Governance and Islamic Bank Risk During Pandemic Period

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ABSTRACT

Investment decision risk could be minimized by good governance, and it becomes an essential strategy for the industry, including Sharia banking, for sustainable performance during an abnormal economic impacted pandemic. We examine the role of Sharia bank governance proxied by supervisory boards, board commissioners, and independent commissioners in managing the risk level. Then, Capital Adequacy Ratio (CAR) is used as risk measurement because it shows the ability of banks to provide funds that are used to overcome possible risks of loss. We used 8 Sharia banks in Indonesia during 2020-2021 as a sample of the study. The data were analyzed descriptively, and used panel data regression to test the hypotheses. The results showed commissioner board significantly affects the level of Sharia bank risk, but no firm evidence of the role of supervisory boards and independent commissioners. The finding implies that Sharia banks should focus on having a good composition of boards to manage the risk level, especially when facing abnormal conditions such as the pandemic.

Keywords: Governance, Supervisory, Board, Independent commissioners, Islamic banking risk

1. INTRODUCTION

The business environment is vital in aligning the environment and the business itself. Several factors affect the business environment that are divided into internal factors and external factors. Internal factors from the business environment significantly influence the rotation of the business and the feedback that the business can provide to the environment. At the same time, external factors cover all layers that are outside the company. Usually, external factors instill an excellent or wrong view of an existing business. These internal and external factors can trigger risks for company activities, including banking.

Islamic banking operates in the financial services sector and have some risks for its capital and position in banking industry. One of the external changes that can trigger trouble is a financial crisis and a pandemic. The Islamic banks have a good performance of earning assets quality in 2018-2021 and its total value of productive assets has increased both during the pandemic and after the pandemic. It means that Islamic commercial banks are becoming increasingly trusted by the public (OJK, 2021)

The development of Islamic banks, which has been increasing rapidly lately, needs to be maintained so that the wider community can still trust them by carrying out good bank management, then it can minimize the Islamic bank risks. According Bank Indonesia regulation (2011), the implementation of risk management for Islamic commercial banks and Islamic business units consist namely Credit Risk, Market Risk, Liquidity Risk, Operational Risk, Legal Risk, Reputation Risk, Strategic Risk, Compliance Risk, Rate of Return Risk, Investment Risk.

One of the risks often faced by Islamic banking is operational risk due to inadequate internal processes, internal process failures, human errors, system failures, and/or external events that affect bank operations. The measurement of operational risk such Capital Adequacy Ratio (CAR) & Operating Expenses to Operating Income. In addition, liquidity risk also needs to be watched out for by Sharia banking due to the inability of the bank to meet its maturing obligations from cash flow funding sources and/or high-quality liquid assets that can be pledged as collateral without disrupting the bank's activities and financial condition. It can be measured using Debt Equity Ratio (DER) & Non Performance Financing (NPF).

Chapra & Ahmad (2006) argued that even though Islamic financial institutions have been running well so far, these institutions address the weaknesses of Corporate Governance (CG) in developing countries. Islamic financial institutions must also be able to seriously improve their performance and fulfill stakeholders' interests by implementing CG effectively. Support for implementing CG in Sharia banking is also provided by Bank Indonesia (BI) as the holder of domestic banking authority by developing a unique CG code of ethics for Sharia banking.

The application of Governance principles in the business world in Indonesia is a demand so that existing Islamic Bank is not oppressed by increasingly fierce global competition. The basic tenets of governance aim to provide progress in the performance of a Islamic Bank. The implementation of governance is one of the key elements in increasing economic efficiency, which can help create a conducive and accountable relationship between elements in the BUS (Board of Commissioners, Board of Independent Commissioners, and shareholders) to improve company performance. The Independent Board of Commissioners has a role in ensuring the transparency and openness of Islamic bank’s financial reports. With an Independent Board of Commissioners, the interests of both majority and minority shareholders are not ignored because the Independent Board of Commissioners is more neutral toward decisions made by managers (Puspitasari & Ernawati, 2010). The governance of Islamic banking in Indonesia is currently based on regulation of Financial Services Authority (OJK) that concerning the implementation of Governance for Islamic Human Resource's Financing Banks, which regulates the mechanism for appointing a director of compliance and his position regulations regarding the board of commissioners.

The essential components of governance must be developed efficiently in Islamic Bank, so that its implementation can minimize the level of bank risk. The implementing Governance linked to Risk is a form of Islamic bank’s commitment to agreeing on regulations made by regulators. In carrying out its duties, Islamic bank is required to maintain and improve the soundness level of its with the principle of prudence in conducting their business. This regulation must be complied with and stipulated by the Financial Services Authority (Anastasia & Novita, 2019).

The active supervision from the Board of Commissioners, Directors, and Sharia Supervisory Board is one of the elements of implementing Islamic banking risk management. Other components according to these provisions are adequacy of risk management policies, procedures, and limits, adequacy of identification, measurement, monitoring, and risk control processes, as well as risk management information systems and a comprehensive internal control system. The incompatibility of bank governance with prudential and Islamic principles creates various risks for the Islamic banking industry (Mutmainah, 2018).

Good Islamic banking governance can prevent banking from occurring risks. Mutmainah (2018) conducted previous research that examined banking risk and control using GCG variables by focusing on the effectiveness of the GCG mechanism, which includes the Board of Commissioners (and the committees it forms, namely the risk monitoring committee and audit committee), the board of directors and the sharia supervisory board. Mutmainah's research (2018) results show that the number of board of directors and risk monitoring committee meetings hurt Islamic bank risk. The number of board of directors' meetings and risk monitoring committee meetings broke Islamic bank risk. In contrast to previous research, this study measured the impact of governance on the risk level of Islamic banks, using the Islamic banks in Indonesia from 2018-2021 as sample data. The research findings are expected to become material for consideration for decision-makers and policies in the field of Islamic banking governance.

2. LITERATURE REVIEW

Development of Islamic Banking

Islamic Banking is an entity that collects funds from the public in the form of financing or other words, carries out the financial intermediation function. The characteristics of the Islamic banking system that operates based on the principle of profit sharing provide an alternative banking system that is mutually beneficial to the community and the bank, and highlights aspects of fairness in transactions, ethical investment, promotes the values of togetherness and brotherhood in production and avoids speculative activities in financial transactions. By providing various banking products and services with a more varied financial scheme, Islamic banking is an alternative, credible banking system that can be enjoyed by all community without exception.

Implementation of the grand strategy aims to develop the Islamic banking financial market, including implementing a new vision for developing Islamic banking, a new Islamic banking image program including positioning, differentiation, and branding, and a new mapping program. That is more accurate towards the potential of the Islamic banking market which in general directs Islamic banking services as universal services or banks for all levels of society and all segments in accordance with the strategies of each Islamic bank, product development programs directed at a wide variety of products supported by the unique value offered (mutual benefit) and the support of an extensive office network and the use of standard product names that are easy to understand, as well as service quality improvement programs supported by Competent human resources and the provision of information technology capable of meeting customer needs and satisfaction as well as being able to communicate products and services of Islamic banks to customers correctly and clearly, while still complying with sharia principles, as well as broader and more efficient outreach and public education programs through various means of direct and indirect communication (print, electronic, online/web-site media), which aim to provide an understanding of the benefits of sharia banking products and services that can be utilized by the public.

Governance and Risk Management

Corporate governance or corporate governance is a series of processes, customs, policies, and rules of an institution that affect the deployment, management, and control of a company or corporation. Elements of governance such as fairness, transparency, accountability, and responsibility must be appropriately implemented to compete in the industry and play an active role in the country's economy. External factors, namely investors, auditors, creditors, and regulators, and internal factors of Islamic banks, namely shareholders, management, and boards, determine the success of suitable bank governance mechanisms (Mahrani & Soewarno, 2018; Hatane et al. (2019).

Bank risk management includes a structured and systematic process of identifying, measuring, mapping, developing alternative risk treatments, and monitoring and controlling risk management. Islamic banks must focus on the determinants of sound risk management implementation, including leverage and profitability.

Islamic bank risk is exposure to income uncertainty, namely the potential for events that can cause bank losses, then bank risk is a combination of the probability of an event occurring and its consequences for the bank, where every activity contains that possibility and has implications for bringing profit or loss or threatening success.

Islamic banking risk is the potential for events involving everything regarding Islamic banking. Risk measurement is needed as a basis (benchmark) to understand the significance of the consequences (losses) caused by the realization of risk, both individually and in the portfolio, on the level of business soundness and continuity of the bank's business. Furthermore, an accurate understanding of this significance will become the basis for directed and successful risk management. (Rivai & Ismail, 2013). This measurement method can be qualitative, quantitative, or a combination. Meanwhile, the risk measurement model used must be by the needs of the bank, the size and complexity of the bank, the benefits obtained, and the applicable regulations (Rivai & Ismail, 2013).

To implement the basic principles of Good Corporate Governance (GCG), tires must comply with various provisions and requirements for implementing GCG. In addition, in implementing GCG, the Sharia banking industry must also comply with Sharia principles (Sharia compliance). The active supervision from the Board of Commissioners, Directors, and Sharia Supervisory Board is an element of implementing Islamic banking risk management which supervise the products and services offered and operational activities in Islamic Financial Institutions.

H1 = The Sharia Supervisory Board influences the Islamic bank risk

The Board of Commissioners is the organization's organ whose job is to carry out general and/or specific supervision and provide advice to the directors in running and managing the company. The Board of Commissioners is tasked with ensuring that the company implements Good Corporate Governance, supervises and provides direction on the Directors' performance, provides advice, and ensures that the Directors carry out their duties in the interests of the interested parties (stakeholders). The board structure in Indonesia organization adheres to a two-tier system that shareholders will appoint a group of managers of company operations, namely management represented by directors and supervisors as management advisors called commissioners (Gago & García, 2018).

H2 = The Board of Commissioners influences the Islamic Bank risk

The independent commissioner's role is indispensable in managing a bank according to the principles of good corporate governance. An independent commissioner is a member of the Board of Commissioners who has no financial, management, share ownership, and/or family relationship with the controlling shareholders, members of the Board of Commissioners, and/or members of the Board of Directors as well as a share ownership relationship with the bank so that they can support their ability to act independently.

H3 = The Independent Commissioner influences the Islamic Bank risk.

3. METHODOLOGY

This study examines the effect of governance on the level of Islamic bank risk with a sample of 8 Islamic Banks Registered at Indonesian Financial Services Authority (OJK) for the 2020-2021 period are Bank Aceh Syariah, BCA Syariah, BJB Syariah, BTP Syariah, Bukopin Syariah, Mega Syariah, Bank Muamalat, dan Bank Panin Dubai Syariah. Research variable data is taken from the annual report and processed through data quality tests and panel data regression to prove the hypothesis. Governance is proxied by the number of Sharia Supervisory Boards and independent commissioners. At the same time, the level of risk is measured by the Capital Adequacy Ratio (CAR) based on the argument that the bank's capital adequacy ratio reflects the bank's ability in existing capital to cover possible losses in credit or securities trading (Lasmi, 2013). Capital adequacy is an essential factor for banks in the context of business development and accommodating the risk of loss.

4. EMPIRICAL RESULTS

The descriptive data show that the number of Sharia Supervisory Board in Indonesian Islamic Bank is average of two person and the Board of Commissioners is average of 3-4 person. Then there is good compliance of Indonesian Islamic Bank about proportion of independent commissioner that indispensable in managing a bank according to the principles of good corporate governance that average in 0,5775. For CAR result, Islamic Bank in Indonesia have average 29,5% that show the bank's ability in existing capital to cover possible losses in credit or securities trading.

Table 1. The Average CAR of Islamic Banks in 2020-2021

NO	BANK NAME	YEAR		AVERAGE
		2020	2021	
1	BANK ACEH SYARIAH	18,06%	20,03%	19,05%
2	BANK BCASYARIAH	45,30%	41,40%	43,35%
3	BANK BJBSYARIAH	24,14%	23,47%	23,81%
4	BANK BTP SYARIAH	49,44%	58,27%	53,86%
5	BANK BUKOPINSYARIAH	22,22%	23,74%	22,98%
6	BANKMEGA SYARIAH	24,15%	25,59%	24,87%
7	BANK MUAMALAT	15,21%	23,76%	19,49%
8	BANK PANIN DUBAI SYARIAH	31,43%	25,81%	28,62%

Source: Researcher Data, 2022

We use panel data regression in random effect model for testing the hypotheses. The results show that Islamic bank's governance which proxied by independent commissioner have significant influence on the risk level, while no strong evidence of Sharia Supervisory Board and Board of Commissioners. Generally, the finding this study have strengthen the empirical of governance determines the level of risk faced by Islamic banks.

5. CONCLUSION

The study explores governance role on Islamic Bank's risk in Indonesia. The descriptive data show that the Sharia Supervisory Board, Board of Commissioners and Independent Commissioners in line with regulation of Indonesian Central Bank. Based on the panel data regression test, only the Independent Commissioners affects Bank Risk Level.

This research was conducted on a sample of Islamic bank in Indonesia for the 2020-2021 period, so it was stated that it did not describe the condition of banking in Indonesia. Suggestions for future researchers are that they can conduct comparative research between Islamic banking and conventional banks so that they can fully explain banking conditions in Indonesia.

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