Analysis of the Impact of Islamic Corporate Governance and Bank Reputation on Islamic Bank Performance in Indonesia

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Abstract. The present research analyzed the impact of Islamic Corporate Governance and bank reputation on the performance of Islamic banks in Indonesia. In this study, the population consisted of 11 Islamic Commercial Banks (ICB) registered in Bank Indonesia. Based on the purposive sampling technique, 8 Islamic banks were selected as the samples because they met the predetermined criteria. The research data were obtained from the annual report during the 2015-2019 period and were subsequently analyzed by the panel data regression analysis using the *EViews 9.0* software for *Windows*. The findings revealed that 1) Islamic Corporate Governance had a positive and significant impact on Islamic bank performance, 2) Bank reputation had a positive and significant impact on Islamic bank performance, and 3) Islamic Corporate Governance and bank reputation simultaneously had a positive and significant impact on Islamic bank performance.

Keywords: Islamic Corporate Governance, Bank Reputation, Bank Performance, Islamic Bank.

1 Introduction

Islamic banks are financial institutions that are more or less similar to conventional banks, but they apply sharia (Islamic) principles such as justice, balance, and beneficence. In conventional banks, pricing is always based on interest. In contrast, Islamic banks depend on the Islamic concept of cooperation, which involves profit-sharing schemes, covering both profit and loss [1]. Islamic banks show how Muslims are trying to base every aspect of their economic lives on the Quran and *Sunnah* [2]. As part of the national banking system, Islamic banking has become a driving force for the national economy. Its expansion in Indonesia began with the founding of Bank Muamalat Indonesia in 1992. However, the Infobank Research Bureau (*BirI*) revealed that the performance of Islamic banking has not improved since 2012, and it has even been challenging for them to survive [3]. Therefore, it is necessary to examine the factors affecting the performance of Islamic banking [4].

One of the predictor variables considered capable of improving the performance of Islamic banking is Islamic Corporate Governance (ICG). It is a good corporate governance model that upholds sharia law and safeguards the rights and interests of all stakeholders. Bhatti and Bhatti (2009) [5] identified two specific qualities of ICG in their investigation. First, it is governed by Islamic or Sharia law, which sets rules for every aspect of a person's life and demands that all Muslim deeds adhere to Islamic law and Islamic ethical principles including fairness, the nature of corporate responsibility, and governance norms. The

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construction of a profit-and-loss sharing-based economic structure, zakat institutions, the prohibition of usury, and other Islamic financial principles, as well as the impact of Sharia law on business practices and policies, must all be examined by the public. Considering that its ultimate objective is the *Maqasid Shari'ah* (the objectives of Islamic law), which speaks of safeguarding people's wealth, lineage, intelligence, life, and religion [6], These facts imply that Islamic corporate governance is different from other concepts.

Another predictive variable that can improve Islamic banks' performance is bank repute. The customer's view of the quality associated with a firm is its reputation. In this regard, the prestige which positively affects the customer's reaction to the resulting product or service is often correlated with the overall reputation [7]. Furthermore, a company's reputation is measured by its capabilities and advantages over its competitors. An increasing reputation can attract investors to invest [8] since it is perceived as a crucial asset that portrays a competitive advantage and improves performance [9].

Previous research on the relationship between Islamic Corporate Governance and bank performance and reputation [10] indicated that ICG had a favorable and significant impact on bank performance. Implementing ICG could reduce instances of fraud, speculation, and insider trading, which have a negative impact on the performance of Islamic banking. According to a recent study [11], the size of the board of commissioners, the proportion of independent commissioners, the amount of commissioner experience, and the size of the audit committee all encouraged the banking sector's management to enhance their adherence to corporate governance. These findings suggested that board monitoring reduced information asymmetry effectively. This investigation also showed how open innovation that complied with current laws may improve legal compliance. The aforementioned findings were consistent with those of a different study [12], which discovered that banks' attempts to improve their reputation by engaging the CSR could boost their performance. However, on the other hand, these findings contradicted another study [13] claiming that ICG had no impact on bank performance.

The hypotheses proposed in the present study were 1) Islamic Corporate Governance influences the performance of Islamic banks; 2) Bank reputation influences the performance of Islamic banks; and 3) both Islamic Corporate Governance and bank reputation influence the performance of Islamic banks. In accordance with these hypotheses, the purpose of this study was to determine 1) The effect of Islamic Corporate Governance on the performance of Islamic banks, 2) The effect of bank reputation on the performance of Islamic banks, and 3) The combined effect of Islamic Corporate Governance and bank reputation on the performance of Islamic banks.

2 Methods

This study employed a quantitative design in the form of causal research since researchers intended to investigate one or more factors that might cause problems by analyzing the correlation between research variables [14]. In this study, the population consisted of 11 Islamic banks registered in Bank Indonesia. Based on the purposive sampling technique, the selected samples were 8 Islamic banks that met the predetermined criteria. In addition, the data was gathered from the 2015-2019 annual report. (1) Islamic banks registered with the Financial Services Authority (OJK) during the 2015-2019 period, (2) Islamic banks that have issued annual reports during the research period, namely 2015-2019, and (3) Islamic banks with complete data related to research variables were the selection criteria for the research samples. In addition, secondary data were gathered from the 2015-2019 annual reports of

Islamic banks, which were published on the official websites of each bank. The annual reports in the context of this research included financial statements, management reports, ICG implementation reports, and bank reputation.

This study incorporated three variables: ICG and bank reputation as independent variables and bank performance as the dependent variable [14]. Islamic Corporate Governance is centered on Islamic principles, wherein all company and operational activities must adhere to sharia or Islamic norms and values [5]. A bank's reputation is a collection of images in the public or stakeholders' minds. Similarly, bank performance is the result of work accomplished by a person or group within an institution in accordance with their particular responsibilities and authorities in accomplishing legally and ethically sound objectives. (Rivai & Fawzi, 2004). In the present investigation, Islamic Corporate Governance was measured by indicators of the board of commissioners, the composition of the board of commissioners, and the audit committee. Bank reputation was assessed by indicators of good image, competitor's reputation, widespread recognition, and ease of remembering.

Meanwhile, banking performance was estimated by Return on Assets (ROA). Subsequently, the research data were analyzed using content analysis, descriptive statistics, and Partial Least Square (PLS). The PLS was carried out by involving the outer and inner models. The outer model incorporated three criteria: Convergent Validity, Discriminant Validity, and Composite Reliability. On the other hand, the inner model considered the relationship between the research models' construct, significance value, and R-squared. Hypothesis testing focused on the output value of path coefficients. The significance of the influence between variables was obtained by examining the t-statistics and p-values.

3 Results and Discussion

3.1 Research Results

3.1.1 Descriptive Statistics

The results of descriptive statistics showed that the mean score of ICG was 0.600 (60.0%), with a maximum value of 0.700 (70.0%) and a minimum of 0.400 (40.0%). It was determined that the implementation of ICG in Islamic banks in Indonesia was good, as the resulting score was above the median value of 0.600 (60%) and precisely between the minimum and maximum values of 40% and 70%. The mean score of bank reputation was 0.700 (70.0%), with a maximum value of 0.800 (80.0%) and a minimum of 0.200 (20.0%). It suggested that the reputation of Islamic banks in Indonesia was not good, considering the acquired mean score of 0.700 (70.0%). The mean score of ROE was 0.650 (65.0%), with a minimum value of 0.200 (20.0%) and a maximum of 0.750 (75.0%), implying the high ability possessed by Islamic banks in Indonesia to generate profits based on their capital.

3.1.2 Outer Model Testing or Measurement

Convergent Validity, Discriminant Validity, and Composite Reliability were utilized for the outer model measurement. In the Convergent Validity (factor loading for each construct), the individual reflective measure was categorized as high if it had a correlation of more than 0.50 with the measured construct. The figure above illustrates that there were indicators that were not significant and had a factor loading of < 0.50. Consequently, researchers must conduct another test by eliminating insignificant indicators. Afterward, it can be seen that ICG, Bank Reputation, and ROA obtained a factor loading above 0.50.

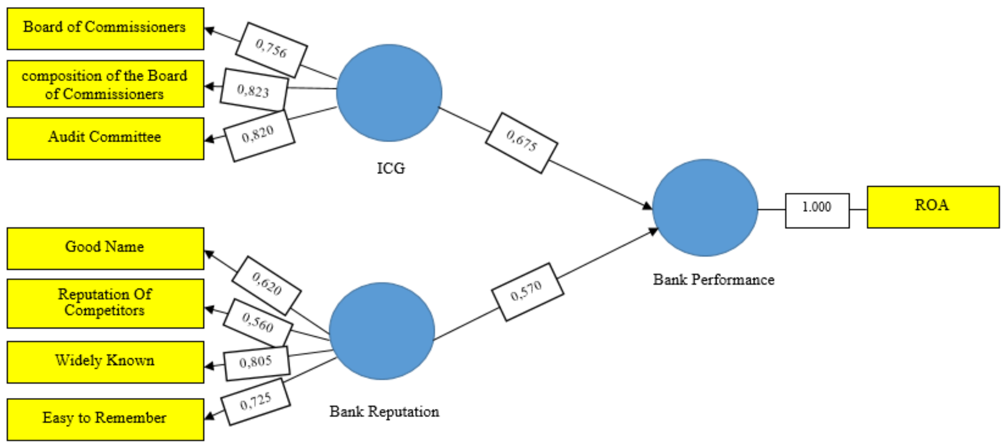

Fig.1. Structural Modeling of Partial Least Square
(Source: Research data processed in *PLS*, 2022)

The following discriminant validity values indicated that all factor loading of each latent variable's indicators were more significant than the others. The results of the discriminant validity testing were as follows:

Table 1. Discriminant Validity Values (Cross Loading)

	ICG	Bank Reputation	Bank Performance
ICG	1.000	0.822	0.288
Bank Reputation	0.822	1.000	0.088
Bank Performance	0.288	0.088	1.000

Source: Research data processed in *PLS*, 2022

The table of Composite Reliability displays that the exogenous and endogenous constructs had good reliability because the value obtained was above 0.70, precisely 1.000, and the AVE was above 0.50, indicating that the constructs had good reliability and validity. The results of the Composite Reliability testing were as follows:

Table 2. Composite Reliability and AVE

	Composite Reliability	AVE
ICG	1.000	1.000
Bank Reputation	1.000	1.000
Bank Performance	1.000	1.000

Source: Research data processed in *PLS*, 2022

3.1.3 Inner Model Testing or Measurement

The testing of the inner model or structural model assessed the relationship between the research model's construct, significant value, and R-squared. The test results showed an R-squared of 0.151, indicating that the ICG and Bank Reputation could only explain 15.1% of Bank Performance. The low R-squared value suggested that the ICG and Bank Reputation variables could not explain the Bank Performance variable. Similarly, the remaining 84.9% could be explained by variables beyond the scope of this study, showing that the applied structural equation was inadequate.

3.1.4 Hypothesis Testing

Hypothesis testing was carried out by examining the values in the output of path coefficients. The test results of the first hypothesis attained an ICG variable coefficient of 0.664. In addition, the impact of the construct of Islamic Corporate Governance (ICG) on bank performance displayed the t-score > t-table (1.99962), namely 3.232 > 1.99962, and a p-value of < 0.05, precisely 0.002 < 0.05. Therefore, researchers interpreted that Islamic Corporate Governance (ICG) had a positive and significant impact on bank performance, suggesting that the first hypothesis was accepted.

The second hypothesis testing obtained a bank reputation variable coefficient of 0.560. Additionally, the impact of the construct of bank reputation on bank performance showed the t-score > t-table (1.99962), namely 4.200 > 1.99962, and a p-value of < 0.02, specifically 0.040 < 0.05. These results depicted that bank reputation had a positive and significant impact on bank performance, implying that the second hypothesis was accepted. The third hypothesis testing confirmed that the coefficient of the ICG and bank reputation variables was 0.720. Furthermore, the impact of the constructs of ICG and bank reputation on bank performance gained a t-score > t-table (1.99962), precisely 3.300 > 1.99962, and a p-value of < 0.02, namely 0.040 < 0.05. These results confirmed that ICG and bank reputation had a positive and significant impact on bank performance, corroborating that the third hypothesis was accepted. The output of the path coefficients was as follows:

Table 3. Path Coefficients (Mean, STDEV, t-values)

	Original Sample (O)	Mean (M)	Standard Deviation (STDEV)	T-statistics (|O/STDEV|)	P-values
ICG > Bank Performance	0.664	0.669	0.205	3.232	0.002
Bank Reputation > Bank Performance	0.560	0.750	0.302	4.200	0.002
ICG and Bank Reputation > Bank Performance	0.720	0.770	0.325	3.300	0.002

Source: Research data processed in *PLS*, 2022

3.2 Discussion

3.2.2 The Impact of Islamic Corporate Governance on Islamic Bank Performance

Islamic Corporate Governance (ICG) was hypothesized to have a positive effect on the performance of Islamic banks. In this regard, the test results presented earlier proved that ICG had a positive and significant impact on bank performance. It was consistent with the first hypothesis proposing that the implementation of ICG could affect the performance of Islamic banks. Thus, the initial hypothesis was confirmed. In conclusion, if the ICG were high, Islamic bank performance would also be high. In contrast, if the ICG were low, Islamic bank performance would undoubtedly be low.

The present study findings supported the stakeholder theory, in which the application of Islamic Corporate Governance is considered capable of realizing stakeholder expectations. Hence, fulfilling all stakeholders' expectations is believed to result in extraordinary company performance [16]. Furthermore, the research results also corroborated the agency theory; to eliminate self-interested agents, Good Corporate Governance must be implemented to guarantee the rights and relationships among all stakeholders, prevent agency conflicts, reduce the risks of management actions that tend to benefit themselves, and ultimately improve company performance [17].

This investigation's findings corresponded with a previous study's [18] conclusion that the application of ICG, including components of corporate governance and compliance to Sharia principles, had a positive effect on Islamic banks' financial performance. Khan and Zahid (2020) [10] also confirmed that ICG had a positive and significant impact on bank performance. Its implementation could minimize fraud, speculation, and insider trading, which subsequently affected the performance of Islamic banks. In addition, another research [11] proved that the size of the board of commissioners, the proportion of independent commissioners, the experience of commissioners, and the size of the audit committee could encourage banking industry management to enhance their corporate governance compliance. It was determined that board monitoring effectively reduced information asymmetry.

Furthermore, it demonstrated that open innovation that adhered to the rules may enhance legal compliance. Nonetheless, the aforementioned findings contrasted the study [13] that concluded ICG had no impact on bank performance.

3.2.2 The Impact of Bank Reputation on Islamic Bank Performance

The second hypothesis proposed in the present research was that bank reputation had a positive impact on Islamic bank performance. The results of hypothesis testing confirmed that bank reputation had a positive and significant impact on bank performance, indicating that the second hypothesis was accepted. Furthermore, it also implied that if bank reputation were good, Islamic bank performance would also be good. Meanwhile, if bank reputation were bad, Islamic bank performance would also be bad.

A company's reputation is a form of appreciation received for competitiveness and fulfillment of all forms of community needs. It can also be described as a good image from the public's beliefs. Several things can build a company's good reputation, such as product quality, service quality, superior members, creation of new things (innovation), and social responsibilities, such as supporting underprivileged communities. The present study findings were in line with the study's results [12] which concluded that banks' efforts in building a reputation through CSR could benefit their performance. The good and sustainable reputation possessed by the company, especially the one established by continuously providing CSR to stakeholders, had a positive impact on the company's performance.

These research findings could further serve as a guide for policymakers in Islamic banking, in which bank performance would not be realized through the increasing CSR activities, although their commitment to CSR could help improve their reputation. While it is crucial for Islamic banks to consider their relationships with stakeholders, they must also maintain their dignity in social interactions [19]. CSR must be implemented despite the fact that it has no effect on the performance of Islamic institutions. Islamic banks need to understand that such activities are not solely for profit but as a form of social responsibility to mitigate social and environmental problems. Moreover, they can also be indirectly promoted through those CSR activities, suggesting that there are still benefits they can get [20].

3.2.3 The Impact of Islamic Corporate Governance and Bank Reputation on Islamic Bank Performance

This study's third hypothesis stated that ICG and bank reputation had a beneficial effect on Islamic bank performance. The findings of the hypothesis testing indicated that both ICG and bank reputation had a favorable and significant impact on bank performance. It signified that the third hypothesis was accepted. In this regard, researchers interpreted that if ICG and bank reputation were good, Islamic bank performance would also be good. Conversely, if ICG and bank reputation were bad, Islamic bank performance would undoubtedly be bad.

Legitimacy theory defines the relationship between companies and society, in which a company carries out its activities and uses existing economic resources [21]. It describes the relationship that occurs as a social contract [21]. Legitimacy theory, associated with social disclosure, suggests that companies must disclose environmental activities required by the communities in which they operate; thereby, a failure to disclose them might be detrimental to the company. In addition, this theory explains that companies conduct the disclosure of social responsibility in an attempt to gain legitimacy [22].

ICG is an advancement of the traditional notion of Good Corporate Governance. According to the aims of Islamic law (*maqashid al shari'ah*) [23], Its major purpose is to establish a system of checks and balances to prevent the exploitation of corporate resources, to promote firm growth, and to uphold fairness, honesty, and the preservation of human needs. The realization of these goals will eventually affect bank performance. Besides, the bank's reputation itself is an embodiment of customer trust [24]. In this context, several items can affect the reputation of Islamic banks, namely bank achievements, bank management, bank products and services, compliance with laws, competence, and others [25].

4 Conclusion and Recommendations

Researchers drew the following conclusions regarding the impact of Islamic Corporate Governance and bank reputation on Islamic bank performance based on data analysis and discussions: 1) Islamic Corporate Governance had an impact on Islamic bank performance, 2) bank reputation had an impact on Islamic bank performance, and 3) both Islamic Corporate Governance and bank reputation had an impact on Islamic bank performance. These points indicated that ICG and bank reputation must be improved to increase bank performance.

Based on the findings and conclusion, researchers provided the following recommendations: 1) For companies, Islamic banks should improve their corporate governance by strengthening internal sharia compliance units and internal sharia verification units because most of them have not worked on those efforts, and 2) For future researchers, subsequent investigations should engage other independent variables considered influential to the Islamic bank performance, such as funding risk, strength ratio, capital structure, intellectual capital, and others.

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