

# Shariah supervisory board, the political connection and performance

## Junta supervisor de la Sharia, conexión política y el desempeño

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### Abstract

The study aims to examine the effect of Characteristics of Shariah Supervisory Board (SSB) towards the financial performance of shariah banking in Indonesia in 1999-2018. The study shows that SSB with their political connections affected the company financial performance. This indicates that members of SSB who possessed a political connection improved the banking performance, meanwhile the number of SSB members with the cross membership and SSB members with doctoral degree have no effect to the financial performance.

**key words:** performance, political connection, shariah bank, shariah supervisory board

### Resumen

El estudio tiene como objetivo examinar el efecto de las Características del Consejo de Supervisión de la Shariah (SSB) en el desempeño financiero de la banca Shariah en Indonesia en 1999-2018. El estudio muestra que SSB con sus conexiones políticas afectó el desempeño financiero de la compañía. Esto indica que los miembros de SSB que poseían una conexión política mejoraron el desempeño bancario, mientras que el número de miembros de SSB con membresía cruzada y miembros de SSB con doctorado no tienen ningún efecto en el desempeño financiero.

**palabras clave:** desempeño, conexión política, banco de la sharia, junta supervisor de la sharia

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## 1. Introduction

Companies with political connection were proven to gain several benefits, such as debt cost (Bliss & Gul, 2012; Houston, Jiang, Lin, & Ma, 2014; Khaw, Zainudin, & Rashid, 2019; Tee, 2019), privileged contract (Albalate, Bel, González-Gómez, & Picazo-Tadeo, 2017; Goldman, Rocholl, & So, 2013), and affected performance (H. K. Chen, Liao, Lin, & Yen, 2018; Haris, Yao, Tariq, Javaid, & Ul Ain, 2019a; Harymawan, Nasih, Ratri, & Nowland, 2019a). The political connection is generally reflected from the political connection of direction boards or the managers.

Indonesia held a presidential election in 2019. In the election process, political connection turned to be an intriguing issue since one of the pair candidates functioned as SSB of state banks. Studies showing the influence of SSB in shariah banks had several findings. The characteristics of SSB affected the financial performance (Hamza, 2013; Alsartawi, 2019b; Nomran, Haron, 2018), the activity of corporate social responsibility (Musibah

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& Alfattani, 2014b), and the decision making (Rafay & Farid, 2018). This study demonstrated how SSB characteristics particularly possessing a political connection affected the improvement of shariah banking performance in developing countries.

There are distinctions between shariah bank and conventional bank (Al Mannai & Ahmed, 2018a; N. Nomran, Haron, & Hassan, 2016). Besides the demands of good performance, shariah banks should obey the Islamic law. The shariah compliance aspect is crucial and becomes the main consideration of the stakeholders specifically the clients. Once a shariah bank disobeys the Islamic law, the trust of the people decreases and takes a higher risk for banking. The supervising function of shariah compliance is laid on SSB (Al Mannai & Ahmed, 2018b). Therefore, SSB characteristics is crucial and takes particular consideration as it affects the trust of the people and shariah banking performance.

Indonesia is a country with the biggest Muslim population in the worldwide, however during 2014-2018 the global shariah finance was under Malaysia, Uni Emirate Arab (UEA) and Bahrain, whilst Indonesia posited number 8 in the world list (Global Islamic Economy Index, 2018). The market share accomplishment of Indonesia's shariah banks for these 20 years has been around 5% (Bapenas, 2018). The low rate of people's acceptance on shariah banking raised a question, how shariah banking performance and supervising function represented by the characteristics of SSB members worked. It was then supported by a study which indicated that the report of SSB performance impacted the decision of investors (Rafay & Farid, 2018). Ajili & Bouri found that SSB characteristics were significantly in-correlated with the shariah bank performance (Ajili & Bouri, 2018), meanwhile other studies showed that SSB characteristics gave positive impacts on shariah bank performance (Mollah & Zaman, 2015). Studies in various countries are required since there are differences in the regulation related to policy or supervision system functioned by SSB (Grassa, 2013).

This study researched if the characteristics of SSB affected the financial performance particularly in Indonesia. Several literatures stated that the presence of *fatwa* (opinions) and country difference affected the operation of shariah banks (Amanullah, 2015; Ho, 2015), meanwhile in Indonesia each shariah bank should take the same fatwa. Different from Middle East countries (gulf area), Indonesia has two supervisions. A supervision in the national level is functioned by National Shariah Board (Dewan Syariah Nasional - DSN) founded by the Indonesian Ulema Council (Majelis Ulama Indonesia – MUI) commissioned to give fatwa related to the product and service offered by shariah financial organizations. Another supervision in the organizational level is functioned by SSB commissioned to assure the compliance of every operations taken. Accordingly, it is necessary to prove if the characteristics of SSB in Indonesia affected the financial performance. In this study, the writers also inserted a new variable, that is the political connection aspect possessed by SSB members which assumable affected SSB performance in conducting supervision function.

Referring to a study by Mollah and Zaman (2015) demonstrating the positive impacts of SSB toward shariah bank performance, there are certain characteristics of SSB required to fulfil in order to optimally function their supervision. A member of SSB must possess adequate knowledge and competence to determine if a bank applies shariah compliance principles. It is represented by the education level (Farook, Hassan, & Lanis, 2011), educational background, reputation, and experience in supervising (Zaman, 2015).

In this study, performance measurement used ROA and ROE proxies obtained from annual reports of 13 Shariah Banks in Indonesia, from 1999 to 2017, meanwhile the data related to SSB were collected from management reports of shariah banks. Afterwards, the collected data were analyzed by using multiple linear regression. The study result found that SSB having political connections significantly affected the financial performance. Meanwhile, SSB characteristics such as the number of SSB members, cross membership, and education level were not related to performance.

This study is divided into four sections, they are 1 introduction, 2 methodology, 3 result, and 4 conclusions.

### 1.1. Literature Review

SSB presence is required for supervision function to assure that the operational management is in accordance with the shariah compliance. SSB is a section of board structures compulsory to exist by the Law to give advices and supervisions. In general, the study result showed that SSB characteristics affected the financial performance. (Al-Matari, Al-Swidi, & Faudziah, 2014). Moreover, SSB reduces agency issues and determines concurrent in shariah banking (Almutairi & Quttainah, 2017). Shariah bank acquires ethical identity since it is in connection with religion (Haniffa & Hudaib, 2007), preceded by products which as the output requiring an approval from National Shariah Board (Dewan Syariah Nasional - DSN), the operational management should also comply with shariah standards up to the supervision. Consequently, Shariah Bank in the implementation demands shariah compliance assurance. A theory of *stakeholder* states that a company is not merely an entity operating for its own benefit, yet it should share benefits to the *stakeholders* (shareholder, creditor, consumer, supplier, government, society, analyst, and other parties). In this case, SSB functions should give benefits such as shariah compliance assurance for the people and investor in such a way that a shariah bank is chosen by them because of religious consideration.

The existence of a company is highly influenced by supports given by *stakeholders* to the company (Ghozali & Chariri, 2007). Deegan (2004) mentioned that every *stakeholder* retains rights to acquire information about the activities of the company in order to make decisions. The notion is later known as a *stakeholders theory*, thereupon the right theory to describe SSB position is *stakeholders theory* (Al-Nasser Mohammed & Muhammed, 2017). SSB on this occasion functions as giving compliance information to capital holders, the management and the society. At that point SSB position will not lean on one of the parties but on all parties.

The public need information about shariah bank compliance on the basis that when they consider a bank as “disobedient” thus it will give an impact on public distrust of shariah bank which then the bank will lose clients. It is supported by very influential factors of public decision over a bank, those are *trust and confidence* (Ashraf, Robson, & Sekhon, 2015). When a bank encounters a decrease of client number, it will cause a decline of profit yearning capability in the future, therefore it decreases its financial performance.

### 1.2. Characteristics of SSB and Company Performance

To assess Shariah Bank performance, we need to look at the shariah, financial, and social performances (Harahap, 2008; Musibah & Alfattani, 2014a). Financial performance measurement is related to profit accomplishment achieved by the company. Shariah performance is measured by shariah compliance, whereas social performance is related to the social contribution.

One of the factors affecting company performance is good management. SSB has the role key of good management operation (Ajili & Bouri, 2018b; Hakimi, Rachdi, Mokni, & Hssini, 2018). Previous studies presented relations between commissary board characteristics and company performance (Liang, Xu, & Jiraporn, 2013), however the literatures discussing relations between SSB characteristics and company performance are very limited. Some previous studies revealed the influence of SSB characteristics and company performance (Hakimi et al., 2018; Alstartawi, 2019c; Nomran et al., 2016), furthermore SSB became a new independent variable in relation with company performance (Nomran, et al., 2016).

#### Shariah supervisory board

Supervision function of SSB will be effective when SSB characteristics are fulfilled optimally. The characteristics are expertise, education (degree), reputation, experience (Grassa & Matoussi, 2014; Mollah & Zaman, 2015; Musibah & Alfattani, 2014b). Several studies presenting bank management issues also found a political

connection variable which affected banking efficacy (Abdelsalam, Mollah, & Tortosa-Ausina, 2017), moreover the presence of independent direction members had negative impacts on profitability (Haris et al., 2019a), as a finding of directional board members who were politicians indeed gave impacts on bank activities (Carretta, Farina, Gon, & Parisi, 2012). SSB is one of variables from management aspects, thus this study also examined whether members of SSB who possessed a political connection improved the banking performance.

### **The Number of SSB Members**

The big number of SSB members result more thoughts and supervisions which generate better performance (Frag, Mallin, & Ow-Yong, 2018; Safiullah & Shamsuddin, 2018). Additionally, the big number of SSB members earns higher shariah awareness (Bukair & Rahman, 2015). Yet, on the other hand, each country determines the number of SSB members distinctively. Indonesia determine the number of SSB members minimum 2 persons and maximum 4 persons, whereas other countries determine 12 persons (Nomran & Haron, 2020). In general, the number of SSB members gives more contributions for the bank's own good. Few studies showed that the number of SSB members gives significant impacts on financial performance (Grassa & Matoussi, 2014; Mollah & Zaman, 2015), moreover in a study by Saifullah, it was found that the bigger the number of SSB members, the better the financial performance (Safiullah & Shamsuddin, 2018). A recent study conducted in 23 countries recommended that the optimal number of SSB members to improve performance was 5 persons, not less than 4 persons and not more than 6 persons (Nomran & Haron, 2020). In accordance with the number of SSB members in Indonesia which is maximum 4 persons (not optimal), the hypothesis is in the following:

H1 : The number of SSB members improve shariah banking performance

### **SSB with Cross membership**

SSB members with cross membership are considered to have more informations from various institutions they supervise. Thereby a SSB member will gain experiences (Muda, 2017) from numerous cases to undertake and will soon make decisions if similar problems happen, which this surely gives impacts on better performance. The hiring of SSB members who are members of SSB in other places will in fact improve the consideration of clients and improve banking performance (R Grassa, 2016). Nevertheless, the cross membership of SSB members also raise worrying concerns on the widely-open information which should be confidential from one institution to another competitor institution if SSB members supervise several financial organizations. However, Wilson (2009) stated if this worrying concern will not occur as SSB members with cross membership turn to be very busy and hardly have time to reveal issues in each bank (Wilson, 2009). Board members who are busy will affect their financial performance (Fich & Shivdasani, 2006), even their bustle will decrease the company performance like a case of a CEO who is busy will decrease the company performance (Harymawan, Nasih, Ratri, & Nowland, 2019b). Thus the hypothesis is in the following:

H2: SSB members with cross membership decrease shariah banking performance

### **Education Qualification of SSB Members**

An individual possessing high education acquires more knowledge and information that will affect the ability of overcoming and solving various problems. The knowledge refers to the knowledge relevant with Islamic finance and banking (Farook & Roman, 2007) as well as Islamic accounting (Nomran, Haron, & Hassan, 2018). Musibah (2014) mentioned that the high education level of SSB members led to high profit accomplishment (Musibah & Alfattani, 2014a). This is understood as the knowledge possessed will accelerate problem solving to such a degree it will improve SSB work efficacy. Thus the hypothesis is in the following:

H3 : Education level of SSB members improves shariah banking performance

**Political Connection Possessed by SSB Members**

Several studies confirmed that board members building political connections with the ruler gained many benefits from the connections, one of them was getting low cost of debt (Harymawan & Nowland, 2016). Meanwhile studies of political connections in the middle east also confirmed that political connections became a vigorous instrument impacting banking efficacy in the weak condition of organization and law management (Abdelsalam, Ebrahim, Mollah & Ausina, 2014), besides political connections also affect banking progress (Haris, Yao, Tariq, Javaid, & Ul Ain, 2019b).

H4 : SSB members with political connections improve shariah banking performance

**2. Methodology**

**2.1. Sample**

There are 13 Shariah Banks in Indonesia registered in the Bank Indonesia until 2017. In accordance with the provided data, this study analyzed data from 1999 to 2018 collecting 125 observable data. The data were manually collected from the website of each shariah bank, both the financial data and the data related with SSB characteristics in the annual reports.

**2.2. Variable definition**

In accordance with the previous studies, a dependent variable in this study was shariah banking performance measured with 2 proxies, they were return on assets (ROA) and return on earnings (ROE) (Almutairi & Quttainah, 2017; Mollah & Zaman, 2015; Musibah & Alfattani, 2014a; Nomran, Haron, 2018). ROA is net income ratio divided by total asset and ROE is net income divided by total equity, these proxies were used since shariah banks in Indonesia are mostly unregistered in shariah capital market, thereby share return measurement could not be used.

Independent variable is SSB characteristics consisting of SSB member number; SSB cross membership, that is the percentage of SSB members who are also SSB members of other places; education qualification is the percentage of SSB members with doctoral degree; and SSB members with political connections. Having political connections verifies at least with one of company owners or top officers who is a parliamentary member, minister, or a close connection with politicians or parties (Faccio, 2006). In this term, SSB members will be identified of ever being a legislative member or having close connections with political parties in line with the government or getting involved in the governance.

Control variables of financial performance were size, age, and leverage. Size was measured with logarithms of total asset, age was the age of shariah bank, and leverage used the counting of debt ratio to equity ratio which was debt divided by total capital (Ajili & Bouri, 2018a; Elsilä, Kallunki, Nilsson, & Sahlström, 2013).

To test the hypothesis, the models used were :

$$ROA = \beta_0 + \beta_1SSB + \beta_2Size + \beta_3Lev + \beta_4Age. \dots\dots\dots(1)$$

$$ROE = \beta_0 + \beta_1SSB + \beta_2Size + \beta_3Lev + \beta_4Age. \dots\dots\dots(2)$$

This study used a model validated by Al Mutairi, which used profitability ratio to measure performance and other several characteristics of SSB (Almutairi & Quttainah, 2017). Next data were analyzed using *pool ordinary least square*.

**Table 1**  
Variable definition

Variable	Measurement
Return on Asset (ROA)	Return divided by total asset
Return on Equity (ROE)	Return divided by equity
Number of SSB (NSSB)	consisting of SSB member number
Cross membership (CRMBS)	the percentage of SSB members who are also SSB members of other places
Education level (PhD)	the percentage of SSB members with doctoral degree
Political Connection (PC)	SSB members will be identified of ever being a legislative member or having close connections with political parties in line with the government or getting involved in the governance.
Ukuran Perusahaan (SIZE)	logarithms of total asset
Leverage (LEV)	debt divided by equity
Usia Perusahaan (AGE)	the age of shariah bank

### 3. Results

#### 3.1. Descriptive statistics

Results for descriptive statistics are shown in table II. Out of 13 Shariah Banks as the object of the study, there were 125 observable data found, with the average ROA and ROE 0,838 and 5,964. The table also explains the average number of SSB in shariah banking which are 2 persons with minimum number of 2 persons and maximum number of 4 persons. SSB number of cross membership is in average 2 persons and the number of possessing doctoral degree is in average 1 person. Whereas SSB member with political connections is no more than 1 person or in average 0,600 with maximum 2 persons in each shariah bank.

**Table 2**  
Descriptive Statistics

Variable	N	Mean	Std. Dev	Min	Max
Performance variables					
ROA	125	0.838	3.597	-20.1300	12.400
ROE	125	5.964	18.806	-94.0100	57.980
(SSB) Characteristics					
NSSB	125	2.472	0.576	2.000	4.000
CRMBS	125	2.008	0.641	0.000	3.000
PhD	125	1.072	0.541	0.000	2.000
PC	125	0.600	0.718	0.000	2.000
Control Variable					
DER	125	2.418	3.595	0.045	30.088
SIZE	125	1.6e+13	2.1e+13	1.6e+11	9.8e+13
AGE	125	7.425	6.130	0.000	27.083

Notes: N= number of observations; ROA= return of asset; ROE= Return of Equity; N SSB= number of shariah supervisory board; CRMBS= cross of membership; PhD= doctoral; PCon= political connection; DER=Debt of equity ratio; SIZE= total assets; AGE= bank age.

### 3.2. Correlation

Table 3. shows coefficient of Pearson correlation from the variable used in this study. The highest correlation is between the size variable of the company (Size) and age variable of the company (Age). In addition, correlation score is under 0,5, this explains the absence of colenierity issue among the independent variables.

**Table 3**  
Pearson Correlation Matrix

	ROA	ROE	NSSB	CRMBS	PhD	PC	DER	AGE	SIZE
ROA	1.000								
ROE	0.738*** (0.000)	1.000							
NSSB	0.060 (0.509)	0.214** (0.017)	1.000						
CRMBS	-0.060 (0.507)	0.064 (0.476)	0.252*** (0.005)	1.000					
PhD	-0.019 (0.832)	0.090 (0.321)	0.278*** (0.002)	-0.095 (0.294)	1.000				
PC	0.181** (0.044)	0.286*** (0.001)	0.518*** (0.000)	0.182** (0.042)	0.075 (0.408)	1.000			
DER	-0.033 (0.717)	0.062 (0.493)	0.033 (0.712)	0.023 (0.797)	-0.022 (0.809)	0.194** (0.031)	1.000		
AGE	-0.076 (0.400)	0.086 (0.341)	0.348*** (0.000)	0.526*** (0.000)	0.338*** (0.000)	0.294*** (0.001)	-0.026 (0.777)	1.000	
SIZE	0.028 (0.756)	0.136 (0.130)	0.280*** (0.002)	0.458*** (0.000)	0.226** (0.011)	0.139 (0.123)	0.062 (0.489)	0.665*** (0.000)	1.000

*p*-values in parentheses

\* *p* < 0.1, \*\* *p* < 0.05, \*\*\* *p* < 0.01

### 3.3. Hypotheses test

The regression test result of SSB characteristics on financial performance is shown in table 4. There is one SSB characteristics affecting the first model (ROA) and the second model (ROE) which is political connections of SSB members.

**Table 4**  
Multiple Linear Regression Analysis

Variable	(1) ROA	(2) ROE
NSSB	-2.273 (-1.46)	3.435 (0.43)
CRMBS	-1.551 (-1.30)	-9.052 (-1.56)
PhD	2.424 (1.39)	4.000 (0.43)
PC	3.620*** (2.65)	15.645** (2.19)
DER	-0.227** (-2.08)	-0.256 (-0.45)
AGE	-0.602 (-1.41)	-0.594 (-0.29)
SIZE	0.364 (1.42)	2.768** (2.56)
_cons	-6.616 (-0.90)	-74.200*** (-2.63)
r2	0.098	0.128
N	124	124

t statistics in parentheses

\*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

\*\*\*, \*\* and , \* significant at 1%, 5% dan 10%. ROA= Return on Asset; ROE= Return on Equity; NSSB= number of SSB; CRMBS=Cross membership of SSB; PhD= educational qualification, PC= political connection, Size= Bank Size; DER= Debt to equity ratio; AGE=Bank Age.

A negative impact was found in the number of SSB members on banking performance in the first model (ROA) even though the impact was insignificant. This negative impact indicated that the more member of SSB did not result better performance. This result was different from a study by Mollah and Zaman (2015) as well as Nomran, Haron and Hassan (2018) which justified that the big number of SSB members would improve performance. However, this finding was similar with a study by Hakimi (2018) which affirmed that the number of SSB members gave no impact on the performance (Hakimi et al., 2018), even the more board members, the lower the profitability (Haris et al., 2019b). More board members will only cause slower decision making and it is not profitable for banking.

The difference in the number of SSB members, many or few, affecting performance was upheld by Norman (2020) stating that the optimal number of SSB members increased performance as many as 5 persons, yet it might not less than 3 persons and not more than 6 persons (N. M. Nomran & Haron, 2020). According to Table 5, the number of SSB members in Indonesia is maximum 4 persons, hence this number is still below the optimal number of SSB members that improves shariah banking performance. As a result, it is acceptable if the number of SSB members will not improve the performance or even decrease shariah banking performance.



**Table 5**  
Description of Size of SSB

Number of SSB	Freq.	Percent	Cumulative
2	71	56.80	56.80
3	49	39.20	96.00
4	5	4.00	100.00
Total	125		

Another condition of SSB in Indonesia is that the members mostly function as advisor instead of supervisor, thus the presence of SSB members (even though it can not be said as many) will only add more cost and decline the return of shariah bank. The result is similar with a study by Alsartawi which examined SSB in gulf countries, explaining that the number of SSB and strict supervision would increase the cost and decrease the return (Musleh Alsartawi, 2019a).

Additionally, political connections showed positive and significant relations to all models with significance level 1%. This proved that political connections of SSB members were strongly related to performance. This result indicated that SSB members with political connections would improve banking performance. It descriptively appeared that every bank in average had almost one person having political connections. This finding highly supported the fact that a company gained benefits from political connections particularly in less developing countries with high corruption rate (Chen, Ding, & Kim, 2010; Faccio, 2006).

The other two SSB characteristics gave no impact on performance, they are cross membership and education level. Cross membership although gave no significant impact conveyed negative signs, which meant that even though there were many SSB members with cross membership, company performance would not be affected. The more SSB members with cross membership, the lower company performance was. SSB members with cross membership would find difficulty to focus on one supervision since they had to supervise other institutions, in such a way that this bustle would only make the supervising work ineffective. Moreover, numerous informations would prolong the decision making as there were a lot of considerations to deliver. It is in accordance with the researchers' ideas convincing that cross membership of SSB members gave negative impacts on board effectiveness (Alman, 2012) and triggered conflicts of interest (Nathan Garas, 2012).

Education level of doctoral degree did not affect ROA and ROE. This was caused by SSB member election in the early establishment of shariah bank was more on the public figure than the main competence required. By examining more detail on the SSB educational background, it shows that SSB members were dominantly from religious science, whereas supervision required expertise of accounting and finance.

The result of the study confirmed a finding by the National Shariah Board (Dewan Syariah Nasional - DSN) stating that the cause of shariah banking performance weakness was less optimal performance of SSB members. Not only that, the presence of SSB in meetings was still low, their thoughts and opinions were also less qualified, as well as the in objective and inaccurate finding of deviations stated by SSB.

In other words, the high number of SSB members with cross membership and possessing doctoral degree was irrelevant with banking performance. This condition might be resulted from by the too many SSB members will not accomodate with the frequency of meeting presence or supervision which caused high cost and low supervision quality. This result was in accordance with the previous findings which analyzed the performance of SSB in Malaysia. It was explained that SSB varied in competence, in which minimum background of banking and finance, even more on the supervision that tended to be ceremonial instead of strict supervision (Haridan, Hassan, & Karbhari, 2018).

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## 4. Conclusions

This study was proving if the characteristics of SSB members affected the financial performance, results were found that SSB members with political connections turned to be the most influential factor in the financial performance.

SSB characteristics became a new variable representing good management. The structure of shariah banking differs from the structure of conventional bank. The striking difference is that shariah banking is bound and compulsory to meet the shariah compliance. Regarding the fact that supervision function of shariah banking is under SSB, therefore SSB has a big role in banking operation. It is also related to risk aspects embedded when the company disobeys shariah standards of compliance. Consequently, this study proves the impacts of SSB characteristics on the financial performance. The study result showed that SSB characteristics of their political connections affected the financial performance. The shariah banking performance was in fact affected by political connections possessed by SSB members.

The implication was admitted that the performance improvement was driven by political connections of SSB members, which definitely described low responsibility of shariah banking toward the public who demanded qualified supervision. Therefore, it is necessary to improve the number of SSB members and their competence, as Norman (2020) recommended that the optimal number of SSB members was 5 persons, as well as the competence improvement related to accounting and finance in order to implement the more qualified supervision. Furthermore, it is proper in the recent time if SSB trainings and certifications are massively held in Indonesia to acquire competent and qualified members of SSB. The fact found that SSB performance was far from the expectation particularly in term of competence. Future studies are suggested to find different research method to examine further the work efficacy of SSB members through deeper supervision and interview.

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