“The impact of good corporate governance and Sharia compliance on the profitability of Indonesia’s Sharia banks”

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THE IMPACT OF GOOD CORPORATE GOVERNANCE AND SHARIA COMPLIANCE ON THE PROFITABILITY OF INDONESIA’S SHARIA BANKS

Abstract

This article aimed to observe the influence of Good Corporate Governance (GCG) and Sharia compliance on the profitability of Sharia banks in Indonesia. This study uses secondary data obtained from 2012 until 2016 with nine samples of Indonesia’s Sharia banks according to purposive sampling criteria. Data are processed by using data panel regression analysis. The independent variables used are the composite value of GCG, which is the result of the self-assessment of the Sharia bank, as well as the proxy of Sharia compliance, namely Islamic Income Ratio (IsIR) and Profit Sharing Ratio (PSR), while the dependent variable used is profitability with a Return on Equity (ROE) as the proxy. The results showed that GCG and PSR variables have negative values indicating that there is no influence of GCG and PSR on ROE, while the variable of IsIR influences ROE value. This study provides benefits in presenting useful information to assess the compliance of Islamic banks based on Sharia principles.

Keywords: good corporate governance, Sharia compliance, Islamic income ratio, profitability, profit sharing ratio, return on equity

JEL Classification: G210, G340

INTRODUCTION

The current global economic development provides rapid changes, so it must be adapted quickly by companies including Sharia banks to compete competitively with other banks. The existence of competition in this business makes the bank eager to improve its performance. One of them is by applying good corporate governance mechanism or better known as Good Corporate Governance (GCG). It is a mechanism that organizes the relationship between management performance and the interests of stakeholders so that the effectiveness and efficiency of the company can be realized and it also makes shareholders’ trust increase (Grantham, 2004; Rajagopalan & Zhang, 2008). Weak GCG implementation not only worsens the performance of a company, but also it can cause an economic crisis in a country, even global crisis. One of the causes of the Asian crisis in 1998 was the failure of GCG implementation to trigger macroeconomic fundamentals to be very fragile (Iramani et al., 2018; Johnson et al., 2000; Siswanti et al., 2017) and many companies collapsed (Sanchia & Zen, 2015). The crisis has awakened the importance of investor protection and Good Corporate Governance practices (Cabalu, 2005). With GCG mechanism and supervision, inefficiency due to moral hazard and adverse selection can be minimized.
The concept of GCG is something that must be implemented to build a robust corporate condition. According to Mullineux (2006), proper bank regulation and supervision become part of GCG implementation system. It should be noticed at once whether the transaction incorporates components that eradicate profits or gains in the corporate governance of Sharia-compliant business (Ibrahim, 2006). It is due to Sharia not being only related to the substance, but also to the form of the transaction. The beginning of the need for the implementation of GCG in Islamic banks was marked since the existence of Bank Indonesia Regulation (PBI) No. 8/S4/PBI/2006 on the implementation of GCG in banking, including Sharia banking. It was later replaced with PBI No. 11/33/PBI/2009 on the implementation of GCG for Sharia Commercial Bank and Sharia Business Unit, considering that GCG to be applied to Sharia banking must comply with Sharia principles (Desiana et al., 2016; Suroso et al., 2017).

Business activities run by Sharia banking are activities based on the principle of trust. Realizing good governance systems and maintaining compliance with Sharia principles is a virtue that Sharia banking must undertake to keep the stakeholders’ confidence. Conformity with Sharia principles (Sharia compliance) is a very fundamental thing and even become an obligation that must be applied in Sharia banking, because that distinguishes Islamic banks with conventional banks is the fulfillment of the principle of Sharia. According to Ghayad (2008), the main characteristic of Sharia banking is the absolute prohibition of payment and interest receipt in every transaction. Sharia compliance is part of the implementation of a risk management framework and embodies a culture of respect in managing Islamic banking risks (Widialoka et al., 2016).

The resilience of Sharia banks to the adverse effects of the financial crisis in 2007–2008 has been tested by using financial ratios as the critical factor (Olson & Zoubi in Kolsi & Grassa, 2017). Financial ratios can be used to measure the company’s financial performance, including measuring the ability of banks to generate profits by using profitability ratios. Jeon and Miller (2006) said performance is bank profitability. One proxy of profitability ratios is Return on Equity (ROE), which measures how well the management makes use of shareholder investment. Based on this background, this study intends to test whether GCG and Sharia compliance give effect to the profitability of Sharia banks in Indonesia.

1. **LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT**

There are three fundamental theories that contribute to the emergence of corporate governance, namely agency theory, stewardship theory, and stakeholder theory (Iramani et al., 2018). The first theory is agency theory which explains the relationship between the authorities (principals), which are shareholders, and the recipient of the body (agents), which are managers, who have different interests. Managers tend to fulfill personal goals than those of shareholders. Likewise, information about companies is more owned by managers, because managers are more often confronted with the condition of the company than the owner of the company, so the risk of earnings management is effortless to occur (Mediaty, 2013; Hanifah, 2015; Wiyadi & Sasongko, 2015). This thing will cause agency problem that will impact on the occurrence of information gap or better known as information asymmetry. The problem can be overcome with the implementation of GCG. It is necessary to ensure that the rights of shareholders are met.

The second theory, stewardship theory, illustrates that the motivation of managers is not solely to achieve individual goals, but instead leads to the interests and achievement of organizational goals. The manager will be responsible and work optimally so that the principal’s wishes can be fulfilled. The existence of good relationships, mutual trust, and bilateral cooperation between shareholders and managers will facilitate the achievement of common goals. Stewardship theory prioritizes cooperation and collaboration, in contrast to agency theory that emphasizes conflict and supervision (Sundaramurthy & Lewis, 2003).
The last theory is stakeholder theory. The considered relationship does not only cover the principal (shareholders) and managers, but rather extend to external parties of the company better known as stakeholders. Not only the needs of the company must be met, but the interests of stakeholders must also be accommodated by the company. This theory explains that stakeholders have a significant influence on the existence of the company for the achievement of the goals and sustainability of the company in the future.

According to Effendi (2009), Good Corporate Governance is a set of systems that aim to regulate and control the company to create added value for the stakeholders. In conducting its operations, Sharia banks are always faced with various risks, whether it is a credit risk, market risk, operational risk, or legal risk and reputation risk, so the bank requires careful management. The role of GCG, in this case, becomes very important, because it refers to the system and method of how banks are directed, organized or controlled. If GCG is implemented correctly in a Sharia bank, it will be able to produce good performance between shareholders, board of commissioners and board of directors in making decisions and running them in accordance with the established values, so that the objectives of Islamic banks can be achieved. GCG implementation is needed to strengthen the development of the Islamic banking industry. GCG principles consisting of transparency, accountability, responsibility, independence, and fairness are necessary to realize the business continuity of the company by taking into account the stakeholders (Burak et al., 2017; Gunawan et al., 2014; Lidiyawati, 2015; Wakarmamu, 2015).

The following is the GCG self-assessment composite classification shown in Table 1.

Table 1. Composite value of GCG self-assessment according to Bank Indonesia

<table>
<thead>
<tr>
<th>Composite value</th>
<th>Composite predicate</th>
</tr>
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<tbody>
<tr>
<td>Composite value &lt; 1.5</td>
<td>Very good</td>
</tr>
<tr>
<td>1.5 &lt; composite value &gt; 2.5</td>
<td>Good</td>
</tr>
<tr>
<td>2.5 ≤ composite value &lt; 3.5</td>
<td>Fair</td>
</tr>
<tr>
<td>3.5 ≤ composite value &lt; 4.5</td>
<td>Deficient</td>
</tr>
<tr>
<td>4.5 ≤ composite value &lt; 5</td>
<td>Bad</td>
</tr>
</tbody>
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Based on Table 1, it can be seen that the smaller the composite value obtained by a bank, the better the predicate. However, if the ranking of GCG factors obtained is 3, 4 or 5, then the action plan must be prepared by a bank and submitted to Bank Indonesia, which includes corrective measures in a comprehensive and systematic manner (Circular Letter of Bank Indonesia No. 15/15/DPNP/2013).

As a bank that conducts its activities based on Sharia principles, Sharia compliance is an absolute requirement that must be executed by Sharia banks. Sharia compliance is the fulfillment of all Sharia principles in the policies, regulations and all activities undertaken by Sharia banks. The Republic of Indonesia’s Act No. 21 of 2008 explains that the principle of Sharia is a principle based on Islamic law, which underlies the activities of Islamic banking based on a fatwa from the institution authorized to determine the fatwa, namely the National Sharia Board (DSN) – the Indonesian Council of Ulama (MUI). The prohibition of usury (riba), improbability (gharar), and gambling (maysir) in transactions and halal business investment is part of the implementation of Sharia principles (Mizushima, 2014). Islamic banks must maintain the process of determining profit sharing in mudharabah and...
musyarakah contracts and minimizing the existence of non-halal income. For this reason, the role of the Sharia supervisory board is needed to supervise Islamic banks in carrying out compliance with Sharia principles (Hameed et al., 2004).

Indicators used in Sharia compliance here are part of the Islamicity performance index consisting of Islamic Income Ratio (IsIR) and Profit Sharing Ratio (PSR). This index develops into a quantitative instrument for accountability of Sharia bank compliance with Sharia principles. It is important for Islamic banks to pay attention to which halal transactions are prohibited. Every process that the Islamic bank goes through in its operational activities must proceed properly according to Sharia principles, including the source of income that must be considered halal. For this reason, Islamic banks must honestly disclose how much halal income is obtained in a period that can be measured by IsIR (Hameed et al., 2004), while the PSR to assess how Islamic banks use profit-sharing activities in their activities with the total finance, because profit sharing is the primary goal of Sharia banks. Mudharabah and musyarakah are financing schemes based on profit sharing.

Mudharabah is a contract of cooperation between the owner of capital (shahibul maal) and the fund manager (mudharib), whereby money is provided entirely by the owner of it. This type of mudharabah financing follows the principle of profit sharing where the profits generated will be divided according to the agreement of both parties. If a financial loss occurs, it will be borne by the fund owner, as long as the loss is not caused by the negligence of the fund.

Whereas musyarakah is a business cooperation agreement where each party, namely the capital owner and the fund manager, contributes to giving their capital in the business. This financing scheme uses the principle of profit loss sharing where profits are divided according to the agreement and losses are borne jointly according to the amount of capital invested (Ghayad, 2008). Both types of financing agreements have a high risk compared to another contract financing such as murabahah, which still dominates the distribution of Islamic bank financing in Indonesia (Siswanti et al., 2017; Baktiar et al., 2017).

Profitability is one of the tools to measure the performance of a bank (Siswanti et al., 2017). Profitability is an indicator that describes the company’s ability in generating profit. Profitability ratios also aim to assess the extent to which firms use their assets and manage their operations efficiently (Ross et al., 2012). With profitability, the opportunities and survival of a company in the future can be known. For investors, profitability plays a vital role in influencing its decision to invest capital in the company. High profitability and supported by stronger growth, will make the company able to survive in the business continuity for an extended period (Dilling, 2009).

Return on Equity (ROE) is among the types of profitability ratios that show what percentage of net income was obtained when measured from the owner’s capital (Fardiansyah, Achsani, & Juanda, 2016). The higher this ratio, the better the value of the company and the higher the ability to paid-up capital of the bank in generating shareholder profits. This thing can be an attraction for investors to invest their capital in the company. ROE value is a comparison of net income after tax with total equity (Lesakova, 2007).

Several studies have shown a significant positive effect of GCG implementation on profitability, in this case, represented by ROE (Desiana et al., 2016; Markonah et al., 2016; Tjondro & Wilopo, 2011), while Suroso et al. (2017) also examined the effect of corporate governance on Return on Assets (ROA), which resulted in a positive relationship. However, this contrasts with research conducted by Ferdyant et al. (2014), Permatasari and Novitasary (2014), which show that GCG does not affect the banking profitability. The Sharia compliance testing proxied with issues of Islamic Income Ratio (IsIR) and Profit Sharing Ratio (PSR) has been done by Falikhatun and Yasmin (2012). The results of the IsIR test give a significant positive effect on the financial health of Sharia banking in Indonesia, and PSR shows a positive value of significant influence of PSR on the financial health of Sharia banking in Indonesia (Falikhatun & Yasmin, 2012). Based on this, the proposed hypothesis is:

**H1:** GCG and Sharia compliance (IsIR and PSR) have a positive effect on the profitability (ROE) of Sharia banks.
Implementing GCG and Sharia compliance can improve the profitability of Sharia banks. The better the implementation of GCG, the company will increasingly be able to produce a reasonable profit rate, which will also have a positive impact on the level of increase in Return on Equity (ROE). With GCG, it will limit the interests of the managers of the company to profit themselves so that will increase investor confidence in Islamic banks. The higher ratio of *mudharabah* and *musyarakah* financing launched to society, the higher the financial health of Sharia banking in Indonesia. Islamic banks that implement GCG and Sharia compliance will build a positive image in the eyes of stakeholders and make the company tough in its finances, thus avoiding the risk of failure.

2. METHODS

2.1. Data and methodology

The population in this study were thirteen Islamic commercial banks (BUS) in Indonesia, which were under the control of the Financial Services Authority. The data used in this article are secondary data, which contains items contained in the annual financial statements of Islamic banks obtained from the website of each bank. Sampling is a purposive sample, with the sample based on specific criteria. The criteria for selection of corporate data samples in this study are as follows:

1) Sharia commercial banks registered in Indonesian banks during five years from 2012 to 2016;

2) Sharia commercial banks publish annual financial statements on the websites of Sharia commercial banks from 2012 to 2016;

3) Sharia commercial banks that publish reports on the implementation of Good Corporate Governance on the website of Sharia commercial banks from 2012 to 2016;

4) disclosed data related to research variables are required in full.

Based on the above criteria, the sample in this study consists of nine banks, among others: Bank BCA Syariah, BNI Syariah, Bank Victoria Syariah, Bank Mega Syariah, Bank Muamalat, Bank Bukopin Syariah, BRI Syariah, Panin Syariah Bank, and Bank Syariah Mandiri. The collected data in this research are formed in panel data, which is a combination of time-series and cross-section data (Abduh & Idrees, 2013). Data were processed by using multiple regression analysis that aims to see what factors affect the ROE. Multiple regression analysis is used where the dependent variable is influenced by more than one independent variable. Modeling using panel data regression technique can be done with three approaches:

a. *Ordinary Least Square (OLS) model*

The OLS method is selected when there is no difference between the matrix data in the cross-section dimension. This model estimates the constant value of $\alpha$ for all cross-section dimensions. The analysis is conducted after the mean responses of each construct were computed. The determination of the importance of independent variable towards dependent variable is done using multiple regressions (Nazim & Ahmad, 2013).

b. *Fixed Effect (FE) model*

The FE model is used to provide opportunities for different parameter values across cross-section and cross-time units to have different values. This thing is done with the consideration that intercept values may differ across cross-section units. The existence of a correlation between variables $X$ and individual and period effects will bring FEM, which has a non-random pattern. The model that arises is called the fixed effect, because there is an intercept value that does not vary with time (time-invariant), even though the intercept value is different between individuals.

c. *Random Effect (RE) model*

The decision to include the dummy variable on the RE model has its consequences in the panel data regression analysis. Accordingly, the third type of model approach, the RE model, is used. In the RE model, different parameters between individuals and between times are included in the error component. The absence of correlation between variables $X$ and individual and period effects will give
rise to random effects. The Hausman test is used to test this assumption that is related to the rejection or acceptance of the assumption that there is a correlation between the error component and the independent variable.

2.2. Variables

There are two types of variables used in this study, namely the independent variables and the dependent variable. The dependent variable is ROE, while the independent variables include GCG, IsIR, and PSR. This study was conducted to examine the effect of GCG ($X_1$) and Sharia compliance using the Islamic income ratio ($X_2$) proxy and profit sharing ($X_3$) on profitability with the proxy return on equity ($Y$) shown in Figure 1.

GCG, the proxy used in this study, is the composite value of self-assessment according to Bank Indonesia, which is divided into five categories. Assessing the better implementation of GCG in a bank, it can be seen in the composite rating that is getting smaller. This composite result was obtained from an assessment of 11 aspects of self-assessment in the implementation of sharia compliance that applies to Islamic commercial banks.

Sharia compliance consists of Islamic Income Ratio (IsIR) and Profit Sharing Ratio (PSR). As a Sharia bank, compliance with Sharia principles is a must to be implemented in banking activities. IsIR is used to assess the extent to which Islamic banks generate income from halal sources. The value of IsIR obtained from Islamic revenue amount divided by the total revenue received by Islamic banks both halal and non-halal income. PSR is used to calculate the profit sharing of Islamic bank financing, including mudharabah and musyarakah with total funding distributed by Sharia banks (Hamid et al., 2004).

Profitability quantifies the extent to which a company produces a rate of return that will be given to investors and how much profit the company earns in a certain period. The proxy of profitability measured in this study is ROE that measures the company’s ability to generate profit after tax with available capital (Tjondro & Wilopo, 2011).

\[
ROE = \frac{\text{Earning after taxes}}{\text{Equity}}. \tag{3}
\]

3. RESULTS

The following is the result of the analysis of the use of the regression model for dependent variable of ROE and for the independent variable of GCG, IsIR, and PSR. The output of panel data regression with OLS model can be seen as follows.

From Table 2, there is one variable with the individual test ($t$-test probability), which looks significant with alpha = 5% and the adjusted value of $R^2$ is 0.162523 and with the low Durbin-Watson test value of 0.543773 (far from the range of 2) indicates an autocorrelation problem. The use of this method cannot capture the accurate picture of the relationship between independent variables and dependent variables and the relationship of the individual cross-section. Furthermore, it is necessary to search the specific relationship between each in cross-section data. For this purpose, the data are processed by the Fixed Effect (FE) method.

\[
IsIR = \frac{\text{Islamic income}}{\text{Islamic income} + \text{Non-Islamic income}}. \tag{1}
\]

\[
PSR = \frac{\text{Mudharabah} + \text{Musyarakah}}{\text{Total financing}}. \tag{2}
\]
The output of panel data regression with FE model can be seen as follows. From Table 3, there is one variable with the individual test (t-test probability) that looks significant with alpha = 5% and the adjusted value of $R^2$ equal to 0.111034 and with the value of Durbin-Watson test equal to 0.747229 not yet approaching the range of 2.

Further, the election between the OLS method or FE method is determined by $F$-test (Chow test).

Based on Table 4 above obtained p-value value on chi-square cross-section is $0.5277 > \alpha = 0.05$ then $H1$ is rejected which means the OLS model is better used than the FE model. Given the amount of cross-section (N) data is greater than the amount of time series (T) data, it is necessary to consider the analysis with the RE model.

The result of output from the regression of panel data with RE model can be seen as in Table 5. From Table 5, there is one variable with the individual test (t-test probability), which looks significant with alpha = 5% and the adjusted value of $R^2$ equal to 0.162523 and with the value of Durbin-Watson test value of 0.543773 not yet approaching the range of 2. Thus, the analysis results also have not been able to provide certainty which method should be used. Then, the next step is to use the Hausman test.

The Hausman test was performed with the aim of comparing the FE model and the RE model. The result of the trial by this method is the determination of which model option should be used. Here is the output of Hausman test results.

<table>
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<th>Statistic</th>
<th>d.f.</th>
<th>Prob.</th>
</tr>
</thead>
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<tr>
<td>Cross-section $F$</td>
<td>0.703162</td>
<td>8.33</td>
<td>0.6865</td>
</tr>
<tr>
<td>Cross-section Chi-square</td>
<td>7.082991</td>
<td>8</td>
<td>0.5277</td>
</tr>
</tbody>
</table>
4. DISCUSSIONS

From the results of the model, RE obtained that the independent variables GCG proxies with the value of the composite self-valued negative value of 0.050305, which indicates that GCG does not affect the profitability of Islamic banks. This thing is in line with research conducted by Ferdyant et al. (2014) and Permatasari and Novitasary (2014), which show that GCG does not affect the bank profitability. It has the meaning that the better the GCG composite indicator score, the lower the ROE value. The smaller the value of the composite self-assessment GCG, the better the implementation of corporate governance applied in the banking, but does not guarantee the increase of the bank’s profitability value. For example, the GCG composite value of Bank Victoria Syariah from 2012 to 2014 is increasing, but it is not supported by the increasingly small and even negative ROE. This thing could be due to the increasing number of problematic financing. GCG implementation is aimed more at moral responsibility to the public over the values that have been implemented to create a good governance system. The regression equation obtained from the RE model can be expressed regarding:

\[ Y = 2812.918 - 0.050305 \cdot GCG + 0.073793 \cdot IsIR - 798.8607 \cdot PSR. \]

Results from Table 2 show that Profit Sharing Ratio (PSR) variable is the negative value of 798.8607. This indicates that the higher the PSR value, the lower the ROE value. From the data of PSR of Bank Muamalat, which increased from 2012 to 2013, the value of ROE is decreasing. This thing indicates that the more mudharabah and musyarakah financing distributed to society, the less profit the bank earns. This thing is because the type of financing mudharabah and musyarakah provide a high risk to the bank. Mudharabah financing uses the principle of profit sharing where this type of contract gives consequences if the customer suffers losses caused not because of customer negligence, then the loss will be borne by the owner of the fund, in this case, the banking, thus impacting on the small profit to be obtained by the bank, while musyarakah uses the principle of profit loss sharing, meaning that profits and losses are shared between the bank and the customer, the amount of which is by the portion of capital invested, respectively. When a bank distributes mudharabah and musyarakah financing, the bank must be prepared to face the risk of loss if problematic financing occurs. Results from Table 2 show that the variable of Islamic Income Ratio (IsIR) yields a positive value of 0.073793, which has the meaning that the better composite IsIR indicator score will be the better profitability of the company. In this case, ROE will increase. The average income of Sharia banks is 99% comes from halal income, resulting in increased public confidence to invest funds in Sharia banks and this will increase the bank’s profit. Customers do not have to worry, because
the results they get by the principles of Sharia. The more Islamic banks try to eliminate the effects of non-halal income, the more it will enhance the image and trust of external parties to the Islamic bank. This thing is similar to research conducted by Falikhatun and Yasmin (2012) in which IsIR affects the financial health of Sharia banking in Indonesia.

**CONCLUSION**

The result of regression analysis of panel data of dependent variable of ROE to independent variable of GCG, IsIR, and PSR proves that GCG and PSR variables have a negative value, which means that better score of GCG and PSR composite indicator will decrease ROE value. So a proper GCG implementation does not guarantee an increase in ROE, while the independent variable IsIR produces a definite amount. Which means that the better the comparative IsIR composite indicator score will further increase the value of ROE. This thing shows that the implementation of Sharia compliance, in this case, the source of Islamic banking revenue derived from halal income, affects the profitability obtained by Sharia banks. So it is important for Islamic banks to continue to pay attention and maintain sharia principles as part of Sharia compliance, which is a reference in the implementation of its operations. The purer halal income obtained by Islamic banks, then the trust value obtained from stakeholders will also increase. Besides, Islamic banks should also be able to increase the amount of profitability to keep Islamic banks healthy and have more value in the eyes of investors. Further research is expected to add another independent variable in measuring Sharia compliance, extending the study period and further research is needed for this.

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