“Corporate governance mechanism and risk disclosure by Islamic banks in Indonesia”

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CORPORATE GOVERNANCE MECHANISM AND RISK DISCLOSURE BY ISLAMIC BANKS IN INDONESIA

Abstract

The disclosure of risk by Islamic banks is very important, as this openness of information is emphasized in Islamic teachings. The purpose of this article is to provide empirical evidence regarding the influence of the number of members of the Sharia Supervisory Board (SSB) and their cross membership, the debt and the Syirkah fund ratio (investment accounts), the composition of the board of commissioners, the number of audit committee members, and the amount of assets on risk disclosure by Indonesian Islamic banks.

The study uses content analysis techniques to measure risk disclosure by Islamic banks. The analysis uses panel data regression with observations for the period of 2010–2017. Based on the Fixed Effect Model, the study found out that the number of SSB members, the cross memberships of SSB, the ratio of independent commissioners to the number of audit committees do not influence risk disclosure. The leverage to investment account ratio does not influence risk disclosure. Also, the results of this study demonstrate that only the amount of assets influences risk disclosure.

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INTRODUCTION

An Islamic bank is a bank that applies the principles of Islamic law in all its operations. For Islamic banks to implement Sharia rules, disclosure of information is essential. This disclosure may enable consumers to make policy evaluations, and may also be a way of obtaining information about the use of consumer funds by banks. Maali, Casson, and Napier (2006) find out that in Islam, disclosure of information for decision making is a secondary goal. According to Islam, disclosure of all information is needed to notify *umma* (the Islamic community) about the company's operations, since *umma* has the right to know how the *umma* organizations influence their well-being (Maali et al., 2006).

One type of disclosure that Islamic banks must make is risk disclosure (Dignah, Latiff, & Rahman, 2012; OJK, 2016). Among various studies describing information disclosure by Islamic banks, many have focused on disclosing information about banks' social activities (see Aribi & Gao, 2010; El-halaby & Hussainey, 2015, 2016; Farook, Hassan, & Lanis, 2011; Hassan & Harahap, 2010; Nawaiseh, Also Boa, & El-Shohnah, 2015; Rahman & Bukair, 2013), and about disclosure of SSB information and financial reporting (El-Halaby & Hussainey, 2016).

Disclosure of risks faced by Islamic banks is still poorly studied. This situation is unfortunate because information about the risks faced by banks is needed by stakeholders. In addition, risk is a main source of financial distress in banks (Neifar & Jarboui, 2018). Moreover, Islamic banks have more diverse risks than conventional banks. There has been a limited body of research that explored risk disclosures in Islamic banks (Dignah, Latiff, & Rahman, 2012; Ellili & Nobanee, 2017; Neifar & Jarboui, 2018; Saufanny & Khomsatun, 2017; Srairi, 2018). Based on the above studies, one can divide the variables used into three types, namely the GCG mechanism, financial condition, and the role of SSB.

This study has added the Investment Account Holders (IAH) variable as a variable that is strongly suspected of influencing risk disclosure. IAH is a funding source that complements equity (Bukair & Abdul Rahman, 2015) and is a funding source that is typical in Islamic banks. This is because IAH is a bank funding source that does not have fixed costs, but depends on the bank performance (Farag, Mallin, & Ow-yong, 2017), and uses a profit sharing system (Alshattarat & Atmeh, 2016). The reason for adding this ratio as a new variable that influences risk disclosure is because the IAH fund owner has a large risk due to uncertainty over the profit share obtained from IAHs investment (Alshattarat & Atmeh, 2016; Sundararajan, 2005).

In addition, the reason for this study is the inconsistency of the results of previous studies. One of the discrepancies in result research is the role of SSB in influencing risk disclosure. Neifar and Jarboui (2018), and Elamer, Ntim, and Abdou (2017) provided evidence that SSB had a positive influence on risk disclosure. Different evidence is provided by Saufanny and Khomsatun (2017) and Srairi (2018) who believe that SSB does not affect risk disclosure. Thus, research on the impact of corporate governance mechanisms on risk disclosure needs to be deepened (Al-Maghzom, 2016).

1. LITERATURE REVIEW

Banks are entities with relatively high operational risks. This risk arises because the function of banks is to act as an intermediary institution between a surplus of funds and a deficit of funds. Sharia banks prohibit the use of systems based on interest, and instead they promote profit sharing systems (*syirkah*). This profit sharing system allows the sharing of losses by both banks and customers. This system has consequences in terms of greater risks faced by Islamic banks than conventional banks (Mairafi, Hassan, & Arshad, 2018). In his study, Lassoued (2018) finds that Islamic banks have greater credit risk than conventional banks. The high operational risks faced by these Islamic banks have caused the need for banks to carry out risk management and present risks and management policies to stakeholders in the form of disclosure of bank operational risk (OJK, 2016).

Accountability is an output in the form of information produced by financial accounting (Rahman & Bukair, 2013). Accountability in Islam concerns accountability to God and to the general public (Rahman & Bukair, 2013). The company's management gains the trust of the community when managing the resources owned by the company. The logical consequence of this trust is that management has an obligation to provide information as its personal and community responsibility (Rahman & Bukair, 2013).

In the agency theory concept, financial statement transparency can reduce information asymmetry among stakeholders. In the context of agency conflict, information asymmetry can occur between directors and customers, and between creditors and other stakeholders. This concept supports the idea that information disclosure is needed for all stakeholders to reduce information asymmetry.

In addition, in the theoretical concept of stakeholders, bank management should be accountable to all stakeholders for managing the company. This effort is the means by which management is held to account for its performance. Disclosure also includes disclosure of risks that banks face. This is because risk is part of the business information that stakeholders need to make their decisions.

One of the factors that are suspected of influencing risk disclosure is SSB. SSB is a function of supervising and auditing management in terms

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of its compliance with Sharia law. Disclosure is part of Islamic teaching (Maali et al., 2006). The Islamic community (*umma*) has the right to know about the bank's operations. Information disclosure is a way for the *umma* to know about banking. Thus, if the SSB role is more effective, it forces banks to disclose more information, including risk information.

2. DEVELOPMENT OF HYPOTHESES

Some researchers, such as Neifar and Jarboui (2018), Dignah et al. (2012) and Srairi (2018), have used SSB as a proxy that influences risk disclosure. However, the results of studies linking SSB to risk disclosure are inconsistent. Elamer, Ntim, Abdou, Zalata, and Elmagrhi (2019) and Neifar and Jarboui (2018) use SSB and find that it has a negative influence on the quality of risk disclosure. Meanwhile, Srairi (2018) uses SSB index, size of membership, cross-membership, SSB meetings, and the presence of accounting to find no significant relationship between SSB and risk disclosure by Sharia banks. The research results of Srairi (2018) were also supported by Saufanny and Khomsatun (2017) who find that the number of SSB members has no impact on risk disclosure.

H1: The number of SSB members has a positive influence on corporate disclosure risk.

In addition to the number of members, some researchers also use members' cross memberships as a factor in measuring the improvement in SSB performance. According to previous research, there are two reasons why cross membership can improve SSB performance. The first is that cross membership has an impact on the potential for exchange of experience and knowledge between SSBs (Rahman & Bukair, 2013). An SSB member who has a duty on SSBs in several banks allows the SSBs to interact. El-Halaby and Hussainey (2016) find that SSB members with cross-membership are able to adopt their knowledge discreetly and explicitly for the application of Sharia law in their work. Furthermore Dahya, Lonie, and Power (1996) have demonstrated that cross-directorships can improve the information presented by the director through comparing knowledge from other companies. Farook et al. (2011) demonstrate empirically that the cross-membership of SSB can influence the disclosure of Islamic banks. For this reason, the authors posit that cross-membership will have a positive influence on the SSB performance.

Meanwhile, another opinion states that cross-membership has a negative influence on SSB in the performance of its duties. The reason is that the SSB member, who is obliged to become an SSB for many banks, will force the corresponding SSB member not to focus on the performance of their duties because they have to divide their time in carrying out their duties. More and more monitored banks will reduce SSB performance. In discussing this point of view, the study uses the hypothesis:

H2: Cross membership of SSB has a significant influence on disclosure of banking risk.

According to stakeholder theory, management is required to report on the company's activities to stakeholders as a basis for policy making. Major stakeholders become a big boost to information disclosure. In view of agency conflict between management and stakeholders (external banks), leverage is one method that can be used to measure the amount of encouragement of stakeholders.

Stakeholders' encouragement can be measured by bank leverage. Banks that have high leverage will increase the encouragement the stakeholders give to bank management to provide performance information. In addition to leverage, the authors also use the ratio of *syirkah* funds to measure stakeholders' encouragement. Both of these measurement methods have been used by Mukhibad (2018) who finds that debt and IAH have an influence on disclosure of social performance. This hypothesis has also been demonstrated empirically by M. K. Hassan (2009) who finds that the debt to equity ratio has a positive influence on risk disclosure.

H3: Debt ratio has a positive influence on risk disclosure.

H4: Investment account holders have a positive influence on risk disclosure.

Information is needed to reduce information asymmetry between directors and stakeholders. According to agency theory, this information asymmetry will then cause agency problems. Agency problems can arise between directors and stakeholders or between controlling shareholders and others. To reduce the potential for this problem, good corporate governance is urgently needed (Srairi, 2018). Neifar and Jarboui (2018) and Srairi (2018) have found a relationship between the composition of boards of commissioners and risk disclosures.

H5: The composition of the board of commissioners has a positive influence on risk disclosure.

Risk management communication is a core component of corporate governance (Abdullah & Shukor, 2017). Bank Indonesia requires Islamic banks to have at least three committees, namely an audit committee, a remuneration and nomination committee, and a risk monitoring committee (Darmadi, 2013), to support the implementation of GCG. The audit committee has the duty of overseeing the operations of the company (Srairi, 2018), including the disclosure of the company's financial statements (Anderson, Mansi, & Reeb, 2004). The size of audit committees has an important role in increasing the reliability of financial statements (Anderson et al., 2004). Besides, the size of audit committees will have a positive effect on broader disclosures (Deloitte, 2018). The audit committee performs the risk management tasks (Abdullah & Shukor, 2017). Thus the following hypothesis can be developed:

H6: Audit committees have a positive influence on risk disclosure.

Some researchers also use the amount of assets as one of the factors influencing the extent of disclosure by the entity. Risk disclosure is the provision of information to stakeholders about the risks faced by the entity. This information is needed because it is related to investment decisions by stakeholders. The use of total assets as a factor that influences the extent of risk disclosure is due to the assumption that the more assets owned, the larger the number of stakeholders they have (Hernández, B. Aibar, & C. Aibar, 2015). A large number of stakeholders is one of the drivers for companies to provide greater risk disclosures. Dobler, Lajili, and Ze (2011), Hernández et al. (2015), M. K. Hassan (2009) and Neifar and Jarboui (2018) have demonstrated empirically that the amount of assets affects the disclosure of company risk.

H7: The amount of assets has a positive influence on risk disclosure.

3. METHODS

The sample of this study is seven Islamic banks in Indonesia with an eight-year observation period between 2010 and 2017. This sample was determined by the purposeful sampling method.

The risk management disclosure variable is measured by calculating the bank's disclosure ratio. The content analysis technique has been applied to measure the risk disclosure variable. The risk disclosure indicator is based on Bank Indonesia Regulation Number 13/23/PBI/2011 pertaining to Application of Risk Management for Sharia Commercial Banks and Sharia Business Units. This variable measurement is given a score of 1 if the bank makes a disclosure and a score of 0 if the bank does not make disclosures. SSB effectiveness is measured by the number of the SSB members, and SSB members' cross membership. Debt ratio is measured by the ratio of debt to assets, while IAH is measured by the ratio of temporary *syirkah* funds to assets. Independent Commissioners are measured by the ratio of the number of independent commissioners to all commissioners. The audit committee is measured by the number of audit committee members. Size is measured by the amount of assets.

This research model is

$$\begin{aligned}
&Risk\ Disclosure = \beta_0 + \beta_1 SSB\ Size + \\
&+\beta_2 SSB\ Cross\ Membership + \\
&+\beta_3 Debt\ Ratio + \beta_4 IAH \\
&+\beta_5 Independent\ Board + \\
&+\beta_6 Audit\ Committee + \beta_7 Assets + e.
\end{aligned} \tag{1}$$

The panel data regression analysis is used to test hypotheses. Testing is performed using the

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Common Effect Model (CEM) test, Fixed Effect Model (FEM) and Random Effect Model (REM). The Chow test is used to select of the best models from the three models above to compare the CEM and FEM test results.

H0: The model will use the CEM model.

Ha: The model will use the FEM model.

The Hausman test is used to compare the results of FEM and REM tests.

H0: The model will use the REM model.

Ha: The model will use the FEM model.

The Lagrange Multiplier test is used to compare the CEM and REM tests.

H0: The model will use the CEM model.

Ha: The model will use REM model.

The Chow, Hausman, and Lagrange tests will accept *H0* if the probability value is less than 5% and accept *Ha* if the probability value is more than 5%.

Based on the Chow, Hausman and Lagrange tests, the study reveals that FEM is the best model. The best test results are tested for classical assumptions, i.e. tests for normality, multicollinearity, heteroscedasticity, and autocorrelation.

4. RESULTS

Regulators in Indonesia have adopted regulations on implementing risk management for Islamic commercial banks. According to these regulations, ten risks need to be disclosed, namely: credit, market, liquidity, operational, legal, reputation, strategic, compliance, yield, and investment risks. The risks that must be disclosed by conventional banks include credit, market, liquidity, operational, legal, reputation, strategic and compliance risks. That is to say, yield risk and investment risk are types of risk that can only be found in Islamic banks. The results of the study, namely the disclosure ratios for the ten risks above, are presented in Table 1.

Table 1. Risk disclosure by Islamic banks

No.	Type of risk	Disclosure (%)
	General risks	
1	Credit risk	100
2	Market risk	96.43
3	Liquidity risk	96.43
4	Operational risk	98.21
5	Legal risk	46.43
6	Reputation risk	39.29
7	Strategic risk	39.29
8	Compliance risk	75.00
	Special risks (Islamic bank risk)	
9	Risk of returns	14.29
10	Investment risk	7.1429
	Average	56.94

Table 1 shows that the average risk disclosure by Islamic banks in Indonesia is 56.94%. In addition, if one distinguishes between general risks and special risks, it can be concluded that general risks are more disclosed than special risks.

The average score of the independent variables is presented in Table 2.

The Chow test is conducted to compare the CEM or FEM test results and determine which model

Table 2. Results of the descriptive test

Variable	Mean	Median	Maximum	Minimum	Std. dev.	Skewness	Kurtosis
Risk disclosure	0.5694	0.5	1	0.1	0.217475	0.137958	2.150062
SSB	2.410714	2	3	2	0.496416	0.362977	1.131752
Cross membership	3.607143	3.666667	5.5	2	0.928466	0.13173	2.317381
Debt ratio	0.166897	0.156433	0.326932	0.027965	0.064208	0.570308	3.173803
IAH	0.704252	0.706605	0.892434	0.526124	0.069557	–0.28983	3.418953
Independent commissioners	0.670238	0.666667	1	0	0.174649	–0.2057	6.058668
Audit committee	3.678571	3	9	2	1.113669	2.332915	10.74627
Assets	30.13224	30.02157	32.10767	26.85169	1.291967	–0.40787	2.502274

is better. This Chow test results in a probability of 0.0000. This probability value is less than 5%, so the conclusion is that the FEM test result is better than the CEM test result.

The next stage is the Hausman test, which is performed to select better test results between FEM and REM. This test results in a probability value of 0.0000, which is less than 5%, so the conclusion is that the FEM test result is better than the REM test result.

To produce the regression fund analysis known as BLUE (Best Linear Unbiase Estimator), some classical assumption tests should be followed. The first classical assumption test is a normality test that gives a probability value of 0.720078, which is greater than 0.05, resulting in the conclusion that the data are distributed normally. The next classical assumption test is a multicollinearity test. This test is performed to find out whether there is a correlation between independent variables. The results of this test produce a correlation value below 0.8. These results determine that there is no multicollinearity between independent variables. The next classical assumption test is a heteroscedasticity test. The results of this test produce a probability value of more than 0.05 for all independent variables . The results of this test conclude that there was no heteroscedasticity. The last classical assumption test is the autocorrelation test. This test is conducted by comparing the Durbin-Watson values with the Durbin-Watson table (N58 and K6). The FEM test results produced a Durbin-Watson value of 1.890712. Durbin-Watson table values with 58 pieces of data and the independent variables numbering 6 (N58 and K6) giving dl 1.38152 and du 1.76767 values. The DW value of 1.76767 is greater than the value of dl, but smaller than 4-du (1.890712), so the conclusion is that autocorrelation does not occur.

The results of the FEM test are presented in Table 3.

5. DISCUSSION

This study indicates that the role of the Sharia Supervisory Board does not influence the risk disclosure of a company. This result is in line with the research of Srairi (2018) and Saufanny and Khomsatun (2017) who find no influence of SSB on the company risk disclosure. However, the results of this study are different from those of Neifar and Jarboui (2018), and Elamer et al. (2019). The larger SSB is not a reason for banks to be overseen in terms of disclosing their business risks. Supervision of risk disclosures reported by Islamic banks is still not the responsibility of SSB. This is a very unfortunate situation since disclosure or provision of in-

Table 3. Test results of the fixed effect model

Source: E-views.

Variable	Coefficient	Std. error	t-statistics	Prob.
Constant	–1.139005	1.449942	–0.785552	0.4364
SSB	–0.042876	0.104591	–0.409943	0.6839
Cross membership	–0.175455	0.262651	–0.668015	0.5077
Debt	0.093439	0.597931	0.156270	0.8766
Investment account holders	0.031686	0.031320	1.011690	0.3173
Independent commissioners	0.052307	0.054236	0.964440	0.3402
Audit committee	–1.139005	1.449942	–0.785552	0.4364
Assets	1.282011	0.691913	1.852851	0.0708

Table 4. Hypothesis acceptance and rejection test

Hypotheses	Conclusion
H1: The number of SSB members has a positive influence on corporate disclosure risk	Rejected
H2: Cross membership of SSB has a significant influence on the disclosure of bank risk	Rejected
H3: Debt ratio has a positive influence on risk disclosure	Rejected
H4: Investment account holders have a positive influence on risk disclosure	Rejected
H5: The composition of the board of commissioners has a positive influence on risk disclosure	Rejected
H6: Audit committees have a positive influence on risk disclosure	Rejected
H7: The amount of assets has a positive influence on risk disclosure	Accepted

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formation by an entity is part of the teachings of Islam. "Do not [...] conceal the truth while you know [it]" (Qur'an, 2:42). Maali et al. (2006) interpret the verse cited as prohibiting companies from hiding information. Muslim communities (*ummah*) have the right to obtain a company's operational information and to comply with Sharia rules (Maali et al., 2006). According to these findings, SSB in Indonesia is still focusing on guaranteeing the Sharia-compliant products owned by Islamic banks.

The results of the study indicate that the ratio of debt to assets has a significant impact on risk disclosure by Islamic banks. Debt as one source of funding from having fixed costs does not cause Islamic banks to provide broader disclosure of the risks involved in their business. The results of this study are different from the findings of Dignah et al. (2012), which demonstrate that the debt to asset ratio has an influence on risk disclosure. One can suggest that this finding indicates that Islamic bank investors do not use risk disclosure as a factor when analyzing the feasibility of their investment. For banks, the results of this study indicate that they did not use risk disclosure as a factor in attracting investors. The results of this study are also supported by the findings that investment account holders (IAH) have no impact on risk disclosure. IAH fund owners, who are generally more at risk than debt holders, should pay more attention to the level of risk the bank faces. However, the results of this study reject this hypothesis. The size of IAH funds owned by banks does not affect the disclosure of risk by Islamic banks.

The composition of the board of commissioners, measured by the ratio of independent commissioners to all commissioners, also demonstrates that it does not affect risk disclosure. These results confirm the findings of Buckby, Gallery, and Ma (2015). The results of this study contradict the findings of Neifar and Jarboui (2018), Srairi (2018), Abdullah and Shukor (2017) and Carmona, Fuentes, and Ruiz (2016) and support the results of Saufanny and Khomsatun (2017). The work of independent commissioners whose function it is to oversee the performance of the bank so that it accommodates all stakeholders' interests, including the interests of stakeholders in obtaining information on the risks faced by the bank, has not been optimal. Based on risk disclosures, the authors suspect that independent commissioners have not been effective in monitoring bank performance. There are other indicators, namely profitability and social performance, that are the object of supervision by independent commissioners.

Risk disclosure is also monitored by audit committees, but their performance is not effective. The audit committee oversees internal financial reporting and related controls, risk, and ethics and compliance (Center-for-Board-Effectiveness, 2018). However, the result of this study indicates that the number of audit committee members does not have a positive influence on the disclosure of bank risk. This result is in line with Buckby, Gallery, and Ma (2015), who find that the ratio of independent audit committee members does not influence risk disclosure. The larger the size of the audit committee, the greater the tendency for them to be more effective in performing their duties, but this is not able to increase the degree of bank risk disclosure. The results of this study are in contrast to those of Saufanny and Khomsatun (2017), Abdullah and Shukor (2017) and Carmona et al. (2016), who find a positive relationship between the number of independent audit committee members and the disclosure of the risk by Islamic banks. The differences between the results of this study and those of Habtoor, Ahmad, Mohamad, and Haat (2017) and Saufanny and Khomsatun (2017) are due to the measurement of the audit committee variable. This study measures the effectiveness of audit committees based on the number of members, while Saufanny and Khomsatun (2017) use the number of independent audit committee members. From these two studies, the authors' conclusion is that an audit committee that is effective in supervising Islamic banks in terms of their disclosure of risk is an independent audit committee.

The results of this study reinforce previous research, namely that conducted by Dobler, Lajili, and Ze (2011), Hernández et al. (2015), Pangestuti, Takidah, and Zr (2017), Lajili (2009), and Neifar and Jarboui (2018), which find a positive relationship between company size and risk disclosure. This study measures the size of a company using the amount of assets. Thus, it can be explained that Islamic banks that have a lot of assets will provide more information on the risks they face. Banks with many assets have more stakeholders who are also more diverse. This larger number of stakeholders encourages banks for greater risk disclosures.

CONCLUSION

This study demonstrates that the number of SSB members, cross-membership of an SSB, the composition of the commissioners' board, and the number of audit committee members do not have a positive impact on the risk disclosure by Islamic banks in Indonesia. Corporate governance mechanisms in Islamic banks in Indonesia have failed to increase the extent of risk disclosure.

In addition, the funding structure originating from debt and IAH funds also fails to increase the extent risk disclosures by banks. The study found that only the amount of assets has a positive influence on the disclosure of bank risk. Larger banks tend to make their business risks more widely known to stakeholders.

Islamic banks that take more risks than conventional banks should provide information about those risks that are more complete and serve as key information for stakeholder decision making. Nevertheless, Islamic banks are advised to provide information about risk because the provision of such information to stakeholders is highly recommended according to Islamic principles. Regulators are recommended to assess the extent to which Islamic banks are compliant in terms of providing risk information in accordance with OJK Regulation No. 65/POJK.03/2016, pertaining to Acceptance of Risk Management for Sharia Commercial Banks and Sharia Business Units.

The results of this study indicate that further research will explore the role of stakeholders' risk disclosure by Islamic banks, especially for clients who have temporary *shirkah* funds that are investments for a certain period of time from a business partnership under Islamic financial law.

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