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The Influence of Islamic Governance on Minimizing Non-Compliance with Sharia

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ABSTRACT

Objective – One of the operational objectives of sharia banks is to comply with sharia principles. Therefore, the non-compliance of sharia banks to sharia law may be prevented by implementing Islamic Good Corporate Governance (GCG), which is controlled by the Sharia Supervisory Board (SSB), the board of directors, and the board of management.
Methodology/Technique – In this study, sharia non-compliance is defined as all cases of disobedience found in the report of sharia banks, covering things such as non-halal income, criminal law violations, civil law violations, and fraud. The unit of analysis of this research is sharia banks in Indonesia. Seven sharia banks were used as the study sample for the period between 2012 and 2015. The source of data for this study comprised of GCG annual reports. The data analysis method and hypothesis testing was conducted using a factor analysis and multiple regression analysis.
Findings – The findings show that higher levels of supervision from the SSB tend to minimize the instanc of sharia non-compliance as a whole, criminal and civil law violations, and fraud, although not to a level that is statistically significant.
Novelty – The influence of the board of management on non-halal income was negative, although statistically insignificant. The influence of the supervision from both the board of directors and the board of management on overall sharia non-compliance is also not statistically significant.
Type of Paper: Empirical.

Keywords: Sharia Non-compliance; Islamic Bank; Islamic GCG; Sharia Supervisory Board; Board of Directors; Board of Management.
JEL Classification: M10, M14, M19

1. Introduction

One of the main sharia principles is to not pursue worldly values, but to reach falah. Compliance with Sharia is thus a key element for Islamic entities working to reach the goal of falah.

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Various efforts have been made by sharia banks supervised by stakeholders through the use of an Islamic Good Corporate Governance (GCG) framework. However, a previous study has found that sharia GCG plays an important role in improving risk monitoring and financial performance (Sabur et al., 2016). Therefore, Islamic GCG is expected to be able to improve the compliance of sharia banks with sharia principles. As such, sharia non-compliance may be minimized by optimizing the supervisory function in Islamic GCG.

Instances of sharia compliance or non-compliance are periodically reported by sharia banks as a requirement of their GCG principles, namely, accountability and transparency. Sharia non-compliance is investigated annually and is reported in Islamic GCG annual reports. These reports provide details on things such as non-halal income, criminal and civil law violations, and internal fraud. Despite this, however, sharia non-compliance continues to exist. In 2013, for example, the Bank of Syariah Mandiri (BSM) officials faced sanctions for allegedly stealing from their own company by providing finance to 197 fictitious recipients. There were also allegations of other unlawful acts that resulted in significant losses to the state. The aim of this study is to demonstrate that a better quality of supervision in Islamic GCG will result in a better compliance to sharia principles by sharia banks.

The Sharia Supervisory Board (SSB) is represented as an Islamic bank that has characteristics of a good governance structure (Advanced, 2012; Sabur et al., 2016). The SSB is expected to be able to optimize its role as a direct supervisor to monitor sharia compliance, which may reduce the level of non-compliance to sharia principles (Alman, 2012). The role of the board of directors, assisted by the board audit committee and risk oversight committee, is to supervise all aspects in relation to the owners. In addition, the board of directors aims to improve the quality of GCG while also supervising other functions. Meanwhile, the board of directors, as a policymaker and executor, is expected to minimize the instance of sharia non-compliance. This study is therefore carried out to empirically examine the potential supervision factors that may reduce the rate of sharia non-compliances by sharia banks in Indonesia.

2. Literature Review and Theoretical Framework

Shari'a corporate theory states that the axiom that underpins the determination of the entity theory (which states that God is the creator of all resources in the universe) has consequences for responsibility in terms of goals, uses, and methods, as determined by the Trustee (Puspitasari et al., 2017). This theory explains the basic needs and responsibilities of the entity to always adhere to shariah as a provision of the Creator and to help each other in the effort to operate in the corridor of rules of God.

2.1 Sharia Board of Directors and Directors Board

Islamic Corporate Governance (ICG) is a unit of company management focusing on Islamic aspects in the running of financial business activities. A Sharia or Islamic governance system refers to a set of institutional and organizational arrangements for Islamic Financial Institutions (IFIs) that guarantees the effective oversight of Sharia compliance (IFSB, 2009). ICG aims to protect all stakeholders through sharia compliance. Moreover, it also plays an important role in influencing the risk preference with regard to risk monitoring in the form of a loan portfolio (Alman, 2012). The board of directors, assisted by the board audit committee and risk oversight committee, conducts a comprehensive oversight function on behalf of the owners. The board of directors aim to improving the quality of GCG at a time when other supervisory roles are not yet optimal (Andreas and Vallelado, 2008). The board of directors, as the policymakers and executors, are expected to minimize the instance of sharia compliance violations by a sharia banks. This research is conducted to identify the supervisory factors that contribute to the reduction of sharia non-compliance by sharia banks.

2.2 Sharia Supervisory Board, Board of Directors, and Board of Management

ICG is a form of corporate governance that takes into account all aspects of Islamic rules (Islamic law) in every activity. A "Sharia governance system refers to the set of institutional and organizational arrangements through which an institution offering Islamic Financial Services (IIFS) ensures that there is effective independent oversight of Sharia compliance" (IFSB, 2009). ICG aims to protect all stakeholders through by ensuring effective compliance.

One of the most important ICG structures in sharia is the Sharia Supervisory Board (SSB). According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2008), the SSB is an independent board that consists of sharia scholars and others who are experts in the field of IFIs. The SSB has a duty to supervise, review and direct the activities of IFIs in order to ensure that they comply with Islamic Sharia. The SSB, as part of the internal governance structure, can improve a company's credibility among its customers, shareholders, and stakeholders (Rammal, 2006). The board has the following roles: (1) approving sharia in formal documents produced by an Islamic financial institution, (2) approving sharia in LKS transactions, (3) supervising sharia to check transactions, (4) approving and contributing to the generation of new products, (5) submitting the SSB's annual report, and (6) responding to requests of management.

In terms of the board of directors, as part of the GCG structure, 30% of the board should consist of independent commissioners. The board has aims to improve the effectiveness of supervision as an independent board of directors that engages in little in the way of conflict when monitoring managers; thus, it can be expected that there will be a positive link between bank value and the presence of outsiders (Andres and Vallelado, 2008). In addition, within the structure of GCG, the board of directors is supported by a board audit committee and risk oversight committee. According to OJK 55/2015, the board audit committee has the task of reviewing financial information and other financial reports. Based on POJK 55/2016 on risk oversight, the board is responsible for evaluating whether the execution of the sharia bank's policies is appropriate for risk management. Further, according to POJK 65/2016, compliance risk is one of the largest risks faced by sharia banks due to their failure to comply with and/or failure to implement laws and regulations based on Sharia principles.

According to POJK 55/2016, the Board of Management is responsible for the bank's management. The Board of Management should therefore apply the principles of ICG in each bank's business activities in all levels of the organization.

2.3 The Influence of the Sharia Supervisory Board on Sharia Compliance

Islamic banking institutions are responsible for ensuring that their activities comply with the basic sharia principles, even if it means sacrificing their own interests (Alnasser and Muhammed, 2012; Ariffin et al., 2007; Lee and Ullah, 2011, in Hasan et al., 2012). Compliance has the effect of ensuring customers are secure with the money that is used to run their halal businesses and social activities, as instructed by Islamic principles. In addition, these institutions are also obliged to demonstrate good sharia compliance accountability as part of their GCG obligations, which is carried out through the reporting of sharia non-compliance. This is consistent with the findings of Gallhofer and Haslam (1993), in Shah (1998), who state that one of the most effective methods by which to undertake creative accounting is the publication of non-compliance. This publication is reported in the form of an ICG report that includes information on non-halal income, internal fraud, and criminal and civil law violations. Non-halal income indicates a relationship with investments, savings, and other transactions with conventional institutions. Civil and criminal law violations, as well as fraud, also identify a violation of sharia compliance.

The SSB is an important organization within ICG. The SSB must ensure that all objectives of Islamic governance are well achieved, including directing, reviewing, and supervising that all Islamic financial institution activities have been appropriately conducted in line with sharia principles. Therefore, the SSB plays an important internal control function (Haniffa and Hudaib, 2007). Empirical data shows that in practice, shariah compliance remains problematic. Waemustafa and Abdullah (2015) found that an effective SSB does not have a significant influence on the choice of Islamic financial modes in Malaysia, however, the remuneration of board members does. Further, Khan et al. (2015) has found that in some countries, the SSB is not overly concerned with Shariah compliance, and that the choice of framework is delegated to the IFI (Khan et al., 2015).

The role of the SSB is to monitor the transactions of the Islamic bank (Arman, 2013). Gulzar (2006). Injas et al. (2016), investigates the role of the SSB in supervising all of the activities of an Islamic bank to ensure compliance with Islamic principles and frameworks. Moreover, the independence of the sharia supervisory board, in reference to its supervisory objective and the consistency of sharia decisions, refers to the main components of an efficient Sharia governance structure (Hamza, 2013). Consequently, it is assumed that a stronger SSB will result in a lower rate of non-halal income, civil and criminal law violations, and fraud.

H1: The SSB has a negative influence on sharia non-compliance.
H1a: The SSB has a negative influence on non-halal income.
H1b: The SSB has a negative influence on law violation.
H1c: The SSB has a negative influence on fraud.

2.4. Influence of the Board of Directors on Sharia Compliance

The Board of Directors, as supported by the independent commissioners, the board audit committee, and the risk-monitoring board, all have a responsibility to ensure that all aspects of Islamic bank management achieve the objectives of sharia entities. These boards play an important role in guiding Islamic banks to conduct their business in accordance with Islamic accounting achievements (Rini, 2014).

According to POJK 55/2016, the Board of Directors is responsible for directing, monitoring, and evaluating the strategic policy of banks, particularly with regard to sharia bank policies, which must be aligned with sharia principles. The existence of an independent committee is expected to improve the effectiveness of supervision of the board of directors. In this case, the board audit committee carries out active supervision of the financial reporting process, which is regulated by multiple codes of conduct and company management (Song and Windram, 2004, in Ghazali and Ika, 2012). On the other hand, in the context of the implementation of risk management, risk of compliance is included in cases of internal audits. In POJK 55/2016, the risk oversight committee has a responsibility for evaluating the consistency between the execution of bank policies and risk management policies, particularly in relation to risk management of compliance. Hence, a better quality of supervision will reduce the rate of non-compliance with sharia principles.

H2a: The board of directors has a negative influence on sharia non-compliance.
H2b: The board of directors has a negative influence on non-halal income.
H2c: The board of directors has a negative influence on law violation.
H2d: The board of directors has a negative influence on fraud.

According to the OJK regulation, banks are required to have at least 3 directors, each of whom has a responsibility for the implementation of good management principles in the running of all activities at all organizational levels. According to Hejazi (2005), in Injas et al. (2016), Islamic banks must not engage in unethical conduct with respect to their customer’s wealth, but should adhere to good management based on sharia principles.

H3a: The board of management has a negative influence on sharia non-compliance.

H3b: The board of management has a negative influence on non-halal income.
H3c: The board of management has a negative influence on law violation.
H3d: The board of management has a negative influence on fraud.

3. Research Methodology

The unit of analysis in this research is sharia banks in Indonesia, with 7 sharia banks that publish an ICG report included as the study sample. The reports used by the study cover the period between 2012 and 2015 and were obtained from the annual GCG sharia reports. The dependent variables include Non-Halal Income (NHI), which was measured by the amount of non-halal income in Rupiahs, while law violations (LV) were counted by the number of criminal law and civil law violations. In addition, Fraud (FR) was calculated based on the number of fraud events, while Sharia Non-Compliance (SNC) was investigated based on the average score factor as a result of the non-halal income, law violation, and fraud factor analysis. Meanwhile, the independent variables include the Sharia Supervisory Board (SSB), comprising of the SSB members, the board of directors (BOD), rated using the average factor analysis score from the number of independent commissioners, the number of board audit committee members, the number of risk oversight committee members, the number of board audit committee meetings and the number of risk oversight committee meetings, and the board of management (DIR), which consists of top management members.

In terms of data analysis, a multiple regression analysis and factor analysis were employed to analyze the data and test the hypotheses. In contrast, a factor analysis was conducted based on indicators given by the board of directors involving the number of independent commissioners, the number of members of the board audit committee, the number of members on the risk oversight committee, and the number of board audit committee meetings and risk oversight committee meetings. A factor analysis was also carried out in the final model in respect of sharia non-compliance. It should be noted that all of the data used in this study was normally distributed, with the exception of the non-halal income of sharia banks.

4. Results of the Study

The results of the study can be seen in the following table:

Table 1. Results of the Study

Model	Dependent variable	Independent variable	Standardized coefficient	P Value of Coefficient	P Value of Model	R Square
1	SNC	SSB	**- 0.10**	(0.476)	(0.013)	35.6%
		BOD	0.40*	(0.034)		
		DIR	0.38**	(0.064)		
2	NHI	SSB	0.126	(0.550)	(0.110)	21.8%
		BOD	0.43*	(0.034)		
		DIR	**- 0.51**	(0.814)		
3	LV	SSB	**- 0.127**	(0.468)	(0.002)	46.2%
		BOD	0.117	(0.475)		
		DIR	0.684*	(0.001)		
4	FR	SSB	**- 0.27**	(0.904)	(0.330)	13.1%
		BOD	0.20	(0.352)		
		DIR	0.17	(0.743)		

The above table presents the hypothesis testing, from which the following points can be drawn:

Models (1), (3), and (4) indicate that if the number of SSB members increases, the amount of non-halal income decreases, while the number of civil and criminal violations decreases and the level of sharia non-compliance declines, although the effect of SSB is statistically not significant at α 5%.

Meanwhile, in model (2), the board of management has a negative effect, although it is statistically not significant. In models (1) and (3), the board of management has a positive effect that is statistically significant at the α 5% level.

In all models, the board of directors has a positive effect, although statistical significance at the α 5% level occurred only in the Sharia non-compliance models of non-halal income (2) and sharia non-compliance as a whole (1).

5. Discussion

The SSB acts supervises sharia compliance in Indonesian Islamic banks to ensure that they conduct their financial activities in accordance with Islamic principles (Gulzar, 2006, in Gospel et al., 2016). The findings of this study reveal that customers are able to trust the SSB to protect their transactions against any sharia violations that might be carried out by sharia banks, although it is believed that the SSB does not supervise fraud effectively. The intensity of fraud was also influenced by other dominant factors, such as weak internal controls, the whistleblowing system, high risk, and a poor ethical culture. Future research should examine a greater sample size to measure greater statistical significance and achieve generalization of results.

However, in this study, neither the number of the Board of Directors or the Board of Management nor the frequency of meetings had a negative relationship with the instance of sharia non-compliance. These findings are inconsistent with previous research by Hejazi (2005), as cited in Injas et al. (2016), which states that Islamic banks have to adopt good management based on Islamic principles. These findings require further research to confirm the meeting agendas and skills background of each member. The results of this study are valuable as they have not been achieved previously through the use of this research model.

6. Conclusion

Islamic banks operating in countries with a majority Muslim population need to further improve their compliance with Islamic principles. The SSB plays a central role in ensuring the compliance of Islamic banks. The effectiveness of the SSB, which is expected to be negatively associated with sharia non-compliance, should be improved from year to year. Subsequent research should examine the number of meetings and the qualifications of the personnel working in Islamic finance to identify the effect these items have on the ability for the SSB to achieve its function.

The board of commissioners and board of directors of Islamic banks in Indonesia are more concerned with legal risk and operational risk, in particular fraud, as opposed to non-halal income, which is one of the main focuses of the SSB. Subsequent research using data from the current period may therefore be expected to show an improvement in the role of the SSB, so that the 3 forms of sharia non-compliance in Islamic banks, (non-halal income, fraud, and law violations) are reduced.

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