

## THE EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL STABILITY SHARIA BANK IN INDONESIA

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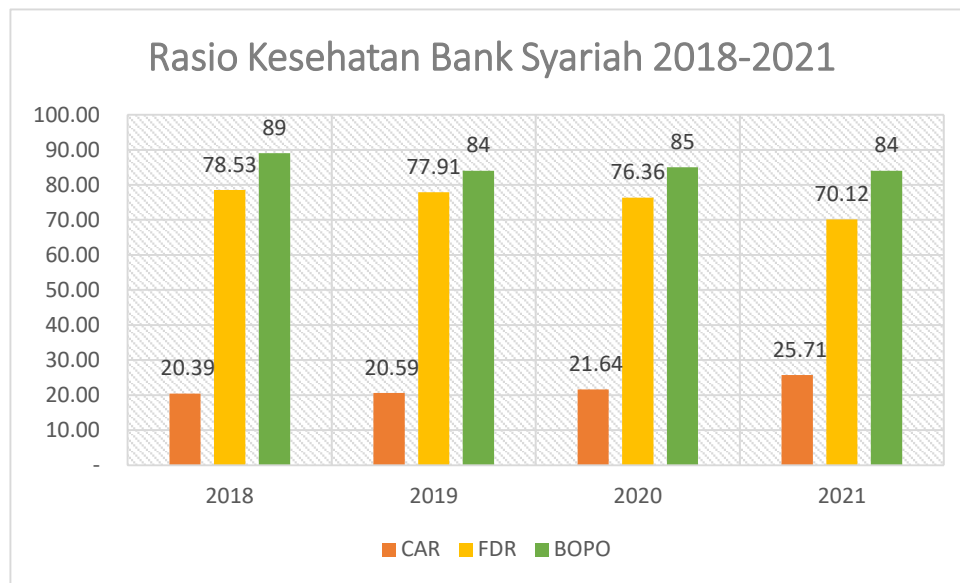
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Article Info	Abstract
<p><b>Article History</b></p> <p>Received: 7 March 2023</p> <p>Accepted: 10 June 2023</p> <p>Published: 30 June 2023</p>	<p><i>This study aims to determine the effect of corporate governance on the financial stability of Islamic banks in Indonesia as measured using the z-score. The characteristics of the board of commissioners are proxied by the variable size of the board of commissioners, independent board of commissioners, board of commissioners meetings, and educational background of the board of commissioners. The study used panel data with a sample of Islamic commercial banks in Indonesia from 2015 to 2016 with a total sample of 78 data. The data analysis technique used multiple linear regression with the fixed effect model and the classical assumption test for the suitability of the regression model. The test results show that the variable size of the board of commissioners, independent board of commissioners, and educational background of the board of commissioners has no effect on the soundness of Islamic banks. Meanwhile, the board of commissioners meeting variable has a positive effect on the soundness level of Islamic banks. The control variables for bank size and NPF have no effect on bank soundness.</i></p> <p><b>Keywords:</b> <i>Corporate Governance, Size of the Board of Commissioners, Independent Board of Commissioners, Size of Islamic Banks, NPF, Z-Score.</i></p>

### INTRODUCTION

Indonesia is the largest archipelago country in the world consisting of 17,508 islands, around 6,000 of which are inhabited. Having a population of 262 million (2017), Indonesia is the 4th most populous country in the world, and the largest Muslim country by population (IsDB). It is the 16th largest economy in the world in terms of nominal GDP (US\$1.015 billion in 2017); 8th largest economy in the world in terms of purchasing power parity; largest OIC economy; the largest economy in Southeast Asia; and members of the G-20. According to the Global Islamic Economy Indicator Score in 2021, Indonesia is ranked as the fourth largest Islamic finance in the world.

According to the Financial Services Authority, the growth of Islamic bank assets in Indonesia in 2021 has increased by 13.94 percent with total assets of 693 trillion (OJK, 2021). The size of these assets shows that Islamic banks encourage integrity, honesty, accountability, transparency and responsibility among stakeholders in their management (Khalil, 2021a). As a result, that there is a need to implement good corporate governance (Amine, 2018; Kacanski, 2020). Good corporate governance will result in assets being managed properly.



The data above shows that the bank's soundness level for CAR is very healthy, while other ratios such as FDR and BOPO also show healthy levels but the numbers fluctuate. Under these conditions, researchers want to use another measure in assessing the health of Islamic banks, namely by using the Z-Score. Several results show the Z-Score value of the predictive power of focus indicators on the banking sector (Bongini et al., 2018; Chiaramonte et al., 2015; Lepetit & Strobel, 2013). The Z Score, as a simple accounting-based measure, can help analysts and investors gain a better understanding of the risk factors in the banking sector.

According to agency theory, larger boards of commissioners raise communication problems and present difficulties in coordinating efforts among commissioners (Jensen, 1976). Amine (2018) adds that boards with a large number of directors may be associated with higher financial risks. Bukair & Rahman (2015) show that the size of the commissioners has a negative effect on the financial performance of Islamic banks. These results are also confirmed by Buallay (2019) for a sample of 127 banks in MENA countries during the 2007–2016 period. Proponents of the resource dependency theory, in contrast, say that larger boards have a wide range of knowledge and experience (Rashid, 2020). In addition, large boards increase control, make effective decisions and meet stakeholder needs (Fama & Jensen, 1983). Many researchers show that a large board of

commissioners is positively related to financial performance and can manage risks better to avoid bankruptcy (Abdelaziz et al., 2022; Naveed, 2021).

An independent board of commissioners is responsible for improving the performance of Islamic banks (Rashid, 2020). Naveed (2021) includes that a highly independent board improves the credit rating of Islamic banks and reduces the risk of default. Amine (2018) reports that the independence of commissioners has a positive effect on the stability and soundness of Islamic banks. However, other academic researchers argue that the independent non-executive director has difficulty understanding his role on the board due to his limited involvement in financial institution activities and the executive director's refusal to disclose information (Hassan & Lahyani, 2020; Lassoued, 2018). Buallay, (2019) investigates 100 banks in Middle East/North Africa (MENA) countries from 2007 to 2016. The results show that independent commissioners have a negative relationship on the performance of Islamic banks.

In addition, the number of board of commissioners meetings is the next benchmark. The intensity of board activity is measured by the frequency of board meetings, and the quality or effectiveness of their monitoring (Vafeas, 1999). Higher frequency of board meetings leads to higher quality of managerial monitoring, and therefore positively affects financial health (Ntim & Osei, 2011).

The next characteristic is the educational background of the board of commissioners. Researchers chose this variable because Islamic banks are different from conventional banks, so they need a slightly different education. In general, educational background can be considered as an important factor in disclosure practices (Haniffa & Cooke, 2002). In particular, educational level can affect social disclosure (Farook et al., 2011). Economic education background is considered better in overseeing the health of Islamic banks in Indonesia.

## **LITERATURE REVIEW**

### **Agency Theory**

In most studies, the authors trace the roots of agency theory back to economics and finance (Davis et al., 1997). Jensen (1976), defines agency theory as a contractual agreement in which one or more people (principals) involve another person (agent) to perform certain services on their behalf including delegating some decision-making authority to the agent. Therefore agency theory provides a means of addressing the relationship between two or more contractual and/or implied parties that may cause problems. The corporate board is the corporate governance mechanism; their composition can play an important role in reducing agency costs.

An effective board structure can be an effective measure of internal control that aligns the interests of management and stakeholders, thereby deterring management from opportunistic behavior. The diversity of board demographics also represents the evolving cultural, political, and social views of board membership to ensure a positive impact on company performance. Previous research has identified several benefits of having a diverse board, such as increasing creativity and innovation, so every problem can be solved (Carter et al., 2003; Mishra et al., 2013). Board size, independent commissioners, number of board meetings and educational background of the board serve as corporate governance proxies.

### **Size of the Board of Commissioners and the Health of Islamic Banks**

The Commissioners Board with its large size contains scholars with various experiences and skills and fiqh schools which lead to better interpretation of products and operations, and later, better health (Hamza, 2016). Several empirical studies have examined the impact of the size of the Board of Commissioners on the health of Islamic banks such as the research of Grassa & Matoussi (2014) and Mollah & Zaman (2015) where they found that the size of the Commissioners Board has a significant impact on the profitability of Islamic banks. So that the hypothesis can be taken as follows.

H1. The size of the Board of Commissioners has a positive effect on the health of Islamic banks

### **The Independent Commissioners Board and the Sharia Bank Health**

According to resource dependency theory, a larger number of independent directors provides better financial skills and performance (Aduda et al., 2013). Independent non-executive directors are responsible for improving performance and stability, as well as identifying key risks (Buallay, 2019). Various proponents of agency theory suggest that having a higher number of independent non-executive directors allows for better control of activities and reduces manager interest (Fama & Jensen, 1983; Jensen, 1976). In addition, independent non-executive directors assist the Sharia Board to verify compliance of financial products with Sharia law (Quttainah et al., 2013). In addition, the existence of an independent non-executive director ensures the independence of the Board of Directors (Ramly & Nordin, 2018). Others' study, in contrast, ignores the positive impact of independent non-executive directors on a bank's financial health. In addition, independent non-executive directors find it difficult to cancel understanding their main responsibilities at the bank because of the executive director's refusal to disclose information and limited participation in financial institution activities (Lassoued, 2018). So that, the hypothesis can be taken as follows:

H2. The independent Board of Commissioners has a positive effect on the health of Islamic banks

**Meeting of the Board of Commissioners and the Health of Sharia Bank**

The intensity of board activity is measured by the frequency of board meetings, and the quality or effectiveness of their monitoring (Vafeas, 1999). A higher frequency of board meetings leads to a higher quality of managerial monitoring, and therefore positively affects financial health (Ntim & Osei, 2011). Frequent meetings with informal sideline interactions can create and strengthen cohesive bonds among directors (Lipton & Lorsch, 1992), and will have a positive effect on company health. (Tauringana et al., 2008) reveal a positive relationship between the frequency of the Board of Commissioners' meetings and the company's health financial reporting. So it can be assumed that there is a positive relationship between the frequency of sharia supervisory board meetings and the health of the company. So that the hypothesis can be taken as follows.

H3. Meetings of the Board of Commissioners have a positive effect on the health of Islamic banks

**Educational background of the Board of Commissioners and the health of Islamic banks**

Researchers chose this variable because Islamic banks are different from conventional banks, so they need a slightly different education. In general, educational background can be considered as an important factor in disclosure practices (Haniffa & Cooke, 2002). Thus, the hypothesis can be taken as follows.

H4. The educational background of the Board of Commissioners has a positive effect on the health of Islamic banks.

**METHOD**

The selection of the research method in this study was a quantitative research method. The sample in this research was Islamic commercial banks in Indonesia during 2015-2020 using panel data. The technique for determining the sample used the Purposive Sampling method, the purposive sampling method was to determine certain criteria in selecting samples, namely Islamic banks that issue a complete annual report (Sugiyono, 2017). The dependent variable in this study is financial health proxied by the Z-Score.

The independent variables consisted of corporate governance proxied by (size of the board of commissioners, independent commissioners, meetings of the board of commissioners, educational background of the board of commissioners as well as control variables for company size and NPF).

The dependent variable used in this study was the financial health of the banking sector proxied in the Z-Score. (Bourkhis & Nabi, 2013) defines a bank's financial health as its ability to withstand adverse events (e.g. financial crises, natural disasters, policy changes, etc.). As such, it demonstrates a bank's ability to be and remain healthy in difficult economic conditions by using its reserve accounts and capital. According to Karkowska & Acedański, (2020) and Qasim (2020), they calculate the Z-score as follows:  $Z\text{-Score} = (ROA+KA)/\delta ROA$

The independent variables in this study consist of: The size of the Board of Commissioners is measured using the number of boards of commissioners at Islamic banks (Khalil, 2021). The Independent Board of Commissioners is measured by the percentage of total independent commissioners (Doğan & Ekşi, 2020) The Board of Commissioners' meetings are measured using the number of meetings held by the board of commissioners in one year (Ntim & Osei, 2011). Educational Background of the Board of Commissioners is measured by the number of commissioners who have an economic/financial educational background (Farook et al., 2011). Control Variable Bank size is measured using the total assets of Islamic banks. The total assets of Islamic banks are calculated using the natural logarithm of total assets. Non Performing Financing is the amount of problem financing in Islamic banks. NPF is calculated by the number of non-performing financing divided by the total amount of Islamic bank financing. With the regression equation:

$$Z\text{-Score} = \alpha + \beta_1DK_{it} + \beta_2DKI_{it} + \beta_3RDK_{it} + \beta_4PDK_{it} + \beta_5LN\_Aset_{it} + \beta_6NPF_{it} + e$$

**RESULTS & DISCUSSION**

**RESULT**

Descriptive statistical calculation of all research variables consisting of the independent variables of the board of commissioners, the independent board of commissioners, the board of commissioners' meetings and educational background of the board of commissioners and the dependent variable of bank health. Table 1 below shows the minimum, maximum, mean, and standard deviation values of each research variable.

Table 1. Test of Descriptive Statistics

	ZSCORE	DK	DKI	RDK	PDK	LN_ASET	NPF
Mean	15.02095	3.525641	0.637179	11.42308	2.397436	16.31330	4.261026
Median	7.625428	3.000000	0.670000	10.00000	2.000000	15.97871	2.690000
Maximum	84.59199	5.000000	1.000000	36.00000	6.000000	27.95257	43.99000
Minimum	-2.087976	2.000000	0.330000	2.000000	0.000000	13.40289	0.000000
Std. Dev.	18.41029	0.715766	0.133824	6.401135	1.143471	1.827821	6.766362
Observations	78	78	78	78	78	78	78

Source: Data Processed (2023)

Based on table 1, the results of the descriptive statistical test can be explained as follows. From the results of the descriptive statistics on the health of the bank as measured by the z-score, the highest value is 84.59, the lowest is -2.08, while the mean is 15.20. From the results of the z-score, it shows that there are banks that are in an unhealthy condition, shown by a minus z-score.

The variable of board of commissioners is the number of commissioners in Islamic banks. The results of the descriptive statistics show that the highest number of commissioners is 5 members, and a minimum of 3 members and a mean of 3.52. This shows that the number of board members is in accordance with Bank Indonesia regulations, encompass the minimum number of board members of 3 people.

The independent variable of board of commissioners is the total proportion of independent commissioners in Islamic banks. The results of the descriptive statistics show that the highest proportion of independent commissioners is 100%, and a minimum of 33% of members and a mean of 63%. This shows that the number of members of the independent board of commissioners is in accordance with OJK regulations, which is 30% of the total board of commissioners.

The variable of the board of commissioners meeting is the number of board of commissioners meetings in sharia banks for one year. From the results of descriptive statistics, it shows that the highest number of board of commissioners meetings is 36 meetings, and a minimum of 2 meetings and a mean of 11. This shows that the number of board member meetings that do not comply with OJK regulations is 2 meetings where the minimum is 12 meetings in one year.

The educational background variable for the board of commissioners is a board of commissioners who has an educational background in economics at an Islamic bank for one year. From the results of descriptive statistics, it shows that the number of commissioners has an educational background in economics, 6 people, and a minimum of 0 and a mean of 2.39.

### Model Selection Test

Tabel 2. Chow Test

Effects Test	Statistic	d.f.	Prob.
Cross-section F	146.678184	(13,58)	0.0000
Cross-section Chi-square	274.771463	13	0.0000

Source: Data Processed (2022)

Based on table 2. the probability value of the chi-square cross-section is  $0.0000 < 0.05$   $H_0$  is rejected. So the right model is the Fixed Effect Model (FEM).

### Correlation Test

The multicollinearity test in this study is used to determine correlation among the independent variables. Knowing the occurrence of multicollinearity is by looking at the correlation value among independent variables, if it is more than 0.80 then the research model has multicollinearity. Conversely, if it is less than 0.80, then the research model does not have multicollinearity.

Table 3. Multicollinearity Test

	ZSCORE	DK	DKI	RDK	PDK	LN_ASET	NPF
ZSCORE	<b>1.0000</b>	0.3068	-0.1397	0.0937	0.4481	0.3019	-0.2333
DK	0.3068	<b>1.0000</b>	-0.3206	0.0075	0.4872	0.2635	-0.0102
DKI	-0.1397	-0.3206	<b>1.0000</b>	0.2074	-0.1767	0.1579	-0.0035
RDK	0.0937	0.0075	0.2074	<b>1.0000</b>	-0.2167	0.0511	-0.1522
PDK	0.4481	0.4872	-0.1767	-0.2167	<b>1.0000</b>	0.0753	0.2083
LN_ASET	0.3019	0.2635	0.1579	0.0511	0.0753	<b>1.0000</b>	-0.1079
NPF	-0.2333	-0.0102	-0.0035	-0.1522	0.2083	-0.1079	<b>1.0000</b>

Source: Data Processed (2023)

Based on table 3 above, the correlation between variables with each other shows that there is no correlation between variables that is high above 0.80. So there is no multicollinearity problem.

Table 4. Regression Test Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	13.95058	4.242062	3.288632	0.0017
DK	-0.638943	0.444787	-1.436512	0.1562
DKI	0.365488	2.135102	0.171181	0.8647
<b>RDK</b>	<b>0.327752</b>	<b>0.098209</b>	<b>3.337295</b>	<b>0.0015</b>
PDK	-0.169559	0.790621	-0.214463	0.8309
LN_ASET	-0.012350	0.144857	-0.085260	0.9323
NPF	-0.010743	0.038568	-0.278546	0.7816
<b>Adjusted R-squared</b>	<b>0.976650</b>			
<b>F-statistic</b>	<b>170.5100</b>			
<b>Prob(F-statistic)</b>	<b>0.000000</b>			

Source: Data Processed (2023)

## DISCUSSION

### Variable of the Board of Commissioners

Based on the results in table 4, it can be interpreted as follows. The first hypothesis ( $H_1$ ) is that the Board of Commissioners has no effect on the health of the bank. This can be seen in the probability value of 0.1562 which means  $> 0.05$ . This means that the Board of Commissioners has no effect on the health of the bank. The first hypothesis in this study is rejected. The results are in line with the findings of Lassoued (2018) finding the size of the board of commissioners has no



effect on the health of the bank. It proves that the size of the commissioners does not affect financial stability as measured by the Z-score (Khalil & Ben Slimene, 2021). Eventhough the data shows that the average board size is in accordance with Bank Indonesia regulations, 3 people, but there are still banks that only have 2 commissioners so that the existence of commissioners does not have a good role in overseeing the health of Islamic banks.

#### **Variable of Independent Commissioner**

The second hypothesis (H2) is that the independent board of commissioners has no effect on the health of the bank. This can be seen in the probability value of .8647 which means  $> 0.05$  indicating that the independent board of commissioners has no effect on the soundness of the bank. This means that the independent board of commissioners has no effect on the health of the bank. The second hypothesis in this study is rejected. This finding is supported by the rooting theory, which states that managers implement strategies, making the role of commissioners passive (Khalil & Ben Slimene, 2021). By appointing unqualified independent commissioners to weaken the role of the board. Another possible explanation of this result is that independent commissioners do not have direct access to the daily operations of Islamic banks and directors refuse to disclose the required information (Buallay, 2019; Lassoued, 2018). The number of independent commissioners is in accordance with bank Indonesia regulations, namely a minimum of 30%.

#### **Variable of Board of Commissioners Meetings**

The third hypothesis (H3) is that board of commissioners meetings have a positive effect on bank health. This can be seen in the probability value of 0.0015 which means  $< 0.05$ . This means that the meeting of the Board of Commissioners has a positive effect on the health of the bank. The third hypothesis in this study is accepted. These results are in line with research by Tauringana et al., (2008) who find a positive relationship between the frequency of the Board of Commissioners' meetings and the health of the company. The results show that the mean meeting of the board of commissioners is 11 times a year, this is in accordance with OJK regulations at least 12 times a year. In one year, the board meets 12 times, which is sufficient in carrying out supervision and coordination to maintain the health of the bank.

#### **Variable Educational Background of the Board of Commissioners**

The third hypothesis (H4) is that the educational background of the Board of Commissioners has no effect on the soundness of the bank. This can be seen in the probability value of 0.8309 which means  $> 0.05$ . This means that the educational background of the Board of Commissioners has no effect on the health of the bank. The fourth hypothesis in this study is rejected. The results of this study are in accordance with the research of Khalil & Boulila Taktak (2020) which shows that a bachelor's degree in finance has no effect on the health of Islamic

banks. This is supported by data that there are still Islamic banks that do not have a board with an economic education background, so they lack the ability to supervise the health of Islamic banks.

## CONCLUSION

This study aims to examine the variables of the board of commissioners, independent board of commissioners, board of commissioners meetings and educational background of the board of commissioners on bank health in Islamic banking in Indonesia. Board of Commissioners meetings have a positive effect on bank health in Islamic banks in Indonesia. Higher frequency of board meetings leads to higher quality managerial monitoring, and therefore positively affects financial health (Ntim & Osei, 2011). Meanwhile, the board of commissioners, independent board of commissioners, and educational background of the board of commissioners have no effect on the health of the bank. The limitations of this study are the small number of samples and it was only conducted in Indonesia. Future research is expected to add to the observation sample and be carried out in several countries.

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