Financing Risk Model Based on Islamic Corporate Governance

by Maya Indriastuti

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ABSTRACT. This paper examines the influences of Islamic corporate governance on financial performance of Islamic banks in Indonesia using financing risk as mediation. A sobel analysis approach was used. The influence between the dependent and independent variables was examined using a multiple regression analysis.The results suggest that Islamic corporate governance strongly influence towards financing risk. Meanwhile, financing risk significantly influenced towards financial performance of Islamic banks in Indonesia. Specifically, the financing risk of Islamic banks is higher than conventional banks.The findings highlight that financing risk (which is seen by Non Performing Financing) is still a scourge for all companies, especially companies engaged in banking, both conventional and Islamic banking. However, this financing risk can be reduced if banks apply Islamic corporate governance that is good and right, on the contrary if the implementation of Islamic corporate governance is not carried out properly and properly, then it can increase the level of financing risk or Non Performing Financing of Islamic banks.In the Islamic context, the study contributes to our theoretical understanding of the Islamic corporate governance and the influence between Islamic corporate governance and financial performance. The findings provide that financing risk able to mediate the Islamic corporate governance with financial performance.

Keywords: Islamic corporate governance, financial performance, financing risk, islamic banks

INTRODUCTION

In 2017-2018, the performance of Islamic banking has seen a significant increase, increasing in the ratio of liquidity, efficiency, profitability, and capital. This indicates that Islamic banks have better assets, financing, and third party funds. Sharia Banking Statistics released by the Financial Services Authority records that up to April 2018, the total financing of Sharia Commercial Bank grows 7.25% year on year becomes IDR 191.04 trillion. The financing growth also successfully hoists the assets of Islamic banks to the level of IDR 290.36 trillion or increases 13.64% compared to April 2017 which amount is IDR 255.49 trillion. The performance and financing growth occurred at sharia private bank can be seen from the assets increment by 19%, financing by 23% and third party funds by 25%. In terms of financing quality, sharia commercial bank is able to maintain financing risk as reflected in the ratio of non-performing financing (NPF) which is kept low at the level of 0.6% up to the end of the first semester of 2018.

The same thing happened to another sharia commercial bank recording a positive growth up to May 2018, including in the net profit after tax which rises 85.16% to IDR 96.31 billion compared to the same month of the previous year IDR 52.02 billion. The profit growth is supported by financing enhancement of 11.5% to IDR 20.42 trillion, whereas third party funds experiences improvement 13.62% from IDR 24.5 trillion in May 2017 to IDR 27.84 trillion. Sharia commercial bank assets achieve a significant growth as many as 21.41% in May 2018 which amount to IDR 35.72 trillion from the previous year of IDR 29.42 trillion. While in terms of financing, up to the end of 2018, sharia private bank is able to distribute funds, amounting to IDR 22.68 trillion and third party funds is pegged to the level of IDR 28.28 trillion. At the term of NPF ratio, sharia commercial bank still records a high non performing financing at the level of 4.32% per May 2018 (Financial Services Authority, 2018). The impact of the positive performance growth results in the emergence of tight competition to maintain and even boost the bank performance. However in fact, the performance of sharia banks is not easy. This has become a duty for all of us, why are sharia commercial banks in Indonesia, which in fact the majority of Indonesians are Muslims amounting 87.18% of the total population of Indonesia, still many used?(Center Bureau of Statistics, 2016).Unfortunately, only around 5.86% or 17 million of the total population of Indonesia have sharia bank accounts (Center Bureau of Statistics, 2016). The number shows that the increasing number of sharia banks is not followed by a large number of customers. This proves that people's interest in partnering with sharia banks is still very low. One of the causes is the lack of public understanding of sharia banking(Grassa, 2016).

One of the predictors that can improve performance is the implementation of good corporate governance. The application of good corporate governance is able to minimize the harmful actions taken by the managers for personal interest(Al. Suhaibani and Naifar, 2014), such as earning management actions, which can harm many parties even the company itself. Implementation of good corporate governance is an absolute requirement needed by a company to maintain the existence of the company, especially financial institutions, to develop better and healthily as stated in the regulation(Regulation of Bank Indonesia, 2009), where the implementation is not only intended for bank management in accordance with the five basic principles that have been established or in accordance with sharia principles, but also is aimed for wider interests. The implementation of good corporate governance in sharia banks is different from the principles of good corporate governance in commercial banks.(Alnasser and Muhammed, 2012) states that businesses based on sharia principles must be able to create a healthy and sustainable business climate with the realization of market discipline born from a good governance culture of sharia business. For this reason, good corporate governance in Islamic financial institutions must also refer to Islamic principles referred to as Islamic corporate governance.

The results of the study conducted by(Mollah et al., 2017)prove that Islamic corporate governance in sharia bank dare to take risk to achieve a better performance. This result consistent with (Choudhury and Alam, 2013) that Islamic corporate governance in sharia bank better than conventional bank. Research (Heenetigala and Armstrong, 2011); (Mohammed and Fatimoh, 2012); (Rehman and Mangla, 2012); (Ghaffar, 2014)states that the GCG has a positive and significant influence on the company's financial performance. This shows that companies that implement GCG strategies can improve company performance. (Obid and Naysary, 2014)states that sharia governance in Islamic financial institution covers accountability, disclosure and transparency, competency, confidentiality and independency. (Paul., 2015)states that there is no influence between GCG on the financial performance of microfinance banks in Nigeria. (Quttainah and Almutairi, 2017) support that Sharia

Supervisory Board in sharia bank influences and forms managerial behavior and reduces agency cost. Besides, Sharia Supervisory Board strengthens the company ethics through management behavior.(Alkhamees, 2013) also supports by his research which finds that the good corporate governance results on the healthy financing system and the investor trust will be also increased. This is also consistent with the research conducted by (Alnasser and Muhammed, 2012) stating that corporate governance in sharia bank builds up a good image of the institution, especially the function of Sharia Supervisory Board. (Bukhari, et al, 2013) reveals that the difference of corporate governance between sharia bank and conventional bank is in the Sharia Supervisory Board and Board of Director. This is contrast with (Mansour and Bhatti, 2018) that finds that Islamic corporate governance is no longer expected as the supervisor in sharia financing institution, except for other approach such as competition, the development of ethics, and new challenges.

In addition to the implementation of Islamic corporate governance, sharia banking must also pay attention to the risk of failure in returning the distributed financing. The sharia bank must be able to keep the Non Performing Financing (NPF) level below 5%. The NPF ratio can be reduced through the application of good and true ICG. This is shown by the results of the study conducted by(Switzer and Wang., 2013); (Ginena, 2014); and (Bourakba and Zerargui., 2015)states that GCG has a negative effect on the bank's credit risk. Therefore, if the implementation of GCG is carried out properly it will be able to reduce the level of credit risk, so the performance of sharia banking will increase. The research conducted by (Aebi, et al, 2011); (Luqman, 2014); (Kebede and Selvaraj, 2015) state that credit risk has a negative effect on bank performance. (Grassa, 2016) states that the level of corporate governance in sharia bank in South East Asia is low. As consequence, it can affect the increment of financing risk. By using sharia-based system, financing risk will be lower because the implementation of Islamic corporate governance (ICG) ismore detail and self-assessment is tighter. Hence, the implementation of ICG is expected to be able to minimize financial risk so that it will affect the performance of sharia bank. Therefore, thisstudy aims to examine financing risk as mediating variable on the correlation between ICG and performance. (El Tiby and Grais, 2015) focus is not Shari'a governance arrangements within a financial organization but Shari'a governance arrangements from a systemic perspective. (El Tiby and Grais, 2015) said that service improvement based on sharia principles requires effective and efficient corporate governance.

LITERATURE REVIEW

Sharia Enterprise Theory

Sharia enterprise theory is a company theory internalized by Islamic values, where economic power is no longer in the hands of shareholders but also in the hands of stakeholders (Triyuwono, 2015). This theory can be said to be a social integration that starts from the existence of *emancipatory* interests to exempt knowledge that is always trapped in the material world into a knowledge that also considers non-material aspects.

Financial Performance

Performance is the achievement of an objective of a particular activity or work to achieve company goals measured by standards (Indriastuti and Kartika, 2018b). Financial performance is an indicator in assessing the financial condition of a company measured by profitability (Indriastuti and Kartika, 2018b). The profitability ratio used in this study is Return on Assets (ROA). ROA is a ratio that reflects the company's ability to generate profits based on certain total assets of the company(Hanafi and Halim, 2012). The choice of ROA is a proxy of a company's financial performance because ROA is used to measure the bank's management ability in obtaining overall profits.

Islamic Corporate Governance

Islamic corporate governance is corporate governance that is directed by moral and social values based on sharia law with the aim of prospering individuals and society as a whole Bhattii and Bhatti (2010: 27). Therefore, it can be said that Islamic corporate governance is a derivative concept of good corporate governance and has the same objectives as commercial GCG (Abdullah, 2010).

The implementation of corporate governance has been regulated in Indonesia by issuing the(Regulation of Bank Indonesia, 2009)was issued because of the desire of Bank Indonesia to build a healthy and strong Islamic banking industry and as an effort to protect stakeholders and improve compliance to laws and regulations that are generally appliedin Islamic banking.

The Islamic corporate governance in this study is illustrated by the implementation of Sharia Supervisor Board duties and responsibilities. These variables were measured based on the self-assessment on the implementation of GCG in sharia bank with the predicate and interval scale as follows: (1) rank one, predicate very well, scale five, (2) rank two, predicate good, scale four, (3) rank three, rank fair, scale three, (4) rank four, predicate less good, scale two, (5) rank five, predicate not good, scale one(Bank Indonesia, 2013).

Financing Risk

Financing risk is used to measure the level of financing problems faced by Islamic banks. Financing risk is measured by the ratio of Non Performing Financing. Non-Performing Finance (NPF) is the ratio between problematic financing and total financing distributed by Islamic banks (Hanafi and Halim, 2012). Based on the criteria set by Bank Indonesia, the categories included in the NPF are financing substandard, doubtful and loss. In(Bank Indonesia, 2006), conducting business activities based on sharia principles article 9 paragraph (2), states that the quality of productive assets in the form of financing is divided into 5 groups such as: smooth, special attention, substandard, doubtful, and financing issues.

HYPOTHESES DEVELOPMENT

Islamic Corporate Governance and Financial Performance

(Mollah et al., 2017) prove that Islamic corporate governance in sharia bank dare to take risk to achieve a better performance, because the implementation of corporate governance can improve financial performance, reduce risk due to management actions that tend to benefit themselves. The existence of Sharia Supervisory Board will make sharia banks in operational activities and in launching products more compliant with sharia principles. Therefore, the Islamic community has a new insight that they would prefer to invest in sharia banks because they believe the funds will be managed according to Islamic law. Hence, if many people automatically invest, the business activities in the bank will be more crowded.

By the increasing business activities, in the end the bank will be able to improve the company performance. This is in line with the results of the study conducted by (Quttainah and Almutairi, 2017) and (Alnasser and Muhammed, 2012) that Sharia Supervisory Board in sharia bank influences and forms managerial behavior and reduces agency cost. Besides, Sharia Supervisory Board strengthens the company ethics through management behavior, and it can builds up a good image of the institution.

(Heenetigala and Armstrong, 2011) states that companies that implement corporate governance strategies can result in a higher profitability and higher stock prices. It is same with the findings of (Gupta and Sharma, 2013) in India and South Korea which shows that corporate governance practices have a positive significant influence on company performance as measured by stock prices. (Rehman and Mangla, 2012);(Ghaffar, 2014); (Haider et al., 2015) also state that all corporate governance variables have a positive and significant influence on the profitability of sharia banks in Pakistan. (Mohammed and Fatimoh, 2012) shows that good corporate governance will affect bank performance. (Alkhamees, 2013) also supports by his research which finds that the good corporate governance results on the healthy financing system and the investor trust will be also increased. (Hoque et al, 2013)shows that common stock ownership and the frequency of audit committee meetings have a significant influence on the banks' financial performance in Bangladesh measured by return on assets, return on equity and Tobin Q companyvalue.(Obid and Naysary, 2014) states that sharia governance in Islamic financial institution covers accountability, disclosure and transparency, competency, confidentiality and independency. The findings of(Gupta and Sharma, 2013) in India and South Korea which shows that corporate governance practices have a positive significant influence on company performance as measured by stock prices.

H1: Islamic corporate governance influences financial performance of Islamic banks.

Islamic Corporate Governance and Financing Risk

Risks in sharia banking are more complex than commercial banking, namely, fiduciary money, fluctuations in interest rates, defaults, operational errors and others, also demanding that sharia financial business players be more prudent including good functioning supervision and control. This is where the need to improve the implementation of Islamic corporate governance in sharia Banking institutions.

Financing risk is very important in the risk of sharia banks, because with the problems of borrowing customers, funds that fail to pay or in making payments that are not in accordance with the agreement will have an adverse effect on the bank (Indriastuti and Kartika, 2018b). Shari'ah Bank is required to have a reliable sharia management to minimize financing risk. If the portion of problem financing increases, this will ultimately affect the possibility of a decrease in the amount of profit / income obtained by the bank. This decrease in income will be able to influence the profitability of sharia banks and in the end, will affect the amount of profitability which is reflected by the Return on Assets (ROA) obtained by sharia banks.

The high failure rate in non-performing financing will have a negative impact on the bank, among others in the form of loss of opportunity to obtain income from disbursed financing, and adversely affect the bank's profitability in the form of a decrease in profitability. The ability of Islamic banks to generate profits is an important indicator of business entity sustainability and the ability to compete with Islamic banks in the long run. A reasonable profit is needed by each bank to attract the interest of the fund owners to deposit their money in the bank. Profits are also needed to fund the expansion of the business and to finance efforts to improve the quality of services. All of this is only possible if the bank can generate adequate profits, one of which is through a non-problematic financing system.

H2: Islamic corporate governance influences financing risk of Islamic banks.

Financing Risk and Financial Performance

Financing risk is used to measure the level of financing problems faced by Islamic banks. Financing risk can be measured by Non Performing Financing. Non Performing Financing is a ratio to measure the bank's ability to maintain the risk of failure of credit repayment by the debtor. The better the quality of financing channeled by banks, the smaller the NPF level (Indriastuti and Kartika, 2018a). The higher the Non Performing Financing ratio, the worse the quality of sharia bank financing will be. This is because the ratio shows the amount of failure caused by the bank. If the bank has a high level of financing risk, it indicates that the bank's ability to generate income will decrease, and the profit sharing that will be given to customers will be small. The results of the study conducted by (Luqman, 2014)which states that there is a significant influence between credit risk on bank performance proxied by the level of profitability. In addition, the results of research conducted (Kebede and Selvaraj, 2015) states that Non-Performing Loans have a significant influence on the profitability of commercial banks in Ethiopia.

H3: Financing risks influences financial performance of Islamic banks.

Based on in-depth literature review, the research is based on empirical model and its scheme can be seen in figure 1.

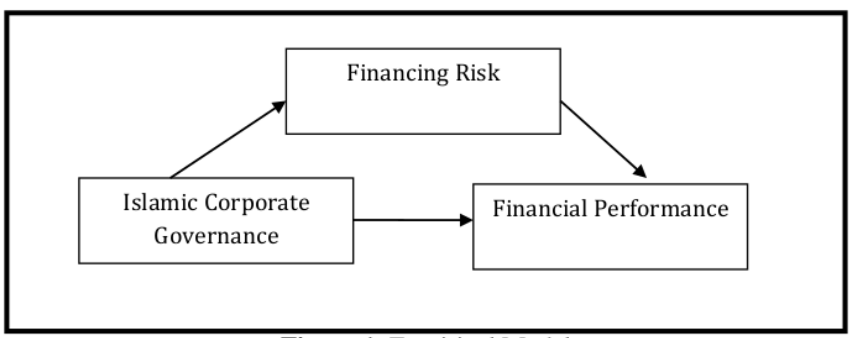

Figure 1. Empirical Model

METHODS

Population and Sample

The population in this study are all Islamic banks in Indonesia that operate from 2013-2018 with total samples of 60 Islamic banks. Samples were taken using purposive sampling technique with the following criteria: (1) Islamic Banks registered at Bank Indonesia during the 2013-2018 period; (2) Islamic Banks that present annual reports during the study period namely 2013-2018; (3) Islamic Banks disclose ICG reports in their annual reports; and (4) Islamic Banks have complete data related to the variables used in the study.

Measures

The company's performance in this study is illustrated by Return on Assets, a ratio that reflects a company's ability to generate profits based on certain total assets of the company (Hanafi and Halim, 2012). Islamic Corporate Governance is a system that regulates and controls companies in running their business in order to increase success and accountability based on Islamic laws. Islamic corporate governance is calculated from the implementation of Sharia Supervisory Board duties and responsibilities as measured by the self assessment of Islamic corporate governance implementation of Islamic banks with the following predicate and interval scale: (1) rank one, predicate very well, scale five, (2) rank second, predicate good, scale four, (3) rank three, rank quite well, scale three, (4) rank four, predicate unfavorable, scale two, (5) rank five, predicate not good, scale one (Bank Indonesia, 2013). Financing risk is measured by the ratio of Non Performing Financing (NPF), which is a measure of credit risk that is a parameter of the bank's health level. This NPF ratio is a comparison between the ratio of non-performing financing compared to the total financing (Bank Indonesia, 2010; Financial Services Authority, 2015).

The Technique of Data Analysis

All data in this study were analysed using regression analysis and sobel test (Ghozali, 2016) with the following equation:

$FR = \alpha + \beta\, ICG + e$……………………..model 1

$FP = \alpha + \beta_1\, ICG + \beta_2\, FR + e$……………model 2

RESULTS AND DISCUSSION

Table 1 shows that the first and second models have F values of 141,451 and 43,676 with a p-value of 0,000 and have the ability to explain the dependent variables of 58.10% and 53.21%, the rest are explained by other variables outside the model. The t test value shows that Islamic Corporate Governance has a positive and insignificant influence on Return on Assets (β = 0.152, p-value> 0.05), Islamic corporate governance has a negative and significant influence on Non Performing Financing (β = -0.314, p-value < 0.05), and Non Performing Financing has a negative and significant influence on Return on Assets (β = -0.868, p-value <0.05). These results provide support for H2 and H3 and reject H1.

Table 1. Hierarchical Regression Analysis

Hypothesis	Regression	Beta	t	p-value	Explanation
H1	ICG*→ ROA**	0.152	.488	.389	Rejected
H2	ICG → NPF	-0.314	-4.818	.000	Accepted
H3	NPF***→ ROA	–0.868	-5.499	.000	Accepted

Adj R^2 = 0.58101, F = 141,451, *p-value* = 0.000

R^2 = 0.53210, F = 43,676, *p-value* = 0.000

*ICG= Islamic Corporate Governance

**ROA = Return on Assets

***NPF = Non Performing Financing

Source: The Processed Primary Data (2018)

Financing risk (which is seen by Non Performing Financing) is still a scourge for all companies, especially companies engaged in banking, both commercial and Islamic banking. However, this financing risk can be reduced if banks apply Islamic corporate governance (ICG) that is good and right, on the contrary if the implementation of Islamic corporate governance (ICG) is not carried out properly and properly, then it can increase the level of financing risk or Non Performing Financing of Islamic banks.

The results of this study are in line with the findings made by (Luqman, 2014) which states that there is a significant influence between credit risk (Non Performance Loan) on bank performance proxied by the level of profitability. The results of research conducted (Kebede and Selvaraj, 2015) state that Non-Performing Loans have a significant influence on the profitability of commercial banks in Ethiopia. In addition, (Ahmed et al, 2018) show that the corporate governance has significantly and negatively related to risk-taking, so that it impacts the financing risk.

However, the results of this study are not in line with the findings (Indriastuti and Kartika, 2018a) stated that the Non Performing Financing (NPF) had no effect on financing volume, but had an effect on performance. (Indriastuti and Kartika, 2018a) also stated that problem financing on sharia banks is worse than the problematic financing of commercial banks. The poor ratio of the sharia bank NPF makes Islamic banks more careful in distributing working capital financing. Like the case of two of eight Islamic banks that still have NPF levels above 5%. The cause of the high NPF was because the bank was too aggressive in channeling financing to the community and a lack of prudent level for the aspect of cost distribution and not prudent in channeling financing to customers.

The average composite value of Islamic Corporate Governance in Islamic banks is good. It can be interpreted that the principles of Islamic Corporate Governance have been well implemented by each Islamic bank. The results of this study are in line with (Bourakba and Zerargui., 2015) which states that there is a negative and significant influence between the variables of Good Corporate Governance and credit risk (Non-Performing Loans) of a bank. The results of the study (Switzer and Wang., 2013) also state that the implementation of Good Corporate Governance can reduce the level of credit risk (Non-Performing Loans). (Asrori, 2016) also suggests that good corporate governance affects profit sharing financing.

The performance conditions of Islamic banks in this study are seen from the acquisition of the level of profitability, where the performance of the Islamic banks will be boosted if they obtain a level of profitability with a positive number. Conversely, if the achievement of negative and low profitability rates will certainly greatly affect the size of the main income of Islamic banks, namely income derived from financing disbursement. Thus, even though a bank's corporate governance application has been implemented according to the principle, it turns out that it cannot guarantee that it can improve the performance of a bank. This result is in line with the findings (Paul, 2015) which states that there is no influence between corporate governance on the financial performance of micro banks (microfinance banks) in Nigeria. This research is also in line with the findings (Vo and Nguyen, 2014) which stated that corporate governance in 177 companies in Vietnam proxied by the existence of an independent board of directors and the number of board of directors did not have an influence on the company's performance measured by four different ratios, namely, ROA, ROE, Z-score, and Tobin Q. (Mansour and Bhatti, 2018) finds that Islamic corporate governance is no longer expected as the supervisor in sharia financing institution, except for other approach such as competition, the development of ethics, and new challenges.

The results of this study were not in line with some of the previous findings. (Heenetigala and Armstrong, 2011) stated that companies that implement corporate governance strategies can result in higher profitability and stock prices. Besides the results of research conducted by (Ghaffar, 2014) states that all corporate governance variables have a positive and significant influence on the profitability of Islamic banks in Pakistan. Mishari, (2018) stated that Corporate Governance also able to improve the Intellectual capital of a company so that it will impact the company's performance. While the results of research conducted by (Mohammed and Fatimoh, 2012) show that with good corporate governance, it will affect bank performance. (Rehman and Mangla, 2012) also stated the same thing, namely there is a significant influence of corporate governance on the financial performance of the banking sector as a whole in the State of Pakistan. The results of research conducted by (Hoque et al, 2013) show that general public share ownership and the frequency of audit committee meetings have a significant influence on the financial performance of banks in Bangladesh as measured by ROA, ROE and the value of Tobin's Q company.

This research is also in line with the findings (Gupta and Sharma, 2013) in the countries of India and South Korea shows that corporate governance practices have a positive and significant influence on company performance as measured by stock prices. The results of the study (Haider et al., 2015) state that corporate governance has a positive and significant influence on the financial performance of Islamic banks in Pakistan. (Alnasser and Muhammed, 2012) also states that the implementation of Islamic Corporate Governance in the implementation of the duties and responsibilities of the Sharia Supervisory Board has a positive and significant effect on the performance of sharia banks. Research (Quttainah and Almutairi, 2017) also shows that Sharia Supervisory Board in sharia bank influences and forms managerial behavior and reduces agency cost. Besides, Sharia Supervisory Board strengthens the company ethics through management behavior. (Alkhamees, 2013) also supports by his research which finds that the good corporate governance results on the healthy financing system and the investor trust will be also increased. This is also consistent with the research conducted by (Alnasser and Muhammed, 2012) stating that corporate governance in sharia bank builds up a good image of the institution, especially the function of Sharia Supervisory Board. (Bukhari, et al, 2013) reveals that the difference of corporate governance between Islamic bank and conventional bank is in the Sharia Supervisory Board and Board of Director.

CONCLUSIONS

This study examines the impact of Islamic corporate governance on Islamic banks during the period from 2013-2018 in Indonesia. The results show that first, a positive and insignificant influence between Islamic corporate governance towards financial performance. Second, the Islamic corporate governance towards financing risk has a positive and significant influence. Third, the financing risk able to mediate the Islamic corporate governance with financial performance. This study has contributed to our theoretical understanding of the Islamic corporate governance and the influence between Islamic corporate governance and financial performance. Despite the contributions presented above, this research has potential limitations that should be taken into consideration. The first possible limitation is associated with the sample. This research depends only on Islamic banks in Indonesia.

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