore, the discussion of sharia compliance in Islamic banks is aimed at attracting Muslim customers and as a form of accountability to Allah SWT on the Day of Judgment (Rahman & Bukair, 2013).

Ullah (2014) found that the low level of sharia compliance in Bangladesh is due to the lack of a sharia supervisory board (SSB) that has a deep understanding, not only in terms of sharia but also in terms of accounting, finance, and the banking industry. Mnif and Tahari (2020a) said that one way to improve the ability of the sharia supervisory board is to provide good remuneration. In addition, the capacity of the sharia supervisory board can also be increased through cross-membership. The result of increasing the ability of the sharia supervisory board is the creation of better sharia compliance (Farook et al., 2011).

The level of sharia compliance is also influenced by the implementation of the good corporate governance function. Some of the key factors are the presence of independent commissioners and the presence of independent parties on the audit committee. Chau and Leung (2006) stated that the existence of an independent board of commissioners will increase supervision over management, because they are not affiliated with the company as officers or employees but are independent representatives of the interests of shareholders. The existence of an audit committee independence will also improve reporting quality, this is because an
independent audit committee can reduce managers' opportunism in determining their financial accounting choices (Mnif & Tahari 2020b).

The factors that influence the level of sharia compliance are financial performance such as profitability, company size, leverage, and investment account holders (IAH). In contrast to financial performance in general, IAH is a representation of the proportion of third-party funds in Islamic banks. Where a large number of IAH in Islamic banks is predicted to affect the extent of the disclosure (Archer et al., 1998).

Based on the explanation above, this study will examine the level of sharia compliance in Islamic banks in Indonesia. The purpose of this study is to provide an overview to Islamic banks and regulators in Indonesia about the factors that affect the level of sharia compliance, hoping to increase sharia bank accountability with sharia law. The indicators used to measure the level of compliance are indicators that have been compiled by El-Halaby and Hussainey (2016). In addition, this study also examines the determinants of sharia compliance comprehensively. The factors tested in this study are divided into three main topics: 1) topics related to the sharia supervisory board, 2) topics related to corporate governance, and 3) topics related to finance.

The difference between this study and previous research is that the researchers tested the governance of Islamic banks more comprehensively and adapted to the conditions of Islamic banks in Indonesia. Where Islamic banks in Indonesia are mostly owned by holding companies, so to examine the effect of ownership structure on the level of disclosure of sharia compliance, the researchers tested it with investment account holders (IAH). Where this IAH in some literature is also mentioned as the owner of an Islamic bank, although it does not have voting rights.

As for the topic of the sharia supervisory board (SSB) in previous studies, the variable of SSB expertise in accounting and finance has been included, but this variable has not been tested on Islamic banks in Indonesia, because most of the SSB who sit on Islamic banks are experts in the field of fiqh muamalah or sharia. So to test the expertise of SSB members, researchers tested it with the level of SSB remuneration. In previous studies, SSB cross-membership was measured by dummy, the drawback of this measurement is that it cannot be tested dynamically, so the researchers tested SSB cross-membership with the proportion of SSB cross-membership.

Agency Theory

In agency theory, the company is described as a collection of contracts to reduce conflicts of interest between agents and principals. The dispute in this company arises because each party has a goal to maximize its utility. In this case, the agent as the party with more information resources can take actions that benefit him. For this reason, the principal will provide a control mechanism in the form of corporate governance to reduce abuse of authority arising from information asymmetry (Jensen & Meckling, 1976; Eisenhardt, 1989)

Signaling Theory

Signaling theory is a theory that argues that companies that have good news will disclose more comprehensive information to the market than when they have bad news (Haniffa & Cooke, 2002). Signaling theory assumes that managers want to send signals to stakeholders, that managers can maximize stakeholder wealth, and signal that the company is run efficiently (Tsalavoutas, 2011). Besides that, information sent to the market is not only about finance, but disclosure of the company's compliance with community values and the requirements of related professional associations is also good information for the market (Omar & Simon, 2011).

Shariah Supervisory Board’s Remuneration

Agency theory explains that high remuneration can motivate and retain agents to carry out their duties and work harder for the benefit of shareholders (Razali et al., 2018; Alman, 2012). Watts and
Zimmerman (1978) also explain that conflicts of interest can be resolved by offering attractive compensation contracts based on organizational performance. By extending this argument to SSB, the remuneration given to SSB members is expected to affect the quality of supervision.

The remuneration given to SSB can also be used as a performance measure because the remuneration given is usually based on the skills and efforts that have been made by SSB. In addition, SSB is also entitled to compensation because they have dedicated their time to issuing fatwas and providing sharia directives. This remuneration also encourages SSB members to devote time to Islamic banks to honor their contractual commitments (Mnif & Tahari, 2020a). Thus, the payment of high SSB remuneration can be a better construction for Islamic supervision and increase the scope of disclosure of Islamic banks. The hypotheses proposed are as follows:

H1: The remuneration received by SSB has a positive effect on the level of sharia compliance of Islamic banks in Indonesia.

Sharia Supervisory Board's Cross-Membership

Cross-membership is a situation where SSB members sit in several sharia banks (Abdullah et al., 2013). This cross-membership raises concerns about confidentiality and conflicts of interest. This is because SSB has access to confidential and sensitive information that may have an impact on competition between Islamic banks. In addition, cross-membership can make SSBs have less time to devote their performance to one Islamic bank (Garas, 2012).

Dahya et al. (1996) stated that cross-membership can provide more experience for SSB members. This allows them to discuss more of the problems faced by Islamic banks, as a result, the knowledge and insight of SSB members are increasing (Farook et al., 2011). Furthermore, Haniffa and Cooke (2002) add that cross-membership can increase transparency for Islamic banks. The first reason is that members with cross-membership can make comparisons of the knowledge gained between banks. Second, decisions in one bank will affect decisions in other banks.

H2: Cross-membership has a positive effect on the level of sharia compliance of Islamic banks in Indonesia

Board Independence

In the corporate governance mechanism, the board is positioned as the party that supervises and directs managers to satisfy the interests of shareholders (Jensen & Meckling, 1976). So, the effectiveness of the board is very necessary. Forker (1992) argues that the effectiveness of a board is determined by its composition. Therefore, inserting an independent board of commissioners into the board of commissioners can be a solution to increasing the effectiveness of the board. The reason is that the independent board of commissioners is not affiliated with the manager. In addition, the presence of an independent director will increase higher qualitative disclosures, through better supervision (Jo & Harjoto, 2011). In line with this, Rahman and Bukair (2015) stated that independent boards tend to encourage managers to engage in more social activities and provide high-quality disclosures.

H3: Board independence has a positive effect on the level of sharia compliance of Islamic banks in Indonesia.

Audit Committee Independence

According to agency theory, the existence of an independent board in the audit committee can increase the effectiveness of the audit committee in supervising and reduce opportunities for management to be opportunistic by hiding information (Cotter & Silvester, 2003). In line with this, Juhmani (2017) said that an audit committee independent is a requirement to carry out its responsibilities objectively. Klein (2002) argues that the way to create an independent audit
committee requires an independent party. The result of the large independent composition of the audit committee is the creation of efficient financial reporting supervision.

H4: Audit committee independence affects the level of sharia compliance of Islamic banks in Indonesia.

**Investment Account Holders**

Investment account holders (IAH) are sources of funds from customers which are formed from equity participation contracts (mudharabah and musharaka) (Aggarwal & Yousef, 2000). Abdullah et al. (2015) stated that the risk faced by IAH account holders is that they do not have formal voting rights. So, in an agency conflict between the bank, shareholders, and IAH account holders, the IAH account holder will be the aggrieved party. Therefore, to reduce concerns over the lack of protection for IAH account holders, Islamic banks need to provide more transparent disclosures. Archer et al. (2009) added that although IAH account holders do not have formal voting rights, their existence, as well as shareholders, can affect the level of information disclosure. This is because IAH is the largest proportion of funds for Islamic banks.

H5: Investment account holders have a positive effect on the level of sharia compliance of Islamic banks in Indonesia.

**Leverage**

Leverage is a ratio that shows how much of a company's working capital is financed with debt (Alrawahi & Sarea, 2016). Agency theory assumes that companies with high debt ratios tend to transfer their wealth to shareholders rather than bondholders. This is so that the company gets additional capital from shareholders (Omar & Simon, 2011). To avoid this situation, bondholders create debt contracts and increase the oversight of managers. The impact of this is increased agency costs (Mnif & Znazen, 2020). Therefore, to avoid high agency costs, managers tend to disclose more information with the intention of convincing bondholders that their debt contracts are protected (Srairi, 2018).

H6: The high level of leverage has a positive effect on the level of sharia compliance of Islamic banks in Indonesia.

**Profitability**

According to Chavent et al. (2006), companies with high levels of profitability tend to provide comparatively wider information. The relationship between the level of profitability and the extent of disclosure of this information can be explained through agency theory and signal theory. Where both theories state that highly profitable companies tend to disclose more information to increase shareholder confidence. Furthermore, managers will get more compensation for this performance (Marston & Polei, 2004).

H7: High profitability has a positive effect on the level of sharia compliance of Islamic banks in Indonesia.

**Firm Size**

In previous studies, several researchers found a significant relationship between firm size and compliance disclosure (El-Halaby & Hussainey, 2016; Garas & ElMassah, 2018). This can be explained through agency theory, where large companies will get more attention from many people. So, to reduce information asymmetry, companies will disclose more information. In addition, large companies also have stronger initiatives to comply with disclosure requirements, to avoid pressure from public scrutiny and investors (Watts & Zimmerman, 1990).

H8: Firm size has a positive effect on the level of sharia compliance of Islamic banks in Indonesia.
Research Method

This study uses secondary data obtained from annual reports published through the official website of each Islamic bank. This study is quantitative in the form of panel data consisting of a time series for 6 years, 2015-2020, and cross-sectional data from 14 Islamic banks. The sample in this study was selected using the purposive sampling method. With criteria in the form of Islamic commercial banks that have published an annual report on the official website of each bank.

Definitions of Variables

Shariah compliance index

Measuring the level of compliance is done by giving 1 point to items that are fulfilled, while 0 points to items that are not met. Furthermore, all items are summed and divided by the total standard disclosure score (El-Halaby & Hussainey, 2016).

Measurement of the independent variables

The data in this study were collected manually through the annual report and the official website of Islamic banks during the 2015-2020 period. Concerning SSB characteristics, we examined SSB remuneration and SSB cross-membership. Next, we examine board independence and audit committee independence as part of corporate governance. For financial performance, we identify how much leverage the company is, the level of profitability, and the size of the company. We also identify IAH as part of a specific CG mechanism owned by Islamic banks. From these independent variables, data sources and references are presented in Table 1.

<table>
<thead>
<tr>
<th>Variable name</th>
<th>Description</th>
<th>Examples of prior studies</th>
</tr>
</thead>
<tbody>
<tr>
<td>SSB Remuneration</td>
<td>The log of total SSB remuneration</td>
<td>Grassa and Matoussi (2014); Mnif and Tahari (2020a)</td>
</tr>
<tr>
<td>SSB cross-membership</td>
<td>The percentage of SSB members who sit on the SSBs of different IFIs at the same time</td>
<td>Nomran et al. (2018)</td>
</tr>
<tr>
<td>Board Independence</td>
<td>The percentage of non-executive directors to the total number of the directors</td>
<td>El-Halaby and Hussainey (2016)</td>
</tr>
<tr>
<td>Audit Committee</td>
<td>The percentage of non-executive directors on the audit committee</td>
<td>Juhmani (2017)</td>
</tr>
<tr>
<td>Independence</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment Account</td>
<td>The ratio of the total amount of investment account funds to paid-up capital in shareholders’ equity</td>
<td>Mnif and Tahari (2020b)</td>
</tr>
<tr>
<td>Holders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leverage</td>
<td>The ratio of the company’s total liabilities to the company’s total assets</td>
<td>El-Halaby et al. (2018)</td>
</tr>
<tr>
<td>Profitability</td>
<td>The ratio of the company’s net income to the company’s total asset</td>
<td>El-Halaby and Hussainey (2016)</td>
</tr>
<tr>
<td>Size Firm</td>
<td>The company log of total asset</td>
<td>El-Halaby and Hussainey (2016)</td>
</tr>
</tbody>
</table>

Result and Discussion

Descriptive Analysis

The descriptive analysis explains in detail the research variables including shariah compliance (SCI), SSB remuneration (SSBREM), SSB cross-membership (SSBCROSS), board independence (KOMIND), audit committee independence (AUDIND), investment account holders (IAH), leverage (LEVERAGE), profitability (PROFIT), and firm size (SIZE). Table 2 shows the descriptive statistical value of each research variable.
Based on Table 2, it is known that the average compliance level of Islamic banks in Indonesia is 81.28%. This shows that Islamic banks in Indonesia have a high level of compliance. Furthermore, SSB remuneration has an average value of 8.86. SSB cross-membership has an average value of 62.39%, this shows the high number of SSBs who sit in more than one Islamic bank at the same time.

Regarding the governance of Islamic banks, it is known that board independence has an average score of 68.75%, this indicates that the majority of Islamic banks in Indonesia are filled by non-executive directors. As for audit committee independence, it has an average value of 83.06%, this shows that on average Islamic banks have audit committees that are dominated by non-executive directors. From the financial performance, it is known that the average Islamic bank has a leverage ratio of 18.29%, a profitability of 0.68%, and a company size with an average value of 13.21.

Classical Assumption Test Results

The results of the normality test in this study indicate that the regression model has met the normality requirements. This result can be seen from the probability value of 0.623224 > 0.05. Meanwhile, in the multicollinearity test, it is known that the correlation between the independent variables is less than 0.09, this result indicates that the regression model does not contain correlation problems. Furthermore, in the autocorrelation test, it is known that the Durbin-Watson (DW) value is 2.004138. Based on the DW table, with a significance level of 5%, it is known that the Durbin Lower (DL) value is 1.2976, Durbin Upper (DU) is 1.8939, 4-DU is 2.1061, and 4-DL is 2.7024. These results indicate that the position of DW is between DU and 4-DU so this model does not occur autocorrelation.

Regression Test Result

The result regression test in this study can be seen in Table 3.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>t-Statistic</th>
<th>P-Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>SCI</td>
<td>-10.798</td>
<td>-0.212</td>
<td>0.833</td>
</tr>
<tr>
<td>SSBREM</td>
<td>-2.466</td>
<td>-0.771</td>
<td>0.445</td>
</tr>
<tr>
<td>SSBCROSS</td>
<td>0.041</td>
<td>2.389</td>
<td>0.021**</td>
</tr>
<tr>
<td>KOMIND</td>
<td>0.057</td>
<td>2.022</td>
<td>0.049**</td>
</tr>
<tr>
<td>AUDIND</td>
<td>-0.079</td>
<td>-2.246</td>
<td>0.030**</td>
</tr>
<tr>
<td>IAH</td>
<td>-0.122</td>
<td>-0.952</td>
<td>0.346</td>
</tr>
<tr>
<td>LEVERAGE</td>
<td>0.060</td>
<td>1.671</td>
<td>0.102</td>
</tr>
<tr>
<td>PROFIT</td>
<td>0.273</td>
<td>1.159</td>
<td>0.253</td>
</tr>
<tr>
<td>SIZE</td>
<td>8.590</td>
<td>2.014</td>
<td>0.050*</td>
</tr>
</tbody>
</table>

Notes *** p < 0.01; ** p < 0.05; * p < 0.10

Based on Table 3, the regression equation model can be formulated as follows:

\[ \text{SCI} = -10.798 - 2.466 \times \text{SSBREM} + 0.041 \times \text{SSBCROSS} + 0.057 \times \text{KOMIND} - 0.079 \times \text{AUDIND} - 0.122 \times \text{IAH} + 0.060 \times \text{LEVERAGE} + 0.273 \times \text{PROFIT} + 8.590 \times \text{SIZE} + e \]
The Effect of SSB Remuneration on Shariah Compliance

Table 3 illustrates that there is no positive relationship between the level of remuneration of SSB and SCI. These results indicate that the high or low remuneration received by SSB does not affect the motivation or dedication of SSB in supervising Islamic banks. Furthermore, in Islamic banks in Indonesia, SSB members are representatives of the DSN-MUI whose task is to ensure that Islamic banks comply with sharia principles. In addition, AAOIFI GS 5 demands that SSB can provide fair supervision without being influenced by pressures of interest including the level of remuneration. These results do not support the findings of Razali et al. (2018) and Aslam et al. (2019) that the level of remuneration can affect the high quality of supervision.

The Effect of SSB Cross-Membership on Shariah Compliance

Table 3 illustrates that there is a positive relationship between SSB cross-membership and SCI. This significant result shows that SSB members who sit in more than one Islamic bank have a better understanding and knowledge of supervisory and reporting practices. This is because cross-membership provides an opportunity for SSB members to face many debates, discussions, comparisons of business practices, and understanding of the application of sharia rules in bank policies. Furthermore, the existence of cross-membership will improve the quality of SSB supervision and transparency among Islamic banks (Farook et al., 2011; Rahman & Bukair, 2013; Srairi, 2018). Furthermore, in the theory of human resources dependency, SSB cross-membership can be a bridge between internal Islamic banks and external banks. The existence of this cross-membership provide an opportunity for Islamic banks to compare better disclosure practices (Nomran et al., 2018).

The Effect of Board Independence on Shariah Compliance

Table 3 shows that there is a positive relationship between board independence and SCI. This significant result shows that the high percentage of board independence increases the effectiveness of the supervisory function. Furthermore, this result is also influenced by the average independence of the board of 68.75% in the sample banks. This average value exceeds the proportion of board independence required in Bank Indonesia Regulation Number 15/13/PBI/2013, which is 50%. This finding supports the research of Khan et al. (2013); Das et al. (2015); and Juhmani (2017) that a high proportion of board independence can improve the supervisory function.

The Effect of Audit Committee Independence on Shariah Compliance

Table 3 shows that there is an influence between the audit committee's independence variable on SCI. These results indicate that the large proportion of non-executive directors on the internal audit committee of Islamic banks affects the level of compliance of Islamic banks with sharia principles. This result is in line with the opinion of Klein (2002) which states that the greater proportion of independents in the audit committee affects the effectiveness of supervision. Fama & Jensen (1983) stated that non-executive directors can withstand management pressure so that supervision can be more objective. Khan et al., (2013) added that the audit committee has a role to approve the choice of accounting policies so that the large proportion of non-executive directors in the audit committee will make companies use better accounting policies.

The Effect of Investment Account Holders on Shariah Compliance

Table 3 illustrates that investment account holders (IAH) have no significant effect on SCI. This result is because IAH account holders do not have voting rights in making policies that will be implemented in Islamic banks. Al-Sadah (2007) explains that most IAH account holders are
passive in transacting with Islamic banks. They do not use company reports to evaluate bank performance. Nevertheless, Islamic banks cannot ignore the satisfaction level of IAH account holders. Even more, IAH account holders are the biggest source of Islamic bank funding.

The Effect of Leverage on Shariah Compliance

Table 3 shows that leverage has no significant effect on SCI. This result is presumably because the average sample of Islamic banks has a fairly low leverage ratio, which is 18.29%. This low debt proportion causes leverage does not affect the level of disclosure. This is in line with agency theory which states that more aggressive disclosure is provided by companies with high debt ratios, to reduce agency costs arising from high monitoring costs (Jensen & Meckling, 1976). Omar and Simon (2011) explain that companies with low leverage tend to prioritize disclosure to shareholders.

The Effect of Profitability on Shariah Compliance

Table 3 shows that profitability has no significant effect on SCI. This result is because the average profitability of the sample banks is quite small, namely 0.68%. So that according to signaling theory, companies with low profitability "bad news" tend to be more conservative than companies with high profitability "good news" which will be aggressive in disclosure (Inchausti, 1997; Chavent et al. 2006).

The Effect of Firm Size on Shariah Compliance

Table 3 illustrates that firm size has a significant effect on SCI. These results explain that large companies will get more attention from stakeholders. Therefore, to reduce information asymmetry, companies will be aggressive in disclosing information (Garas & ElMassah, 2018). Watts and Zimmerman (1990) state that large companies have stronger initiatives to comply with disclosures to avoid pressure from public and investor scrutiny. In addition, Sencal and Asutay (2020) state that the company will gain legitimacy from the community by complying with the disclosure of information in an area.

Conclusion

Based on the results of the research above, it was found that SSB cross-membership, board independence, independent audit committee, and firm size had a significant effect on the level of sharia compliance of Islamic banks. These results can be explained that SSB cross-membership will increase the understanding of SSB in the implementation of Islamic banking practices in terms of understanding fatwas and monitoring compliance. Furthermore, the existence of an independent board and a high proportion of non-executive directors on the audit committee will increase the effectiveness of supervision, this is because independent parties can withstand management pressure. Furthermore, firm size will encourage Islamic banks to comply with sharia principles. This is because, the larger the size of the company, the more Islamic bank will be noticed by various interested parties. So that by complying with sharia principles, banks will gain legitimacy.

While SSB remuneration, IAH, leverage, and profit have no significant effect on the level of sharia compliance. It can be explained that the level of remuneration is not the main factor for SSB in supervising sharia bank operations. Furthermore, IAH account holders do not have voting rights in sharia bank policymaking, this is what makes IAH account holders passive in sharia bank policies. As for leverage and profit, it has no effect because most of the sample Islamic banks have leverage ratios and profitability ratios that are not too high, so these two ratios do not require banks to disclose more information.
Based on the results of this study, it is hoped that it can contribute to the development of Islamic bank governance. The governance of Islamic banks has distinctive characteristics, such as the role of DPS in maintaining sharia compliance and IAH account holders that must be paid more attention to considering that the proportion of funding in Islamic banks is dominated by third-party funds. Furthermore, on the practical aspect, we expect regulators to limit the proportion of SSB cross-membership in Islamic banks. This is because, if the proportion of SSB cross-membership is high, it will reduce the amount of time SSB has in providing advice and sharia supervision on Islamic bank activities. Furthermore, based on the results of this study, we hope that all Islamic banks have high enough independent commissioners, to create efficient Islamic bank governance.

The limitation of this research is that at least the sample can meet the research criteria, so these factors cannot be tested dynamically. In the future, this research can be developed by increasing the number of samples, so that the factors can be tested dynamically and can describe the real conditions of Islamic banks.

References


