

The Effectiveness of The Sharia Supervisory Board's Role: Study on The Islamic Banks in Indonesia

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Abstract

This study aims to investigate the relationship between the characteristics and effectiveness of the Sharia Supervisory Board's (SSB) role in Islamic Banks (IBs). To justify the qualitative study, legal documents, annual reports, books, journals, and previous research were examined. Eight SSB characteristics were also reviewed to see how they affected the effectiveness of the SSB's role in 14 IBs in Indonesia. This study uses the characteristics of SSB as a whole so that it is sufficient to explain the effectiveness of the role of SSB in Islamic Banks. As an additional analysis, the SSB characteristics on SOE-owned IBs before and after the merger were also presented. The research findings show that the dual positions of SSB members and the lack of accounting and financial competence need the government's attention in setting the rules.

Keywords: Sharia Supervisory Board, Islamic Bank, Merger, Characteristics, Content Analysis

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1. INTRODUCTION

The 2008 global financial crisis prompted investors dissatisfied with conventional banks' performance to turn their attention to Islamic Financial Institutions (IFIs) (Johnes et al., 2014). The intensity of investor interest in IBs is evidenced by an increase in Islamic Banking Third Party Funds (DPK) of 11.94% throughout 2019, during the Covid-19 pandemic, so it can be said that IBs hold trust in placing funds from the public (Fakhri & Nuriyah, 2022). Customer trust strengthens IBs in dealing with crises, even Wijana & Widnyana (2022) stating that IBs are considered more stable in facing economic shocks than conventional banks (Dinda Khoirotunnisa & Zulfikar, 2022).

Islamic finance is defined as a specific subset of finance that is subject to sharia governance (SG), which is distinct from the general practice and structure of corporate governance (CG) (Tapanjeh, 2009). IFIs must adhere to sharia principles in all their operations, services, and operations (Md. K. Alam et al., 2021). Every IFI, particularly IBs must employ the

proper strategy while putting solid governance within a sharia-compliant framework in place (Zulfikar et al., 2021). One is to streamline the Sharia Supervisory Board's (SSB) responsibility to oversee IB operations (Shaban et al., 2014).

The SSB establishment through the General Meeting of Shareholders (RUPS) as the bank's supervisory board to carry out the decisions has been recommended by the National Sharia Council (DSN) of the Indonesian Ulema Council (MUI). Moreover, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) explains that the SSB's role includes evaluating, directing, and supervising IB activities to adhere to sharia laws and principles in the Governance Standard for Islamic Financial Institutions (GSIFI).

Specifically, Indonesia, the largest Muslim nation worldwide (Anantyasari et al., 2022), is classified as a developing nation with underdeveloped institutions. High levels of family control and ownership concentration are characteristics of emerging markets. Since it results in less protection

for minority ownership, the sharia governance system is deemed crucial in preventing this occurrence. As stated in the monitoring and inspection indicators reported by Bank Indonesia, several IB operational systems continue to not conform with the sharia values (Mateev & Bachvarov, 2021). Research findings from Bank Indonesia and Ernst and Young also revealed that the SSB's role is still not ideal, negatively affecting the IB's reputation and credibility (Triasari & Zwart, 2021). Further, it will impact public perceptions and judgments, further eroding trust in IBs.

Additionally, SSBs encounter challenges that hinder their effectiveness, including member independence, a lack of financial and economic knowledge, and cross-membership, which lessens the confidentiality of bank information (Graiss & Pellegrini, 2006). As can be observed from the frequency of SSB visits, which are not at least once a month as required by applicable legislation, the SSB's concurrent position weakens the level of supervision. It suggests SSB is only an "additional or side job" (Triasari & Zwart, 2021). Garas & Pierce (2010), Hasan (2011), and Grassa (2013, 2015) have emphasized the regulatory framework's shortcomings, notably regarding the SSB's independence, competence, and cross-membership in various nations.

In Indonesia, an early turning point in the IB formation was the founding of Bank Muamalat Indonesia on November 1, 1991. The dual banking system, which enables banks to operate both traditionally and according to sharia rules, is also inextricably linked to Indonesia's IB growth. Since Law No. 10 of 1998, which amended Law No. 7 of 1992 on banking, this system has been in place. In addition, as stated in Law No. 21 of 2008 about Islamic Banking, conventional banks are permitted to alter their business operations based on sharia principles with the consent of the Financial Services Authority (OJK). By the beginning of 2022, Indonesia had 12 Sharia Commercial Banks, 21 Sharia Business Units, and 165 Sharia People's Financing Banks. Due to the merging of three state-owned IBs, i.e., Bank Syariah Mandiri, BNI Syariah, and BRI Syariah into Bank Syariah Indonesia, the number of BUSs decreased from the previous 14 institutions to 12.

The IB growth in Indonesia is also inseparable from the role played by the government in ensuring IB quality by assisting DSN-MUI in issuing fatwas

concerning goods and services. Since 2013, IB has been under the management and regulation of OJK, having previously been regulated by Bank Indonesia (BI). The number of SSBs, duties and authorities, concurrent positions, and the independence of SSB members are all governed by Financial Services Authority Regulation Number 30/POJK.05/2014 concerning Good Corporate Governance for Financing Companies, which OJK issued.

In several earlier studies on SSB, the emphasis was on empirical research designed to demonstrate how SSB characteristics affected sharia compliance, financial performance, social and environmental performance, and disclosure. The presence of SSB as a component of sharia compliance was revealed by studies by (Kurrohman, 2017; Prabowo & Jamal, 2017; Rashid et al., 2020). Research by Almutairi & Quttainah (2017), Fitriana et al. (2019), Musleh Alsartawi (2019), Nawaz (2019), Nguyen (2021), Baklouti (2022), Jabari & Muhamad (2022), and Kok et al. (2022) uncovered that various SSB characteristics affected financial performance, both as proxied by accounting-based performance such as return on assets (ROA), efficiency, and profit growth and market-based performance, i.e., market capitalization and Tobin's Q value. Meanwhile, studies by Hashim et al. (2015), Musibah & Alfattani (2014), and Fatah et al. (2022) succeeded in documenting the effect of SSB on social and environmental performance. Additionally, by highlighting the SSB's role in promoting corporate disclosure activities, the study findings by Amalina Wan Abdullah et al. (2013), Rahman et al. (2013), Nugraheni & Khasanah (2019), Elamer et al. (2020), and Sencal & Asutay (2021) added to the body of literature.

Most empirical findings have led the researchers to review the literature on the SSB characteristics and the SSB's role effectiveness. For this reason, this research focuses on a literature study by conducting a content analysis of the IBs' annual report. The SSB characteristics are related to the governing law, complemented by previous research reviews as justification. Additional analyzes were also performed on IBs before and after the merger. The SSB characteristics observed included board size, presence of female members, independence, concurrent positions (cross membership), doctoral qualifications, member reputation, accounting and financial competence, and frequency of meetings.

At the very least, this research makes numerous contributions. First, the role of sharia governance in IB supports agency theory. This study also provides evidence that SSB's presence serves the principal's best interests. Second, to maximize the function of SSB in the future, authorities must examine rules and implement legislative reforms. Third, to identify gaps in practice, this research gives an overview of how the rules are implemented in the real world.

2. METHODS

This study employed a qualitative approach to describe and examine phenomena, events, social interactions, and individual and group perceptions and ideas (Sukmadinata, 2012: 60). By researching information sources from books, scientific journals, and other relevant sources, a literature study was applied. Meanwhile, content analysis was designed to gather and examine data from official documents, such as laws, policies, and research findings. This analysis was conducted to determine the significance, context, and relationships of diverse ideas, concepts, policies, programs, actions, and events that exist or take place and to determine the advantages, outcomes, or effects of these things (Sukmadinata, 2012: 81-82).

Further, IB annual reports, books, and journals pertinent to the study issue served as a source of secondary data. Primary data were gathered using a variety of legal documents, including Sharia Banking Laws, Bank Indonesia Regulations (PBI) or OJK Regulations, Bank Indonesia Circular Letters (SEBI), and OJK Circular Letters. These data were obtained by searching the relevant institution's official website.

3. RESULTS & DISCUSSION

3.1. SSB Size

The SSB must have at least two members and a maximum of five members, according to Bank Indonesia Regulation No. 6/24/PBI/2004. By having two people functioning as SSBs, with a composition of one chairperson and one member, several IBs in Indonesia have satisfied the standards set out by Bank Indonesia and the AAOIFI. Three SSB members were reported by Bank Aceh Syariah, Mandiri Syariah, and Maybank Syariah. In 2021, BSI Syariah claimed to have four SSB members more than it did before the merger.

Moreover, the jurisdictions of Malaysia and MENA countries require the number of SSBs of three people, while in the other jurisdiction, such as Qatar,

SSBs must consist of at least two people (Hasan, 2010; Grassa, 2015). Yemen is more specific by saying that the SSB size should be between three and seven people, between three and five in Iraq, and a minimum of two and a maximum of five in Indonesia (Ayedh & Echchabi, 2015; Grassa, 2015). Rahman et al. (2013) and Garas & Pierce (2010), meanwhile, concluded that there is no optimal size limit for SSB.

In this case, the small SSB has an impact on the SSB performance by delaying the meeting if the board quorum is not met (Garas & Pierce, 2010). Small SSBs are also thought to be simple to control by management and directors. Larger SSBs, on the other hand, have members with diverse experiences, skills, and expertise, resulting in better interpretation of products and operations and, as a result, better performance (Hamza, 2016). The knowledge diversity resulting from a greater SSB will enrich the debate, strengthening the bank's credibility when faced with stakeholders and customer trust (Hamza, 2013). These results were confirmed by Mollah & Zaman (2015), Nomran et al. (2016), and Hakimi et al. (2018). Safiullah & Shamsuddin (2018) also found that the SSB size could reduce the risk of IB bankruptcy by controlling managers' risk-taking. Related to that, a larger SSB size could reduce uncertainty and information asymmetry problems by encouraging companies to make disclosures (El-Halaby & Hussainey, 2016).

3.2. The Presence of Female Members

The presence of female SSB members is quite rare in Indonesian IBs. Only three banks reported the presence of female SSB members: Bank Syariah Mandiri, Bank Muamalat Syariah, and Bank Victoria Syariah. Each of these banks had no more than one female SSB member. Previous studies have also revealed a beneficial connection between gender diversity on the board and bank performance (Adams & Ferreira, 2009). Female directors are considered members with better communication skills and less prone to agency problems. Women's councils are also deemed more competent and hardworking, resulting in better monitoring (Baklouti, 2022). Nevertheless, recently, Khan et al. (2020) demonstrated that the presence of women on the board of directors had a negative impact on the board's functioning and, as a result, on the financial performance of IBs. Women in positions of leadership are not accepted by them and are considered to be against Islamic law.

3.3. Independence

Based on the IB's annual report analysis, none of the SSB members had any contact with the other SSB members, the Board of Commissioners, the Board of Directors, or the Controlling Shareholder regarding financial, management, share ownership, and/or family. Alam et al. (2013) argue that SSB independence is crucial to fostering stakeholder confidence regarding adherence to sharia principles. To ensure that SSB members can make the best and most impartial choices, AAOIFI has limited their independence from the board of directors (Musleh Alsartawi, 2019). Members are also prohibited from holding management positions at the same bank and participating in operational duties.

Under AAOIFI Governance Standard No. 1, SSB is permitted to attend the board meeting and discuss the religious implications of their decisions (Musleh Alsartawi, 2019). If positioned on an equal footing with the board of directors, SSB can circumvent any constraints that the board or top management may impose. By separating SSB and management, managers may also be prevented from taking acts that directly benefit themselves and force shareholders to suffer the expenses of such actions. As a result, it is believed that SSB independence helps to improve IB performance, lower financing costs, and solve agency concerns. In addition, better operating and stock performance are characteristics of companies with independent members (Mobbs, 2013).

3.4. Concurrent Position (Cross Membership)

Referring to Bank Indonesia Regulation Number 15/13/PBI/2013 concerning Amendments to Bank Indonesia Regulation Number 11/3/PBI/2009 concerning Sharia Commercial Banks, SSB members can only hold concurrent positions in at most four other IFIs. The annual report's analysis demonstrated that all IBs adhered to these rules. It indicates that no IB had members holding leadership positions or membership in the SSB in more than four other IFIs.

Furthermore, because SSB members hold multiple positions, concerns about confidentiality and conflicts of interest are raised. Members of the SSB have access to confidential and sensitive company information that could be harmful if disclosed to competing banks (Grais & Pellegrini, 2006). Besides, if SSB members are required to serve in many locations, their ability to concentrate on the issues IBs confront would be diminished. However, Amalina

Wan Abdullah et al. (2013) made a different case, arguing that holding concurrent positions at other banks might provide employees with additional experience and allow them to compare best practices across other institutions. Their study findings also demonstrated the impact of cross-membership with improved corporate disclosure procedures.

3.5. Doctoral Qualification

In this study, the proportion of SSB members having doctoral qualifications was close to 70% of all reported SSBs. Education level signifies intellectual ability, knowledge, and human capital (Wang et al., 2017). Safiullah & Shamsuddin (2018) reported that SSB members with advanced academic qualifications might be better able to apply Islamic finance theory to banking practices, particularly enforcing moral prohibitions against excessive risk-taking. In addition, they discovered an inverse relationship between the proportion of highly educated SSB members and the risk of bankruptcy. Higher-educated members also have analytical abilities and a wealth of creative ideas for developing public policy. Moreover, D'Amato & Gallo (2019) concluded that boards with more educated members had lower overall risk exposures, producing more steady performance.

3.6. Member Reputation

In this research, the possession of knowledge and proficiency in the subject of sharia served as a proxy for the SSB members' reputation. Almost all SSB members at Indonesian IBs were reported to have expertise in sharia law and Islamic economics. On the other hand, only one SSB member from BCA Syariah and BRI Syariah lacked this competence. Further, according to AAOIFI (2005), SSB members must be knowledgeable about IFIs to fulfill their role as overseers of the IBs' internal control and financial reporting.

Moreover, reviewing and supervising IBs' transactions, services, and product-related factors is the primary responsibility of SSB. All contracts, agreements, products, and financial transactions must also be reviewed by the SSB to make sure that they adhere to sharia laws and principles. Nathan Garas (2012) also mentions SSB as an ulema who attempts to uphold his integrity by refraining from dubious activities. They, therefore, have high credibility and reputation due to their knowledge of sharia law (Rahman et al., 2013). This reputation is anticipated to enhance IB governance, improving operations and

operating outcomes. Further, studies by Farook et al. (2011) and Nomran et al. (2016) proved how the good reputation of SSB might assure compliance and affect the interests of many depositors and consumers. It helps to lower liquidity risk and boost financial performance.

3.7. Accounting and Finance Competencies

However, except for Bank Jabar Banten Syariah and BRI Syariah, which reported having at least one member with these skills, most SSB members at Indonesian IBs lacked accounting and financial knowledge. Both obtained accounting and finance skills by completing their bachelor's degree in accounting and master's degree in financial management concentration. Accounting professionals, according to Rashid et al. (2020), focus more on profitability than sustainability, lowering the level of compliance with international standards. In contrast, boards with accounting competence would be better able to oversee and counsel bank management to enhance reporting, according to (Armstrong et al., 2015).

In general, SSBs have demonstrated religious knowledge and skills, but they rarely have a solid understanding of financial analysis, management, and banking regulations (Grassa & Matoussi, 2014). Having qualified SSB members with dual expertise in finance and sharia can also boost customer trust in the bank. Furthermore, several studies have discovered a link between the presence of SSB members with religious and financial skills and bank financial performance (Grassa & Matoussi, 2014; Hakimi et al., 2018).

3.8. Meeting Frequency

The SSB meeting must be held at least once every month, according to regulations on PBI No. 11/33/PBI/2009 and SEOJK No. 10/SEOJK.03/2014. During 2020, SSBs in all observed banks reported the implementation of meetings at least 12 times annually. In connection with that, Ntim et al. (2017) mentioned that the frequency of board meetings reflects the effectiveness of board oversight (Amalia et al., 2019). Regular meetings also allow the SSB to establish actual control over all business transactions, which enables them to make rational decisions that contribute positively to performance (Baklouti, 2022). On the other hand, due to the high expense of meetings, Musleh Alsartawi (2019) revealed a negative correlation between the frequency of board

meetings and performance. Some experts also advise holding emergency meetings in place of regular ones at times of monetary crisis, when the CEO is being replaced, or in any other circumstance that can jeopardize equity rights (Ntim et al., 2017).

3.9. Bank Merger

The idea to combine three SOE-owned IBs into one under a new name and identity, PT Bank Syariah Indonesia Tbk, has been authorized by OJK. PT Bank BRI Syariah, PT Bank Syariah Mandiri, and PT Bank BNI Syariah all participated in the merger process. Initially, Mandiri Syariah and BNI Syariah were merged into BRI Syariah (BRIS). Meanwhile, the name of the business license was finally changed from PT Bank BRI Syariah Tbk to PT Bank Syariah Indonesia Tbk. Through a letter with OJK Number SR-3/PB.1/2021, the merger and name change have been approved. Erick Thohir, Minister of State-Owned Enterprises (BUMN), brought out this merger to position Indonesia as a new pillar of national economic strength and push Indonesia as the center of the global Islamic economy and finance (Ulfa, 2021). The Conditional Merger Agreement (CMA) marked the beginning of the merger. Moreover, one of BSI's goals is to become a world-scale IB and be ranked in the top ten worlds IBs, with a significant capitalization value in 2025 (Alhusain, 2021)

Four SSB people were assigned to PT. Bank Syariah Indonesia Tbk: Mohamad Hidayat as chairperson of SSB and Oni Syahroni, Hasanudin, and Didin Hafidhuddin as members. The addition of SSB members to the merged bank was driven by the BRI Syariah Extraordinary General Meeting of Shareholders (EGMS), which agreed on the addition of the SSB's duties, responsibilities, and functions for the merged bank.

4. CONCLUSIONS

This study's conclusions lead to several issues. First, there is no positive legal basis that explicitly regulates SSB. Second, the educational background in accounting, finance, and Islamic banking must be considered when choosing SSB members, in addition to the person's popularity. Third, training is required to improve competence while serving on the SSB or before joining. Fourth, as many members have concurrent positions in different IFIs, the focus of IB supervision is less than ideal. So that the SSB performance can be relied on, emphasis must be

placed on the personal competency and time capabilities of potential members throughout the selection process.

This study examined the effects of eight SSB characteristics on sharia compliance, economic, social, and environmental performance, and disclosure level. These eight SSB characteristics are frequently employed in a few empirical studies. Due to this, an additional study may still examine several indicators of the SSB tasks' implementation effectiveness. These indicators include work experience, tenure, capability, and competency improvement programs followed, SSB's experience as a *mufti* (provider of fatwas), and independence, which can be expanded by a statement not serving as a political party administrator and government official.

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