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Good Corporate Governance And Financial Performance Of Shariah Banks In Indonesia :Literature Review

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Abstract

This essay review examines the relationship between corporate governance and financial performance in Islamic banking. It begins by defining corporate governance and its importance, followed by an explanation of the significance of financial performance in Islamic banking. The review then provides an overview of corporate governance principles and their application in Islamic banking, including a comparison of governance practices in Islamic banking and conventional banking. The essay also includes case studies of a prominent Islamic bank, examining its corporate governance practices and financial performance. The review discusses the factors that affect financial performance in Islamic banking and explores how corporate governance practices can affect financial performance in Islamic banking. It also explores how financial performance can impact corporate governance practices in Islamic banking. Finally, the review summarizes the key findings and implications for future research, as well as implications for practice in Islamic banking. The essay highlights the need for effective governance practices to enhance financial performance in Islamic banking and suggests future research directions, including longitudinal studies, comparative studies, and in-depth case studies. Overall, the essay emphasizes the importance of good governance practices in promoting financial stability and sustainability in Islamic banking.

***Keywords:* Corporate Governance, Governance Structure, Shariah Principles, Financial Performance, Shariah Banks**

1. INTRODUCTION

Nowadays, corporate governance is importance. Corporate governance refers to the system of rules, practices, and processes that a company uses to direct and control its operations. It involves balancing the interests of a company's many stakeholders, such as shareholders, management, customers, suppliers, financiers, government, and the community. The purpose of corporate governance is to provide a framework for attaining a company's objectives, while at the same time, meeting the expectations of stakeholders and fulfilling legal and regulatory obligations (Azid, et. al, 2021).

In the context of Islamic banking, corporate governance is particularly important because Islamic banking operates on the principles of Shariah law, which requires adherence to ethical and moral values, transparency, accountability, and fairness. Corporate governance practices help ensure that Islamic banks uphold these principles and operate in a responsible and sustainable manner (Alam, 2013; Azid et. al, 2021).

Effective corporate governance practices in Islamic banking can contribute to improving customer trust, attracting investors, and enhancing the bank's reputation. It can also help to mitigate risks, prevent fraud, and increase efficiency and productivity. Brief Explanation of the Significance of Financial Performance in Islamic Banking: Financial performance is a critical factor in the success of any banking institution, including Islamic banks. Financial performance is often measured by a range of indicators such as profitability, liquidity, solvency, and asset quality (Aris, 2019; Bhagat, 2019).

Islamic banking is unique in that it operates under the principles of Shariah law, which prohibits the use of interest (riba) and requires adherence to ethical and moral values. This means that Islamic banks must offer products and services that comply with Shariah principles while at the same time generating profits for their shareholders (Birton et. al, 2015).

Financial performance is important in Islamic banking because it reflects the bank's ability to generate profits, manage risks, and meet the needs of its customers. Good financial performance can attract new customers, investors, and shareholders, while poor financial performance can lead to loss of trust and reputation (Brogi & Lagasio, 2019). Moreover, financial performance in Islamic banking is closely linked to the bank's adherence to Shariah principles. A bank that operates in accordance with Shariah principles is likely to attract customers who prefer ethical and moral values over purely financial gain. Therefore, a bank's financial performance is not only a measure of its profitability but also an indication of its adherence to Shariah principles and values (Birton et. al, 2015; Farag, 2015; Federo et. al, 2020).

The purpose of the essay reviewing corporate governance and financial performance of Islamic banking is to provide an in-depth analysis of the practices and performance of

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Islamic banks. The essay aims to explore the importance of corporate governance in Islamic banking, how it is applied, and how it compares to conventional banking. Additionally, the essay seeks to explain the significance of financial performance in Islamic banking, including the unique challenges and factors that affect it.

The essay aims to evaluate the relationship between corporate governance and financial performance in Islamic banking, examining how good governance practices can contribute to better financial performance, and how financial performance can impact corporate governance practices. The overall goal of the essay is to provide a comprehensive understanding of the practices and performance of Islamic banks, and to assess the effectiveness of their corporate governance and financial management. By doing so, the essay aims to identify areas for improvement and make recommendations for enhancing the sustainability and success of Islamic banks.

2. LITERATURE REVIEW

2.1 Overview Of Corporate Governance Principles

Corporate governance principles refer to the set of guidelines and best practices that a company should follow to ensure effective management and control of its operations. Corporate governance principles are designed to promote transparency, accountability, and ethical conduct among companies, and to protect the interests of various stakeholders, including shareholders, employees, customers, and the wider community (Hasan, 2008; Kusi et. al 2018).

According to Kusi et. al (2018) some of the key principles of corporate governance include:

1. Board of Directors: The board of directors is responsible for overseeing the company's strategy, performance, and risk management. It should be composed of independent and competent directors who act in the best interests of the company and its stakeholders.
2. Transparency and Disclosure: Companies should provide clear and accurate information about their financial performance, corporate governance practices, and risk management policies. This information should be easily accessible to all stakeholders.
3. Shareholder Rights: Shareholders should have the right to vote on key decisions, including the appointment of directors and the approval of major transactions. They should also have access to information and be treated fairly and equally.
4. Ethical Conduct: Companies should operate with integrity, and their management should promote ethical behaviour among employees. This includes adhering to legal and

regulatory requirements, avoiding conflicts of interest, and respecting the rights of all stakeholders.

5. Risk Management: Companies should have effective systems in place to identify and manage risks, including financial, operational, and reputational risks.

These principles provide a framework for good corporate governance, and they are particularly relevant to Islamic banking, which operates on the principles of Shariah law. Islamic banking must adhere to ethical and moral values, transparency, accountability, and fairness, making corporate governance even more important. By following these principles, Islamic banks can ensure that they operate in a responsible and sustainable manner, and that they meet the expectations of their stakeholders.

2.2 Overview Of Financial Performance Indicators

Financial performance indicators are metrics used to evaluate the financial health and performance of a company. Here are some of the key financial performance indicators (Esteban, 2017) :

1. Revenue: Revenue is the total income that a company generates from its operations. It is an important indicator of a company's ability to generate income.
2. Net Income: Net income is the profit that a company earns after deducting all expenses from its revenue. It is a key indicator of a company's profitability.
3. Gross Profit Margin: Gross profit margin is the percentage of revenue that remains after deducting the cost of goods sold. It is a measure of a company's efficiency in managing its costs.
4. Return on Equity (ROE): ROE is a measure of a company's profitability relative to the amount of equity invested by shareholders. It indicates how efficiently a company is using shareholder funds to generate profits.
5. Return on Assets (ROA): ROA is a measure of a company's profitability relative to the total assets it holds. It indicates how efficiently a company is using its assets to generate profits.
6. Debt-to-Equity Ratio: Debt-to-equity ratio is a measure of a company's leverage. It compares the amount of debt a company has to the amount of equity held by shareholders. A high debt-to-equity ratio indicates that a company is highly leveraged, which can be a risk factor.

7. Current Ratio: Current ratio is a measure of a company's liquidity. It compares the current assets of a company to its current liabilities. A high current ratio indicates that a company has enough liquid assets to cover its short-term liabilities.
8. Earnings Per Share (EPS): EPS is the amount of profit that a company earns per share of its common stock. It is an important measure of a company's profitability that is used by investors to evaluate its performance.
9. Price-to-Earnings Ratio (P/E Ratio): P/E ratio is the market value of a company's stock divided by its earnings per share. It is an indicator of how much investors are willing to pay for each dollar of earnings.

In summary, financial performance indicators are used to evaluate the financial health and performance of a company. These indicators provide important information about a company's profitability, efficiency, liquidity, leverage, and valuation.

Financial performance of Islamic banks compared to conventional banks

Islamic banks and conventional banks differ in their business models and the way they operate. Islamic banks operate in compliance with Shariah principles, which prohibits interest-based transactions (riba), gambling (maysir), and unethical business practices. In contrast, conventional banks operate under a profit-maximizing model and offer interest-based products (Farag, 2015).

The financial performance of Islamic banks has been compared to conventional banks in several studies. Here are some of the key findings:

Profitability: Islamic banks have shown higher profitability compared to conventional banks in some studies. This is because Islamic banks use profit-and-loss sharing (PLS) contracts that provide incentives for customers to engage in profitable activities, and they avoid interest-based transactions, which can be risky (Buyl et. al, 2019).

Asset quality: Islamic banks have been found to have better asset quality compared to conventional banks. This is because Islamic banks tend to have lower non-performing loan ratios, as they tend to finance real assets rather than speculative activities (Esteban et. al, 2017).

Liquidity: Islamic banks have shown lower liquidity levels compared to conventional banks. This is because Islamic banks rely heavily on PLS contracts, which can be illiquid, and they cannot use interest rates as a tool to manage liquidity (Brogi & Lagasio, 2019).

Capital adequacy: Islamic banks have been found to have higher capital adequacy ratios compared to conventional banks. This is because Islamic banks have to set aside reserves for potential losses and risks, which leads to higher capital requirements (Gangi et. al, 2019).

Overall, the financial performance of Islamic banks compared to conventional banks is mixed, with some studies suggesting that Islamic banks outperform conventional banks in certain areas, such as profitability and asset quality, while underperforming in others, such as liquidity. It is important to note that the performance of individual banks can vary depending on their specific business models, market conditions, and management practices.

3. RESEARCH METHOD

The literature review method is a systematic, explicit, and reproducible research method for identifying, evaluating, and synthesizing published works on a particular topic or research question (Yin, 2019). This method is used by researchers to review and analyses the literature relevant to the topic of this research. In a literature review, once the relevant literature has been identified, the next step is to evaluate and synthesize the literature. Literature evaluation is done by reading and evaluating the quality of the selected literature. While synthesizing the literature is done by integrating the findings from the evaluated literature. The following are the stages carried out by researchers to evaluate and synthesize the literature in the literature review:

1. Evaluate the literature by reading and evaluating the quality of the literature that has been selected. by considering factors such as relevance, credibility, and quality of research methodology.
2. Create a table or diagram to collate the findings from the evaluated literature. This can help in synthesizing the findings.
3. Identify similarities and differences between the findings from the evaluated literature. This may help in synthesizing the findings.
4. Summarize the synthesized findings. This summary can be used as a basis for writing the article.

Create a more in-depth synthesis of the synthesized findings. This synthesis can be used to show the relationship between the synthesized findings.

4. RESULT

This section presents the results of a literature study, conducted on relevant sources, on the implementation of good governance in Islamic banks. in this section researchers present examples of successful shariah banks that implement good governance. how the relationship of good governance to the performance of Islamic banks.

4.1 Comparison of corporate governance practices in Islamic banking and conventional banking

Islamic banking and conventional banking have some similarities and differences in their corporate governance practices. Here are some of the main differences:

Shariah Supervisory Board: One of the key differences between Islamic banking and conventional banking is the presence of a Shariah supervisory board. In Islamic banking, this board is responsible for ensuring that the bank's products and services comply with Shariah principles. There is no equivalent in conventional banking (Mansoor et. al, 2020; Kusi et. al, 2018).

Ethics and Values: Islamic banking is based on the principles of Shariah law, which require adherence to ethical and moral values. Therefore, ethical conduct is fundamental to Islamic banking, and the bank's management should promote ethical behavior among employees. Conventional banking is generally guided by legal and regulatory requirements (Birton et. al, 2015).

Ownership Structure: Islamic banks often have a different ownership structure than conventional banks. In Islamic banking, shareholders are considered partners, and they share in the bank's profits and losses. In conventional banking, shareholders are simply investors who receive dividends (Alam, 2013).

Interest-based Transactions: Islamic banking prohibits interest-based transactions, which means that Islamic banks must use alternative financing methods, such as profit-sharing arrangements or leasing. Conventional banks, on the other hand, rely heavily on interest-based transactions (Aris, 2019).

Risk Management: Islamic banking has a unique approach to risk management. The Shariah supervisory board reviews the bank's risk management policies to ensure that they are in compliance with Shariah principles. Conventional banks also have risk management policies, but they do not have the same level of scrutiny from a Shariah board (Aris, 2019).

Governance Structure: Islamic banks often have a more decentralized governance structure than conventional banks. This is because decisions related to Shariah compliance are often made by the Shariah supervisory board rather than the board of directors (Aris, 2019; Esteban et. al, 2017).

In summary, while there are some similarities in corporate governance practices between Islamic banking and conventional banking, the differences are significant. Islamic banking has a unique governance structure that is based on ethical and moral values, and it is more heavily scrutinized by a Shariah supervisory board. Conventional banking, on the other hand, is generally guided by legal and regulatory requirements.

4.2 Corporate governance in a prominent Islamic bank

One example of corporate governance in a prominent Islamic bank is the Abu Dhabi Islamic Bank (ADIB). ADIB is a leading Islamic bank in the UAE, and it has won several awards for its corporate governance practices. Here are some of the key aspects of corporate governance in ADIB (Azid, 2021):

Board of Directors: ADIB has a board of directors that is responsible for overseeing the bank's operations and ensuring that it operates in compliance with Shariah principles. The board is composed of experienced professionals from different fields, including banking, finance, and law.

Shariah Supervisory Board: ADIB has a Shariah supervisory board that is responsible for ensuring that the bank's products and services comply with Shariah principles. The board is composed of prominent Islamic scholars with expertise in Islamic finance.

Transparency and Disclosure: ADIB is committed to transparency and disclosure. The bank discloses information about its financial performance and operations regularly, and it provides detailed information about its Shariah compliance.

Shareholder Rights: ADIB is committed to protecting shareholder rights. Shareholders have the right to vote on key decisions, including the appointment of directors and the approval of major transactions. They also have access to information and are treated fairly and equally.

Ethical Conduct: ADIB has a code of ethics that promotes ethical behavior among its employees. The bank's management is committed to upholding high ethical standards, and it encourages its employees to do the same.

Risk Management: ADIB has a robust risk management framework that is designed to identify and manage risks effectively. The bank's risk management policies are reviewed regularly by the Shariah supervisory board to ensure that they are in compliance with Shariah principles.

In summary, ADIB has a strong corporate governance framework that is based on the principles of Shariah law. The bank is committed to transparency, ethical conduct, and risk management, and it has a strong focus on protecting shareholder rights. ADIB's commitment to corporate governance has helped it to become a leading Islamic bank in the UAE and to win several awards for its corporate governance practices.

4.3 Financial performance of Islamic banks compared to conventional banks

Islamic banks and conventional banks differ in their business models and the way they operate. Islamic banks operate in compliance with Shariah principles, which prohibits interest-based transactions (riba), gambling (maysir), and unethical business practices. In contrast, conventional banks operate under a profit-maximizing model and offer interest-based products Azid, 2021).

The financial performance of Islamic banks has been compared to conventional banks in several studies. Here are some of the key findings:

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Asset quality: Islamic banks have been found to have better asset quality compared to conventional banks. This is because Islamic banks tend to have lower non-performing loan ratios, as they tend to finance real assets rather than speculative activities.

Liquidity: Islamic banks have shown lower liquidity levels compared to conventional banks. This is because Islamic banks rely heavily on PLS contracts, which can be illiquid, and they cannot use interest rates as a tool to manage liquidity.

Capital adequacy: Islamic banks have been found to have higher capital adequacy ratios compared to conventional banks. This is because Islamic banks have to set aside reserves for potential losses and risks, which leads to higher capital requirements.

Overall, the financial performance of Islamic banks compared to conventional banks is mixed, with some studies suggesting that Islamic banks outperform conventional banks in certain areas, such as profitability and asset quality, while underperforming in others, such as liquidity. It is important to note that the performance of individual banks can vary depending on their specific business models, market conditions, and management practices.

4.4 Factors affecting financial performance in Islamic banking

According to Aris & Arismawati (2019) several factors can affect the financial performance of Islamic banks. Here are some of the key factors:

1. Regulatory environment: The regulatory environment can have a significant impact on the financial performance of Islamic banks. A supportive regulatory environment that provides a level playing field for Islamic banks can help them compete effectively with conventional banks.
2. Business model: The business model of Islamic banks, which is based on Shariah principles, can affect their financial performance. Islamic banks use profit-and-loss sharing (PLS) contracts that provide incentives for customers to engage in profitable activities, but these contracts can also be more complex and require greater due diligence than conventional loans.
3. Market demand: The demand for Islamic financial products and services can affect the financial performance of Islamic banks. A growing demand for Islamic financial products can help Islamic banks increase their market share and profitability.
4. Asset quality: The quality of assets held by Islamic banks can affect their financial performance. Islamic banks tend to have lower non-performing loan ratios than conventional banks, as they finance real assets rather than speculative activities.
5. Risk management: Effective risk management practices can help Islamic banks manage risks and improve their financial performance. Islamic banks have to manage different types of risks, such as credit risk, market risk, and operational risk, and they need to develop appropriate risk management frameworks.
6. Corporate governance: Good corporate governance practices can help Islamic banks improve their financial performance. Effective governance can ensure that Islamic banks have proper risk management, compliance, and internal control systems in place.
7. Human capital: The quality and expertise of staff can affect the financial performance of Islamic banks. Islamic banks need staff who are knowledgeable about Islamic finance and can provide high-quality services to customers.

Overall, the financial performance of Islamic banks is affected by a variety of factors, including regulatory environment, business model, market demand, asset quality, risk management, corporate governance, and human capital. Effective management of these factors can help Islamic banks achieve their financial and strategic goals.

5. DISCUSSION

5.1. Relationship between corporate governance and financial performance

Corporate governance and financial performance are closely interrelated. Good corporate governance practices can positively impact financial performance, while poor corporate governance practices can have a negative impact.

Effective corporate governance can help companies achieve their strategic objectives, enhance shareholder value, and improve financial performance. Good corporate governance practices can provide transparency and accountability, which can help to attract investment and reduce risks. Effective risk management, compliance, and internal control systems can also improve financial performance by reducing losses and improving efficiency (Azid, 2021).

On the other hand, poor corporate governance practices can lead to financial losses, reputational damage, and legal liabilities. Lack of transparency, conflicts of interest, and inadequate risk management can undermine investor confidence and erode shareholder value. Poor corporate governance can also lead to regulatory penalties and fines, which can have a negative impact on financial performance (Brogi, 2019).

Studies have shown that companies with good corporate governance practices tend to perform better financially than companies with poor governance practices. For example, a study by the Organization for Economic Cooperation and Development (OECD) found that companies with good governance practices had higher market valuations, lower cost of capital, and higher return on equity than companies with poor governance practices (Buyl et. al, 2019).

Overall, the relationship between corporate governance and financial performance is a critical one. Effective corporate governance practices can help companies achieve their strategic goals, enhance shareholder value, and improve financial performance, while poor corporate governance practices can have a negative impact on financial performance and create risks for companies.

5.2. Corporate Governance Affects Financial Performance In Islamic Banking

Corporate governance plays a critical role in the financial performance of Islamic banks. Effective corporate governance practices can positively impact financial performance, while poor governance practices can have a negative impact.

Transparency and accountability: Islamic banks that have strong governance practices tend to be more transparent and accountable to their stakeholders. This can help to enhance investor confidence and attract more investment, which can improve financial performance (Farag, 2015).

Risk management: Islamic banks that have effective risk management systems in place can minimize risks and reduce the likelihood of losses. This can lead to improved financial performance and increased profitability (Federo, 2020).

Sharia compliance: Islamic banks that adhere to sharia principles and have effective sharia supervisory boards can improve customer confidence and loyalty. This can lead to increased business and improved financial performance (Gangi, 2019).

Board composition: Islamic banks that have diverse and competent boards can make better decisions, which can lead to improved financial performance. A diverse board can also bring different perspectives and expertise to the decision-making process (Buyl et. al, 2019).

Internal control systems: Islamic banks that have effective internal control systems can reduce the likelihood of fraud and errors, which can improve financial performance and reduce losses (Federo, 2020).

Overall, effective corporate governance practices can help Islamic banks to achieve their strategic objectives, enhance shareholder value, and improve financial performance. Islamic banks that have strong governance practices tend to be more transparent, accountable, and effective in managing risks, which can lead to improved profitability and financial performance.

5.3. Financial Performance Affects Corporate Governance In Islamic Banking

Financial performance can also affect corporate governance in Islamic banking. When Islamic banks perform well financially, it can enhance their governance practices, while poor financial performance can lead to weaknesses in governance.

Attracting investment: Good financial performance can help Islamic banks to attract investment, which can enhance their governance practices. Investors tend to look for banks with strong financial performance, which can help to improve transparency, accountability, and risk management (Gangi, 2015).

Resource allocation: Islamic banks that perform well financially tend to have more resources to allocate towards governance practices, such as investing in training programs for board members, implementing effective internal control systems, and hiring external auditors to ensure compliance with sharia principles (Kusi et. al, 2018).

Reputation: Good financial performance can enhance the reputation of Islamic banks, which can lead to improved governance practices. Banks with a good reputation tend to be more transparent, accountable, and committed to sharia compliance, which can enhance their governance practices (Mansoor et. al, 2020).

Regulatory requirements: Islamic banks that perform well financially tend to be subject to fewer regulatory restrictions and penalties, which can enhance their governance practices. This can lead to improved risk management, compliance, and internal control systems, which can enhance their governance practices (Brogi & Lagasio, 2019).

Shareholder activism: Good financial performance can also lead to increased shareholder activism, which can help to improve governance practices. Shareholders tend to be more active in banks with good financial performance, which can help to ensure accountability and transparency (Birton, 2015).

Overall, financial performance can have a significant impact on governance practices in Islamic banking. Good financial performance can help to enhance governance practices, while poor financial performance can lead to weaknesses in governance.

6. CONCLUSION

The relationship between corporate governance and financial performance in Islamic banking has important implications for practice. The key findings from the literature suggest that good governance practices can enhance financial performance in Islamic banking by improving transparency, accountability, risk management, and compliance with sharia principles. Therefore, Islamic banks should prioritize the implementation of effective governance practices to enhance their financial performance.

Some of the key implications for practice in Islamic banking include: (1) Board composition: Islamic banks should ensure that their board composition is diverse, with members from different backgrounds and expertise. This can bring different perspectives to the decision-making process and enhance the effectiveness of the board. (2) Sharia supervisory board: Islamic banks should establish a dedicated sharia supervisory board to oversee the bank's compliance with sharia principles. The board should ensure that the bank's products and services are sharia-compliant and that its operations are in line with sharia principles. (3) Risk management: Islamic banks should implement an effective risk management system that includes a comprehensive risk assessment, risk monitoring, and risk reporting. The bank should also establish a dedicated risk management committee that oversees the bank's risk management activities. (4) Internal control systems: Islamic banks should implement effective internal control systems that include policies, procedures, and controls to ensure compliance with laws and regulations, prevent fraud and errors, and protect customer information. (5) Transparency and accountability: Islamic banks should have a strong commitment to transparency and accountability. The bank should regularly disclose its financial performance, risk exposure, and governance practices to its stakeholders. Overall, the implications for practice in Islamic banking are to prioritize the implementation of effective governance practices to enhance financial performance. The effective implementation of governance practices can enhance investor confidence, attract more investment, and improve the bank's overall financial performance.

The study of the relationship between corporate governance and financial performance in Islamic banking has some limitations. One of the limitations is that most of the studies on this topic are based on literature review, which makes it difficult to establish a causal relationship between corporate governance and financial performance. Another limitation is that the studies on this topic are mostly limited to specific countries, which makes it difficult to generalize the findings to other countries.

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