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HOW ISLAMIC CORPORATE GOVERNANCE MITIGATES FINANCING RISK IN INDONESIAN ISLAMIC BANKING?

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ABSTRACT – Islamic banking in Indonesia exhibits strong growth but continues to grapple with high financing risk, as evidenced by Non-Performing Financing (NPF) levels. While previous research suggests a link between Sharia Supervisory Boards (DPS), Financing to Deposit Ratios (FDR), and NPF, findings remain inconsistent. This study investigates the mediating role of Islamic Corporate Governance (ICG) in the relationship between DPS, FDR, and NPF within the context of Indonesian Islamic commercial banks. Panel data from 12 Indonesian Islamic commercial banks between 2016 and 2021 were analyzed using panel multiple regression. The Sobel test was employed to assess the mediating effect of ICG. The study reveals a positive relationship between DPS and NPF, while FDR showed no significant effect on NPF. Importantly, ICG had a negative impact on NPF and partially mediated the relationship between DPS and NPF. These findings highlight the critical importance of robust ICG practices in mitigating financing risk within Islamic banking. The study recommends further research into the influence of macroeconomic factors on NPF and exploring the effectiveness of DPS functions in enhancing ICG practices.
Keywords: Islamic Corporate Governance, Sharia Supervisory Board, Financing to Deposit Ratio, Non-Performing Financing, Islamic Banking.

ABSTRAK – Bagaimana Tata Kelola Syariah Memitigasi Risiko Pembiayaan pada Perbankan Syariah di Indonesia? *Perbankan syariah di Indonesia mengalami pertumbuhan yang pesat namun terus menghadapi risiko pembiayaan yang tinggi, seperti yang terlihat dari tingkat pembiayaan bermasalah (NPF). Meskipun penelitian sebelumnya menunjukkan adanya hubungan antara tingkat NPF dengan Dewan Pengawas Syariah (DPS), Rasio Pembiayaan terhadap Simpanan (FDR), dan Tata Kelola Perusahaan Syariah (ICG), namun hasilnya belum konsisten. Penelitian ini mengkaji peran mediasi ICG dalam hubungan antara DPS, FDR, dan NPF dalam konteks bank umum syariah di Indonesia. Penelitian ini menggunakan data panel dari 12 bank umum syariah di Indonesia selama periode 2016-2021. Metode analisis yang digunakan adalah regresi panel berganda dengan uji Sobel untuk menguji efek mediasi. Hasil penelitian menunjukkan bahwa DPS berpengaruh positif terhadap risiko pembiayaan syariah sedangkan FDR tidak berpengaruh terhadap risiko pembiayaan syariah. Kemudian ICG berpengaruh negatif terhadap risiko pembiayaan syariah. Selain itu, hasil uji Sobel menunjukkan bahwa ICG secara parsial memediasi pengaruh DPS dan FDR terhadap risiko pembiayaan syariah. Temuan ini menggarisbawahi pentinya praktik ICG yang baik dalam mengurangi risiko pembiayaan dalam perbankan syariah. Kajian ini merekomendasikan agar penelitian lebih lanjut fokus pada pengaruh faktor makroekonomi terhadap NPF dan menganalisis efektivitas fungsi DPS dalam meningkatkan praktik ICG.*
Kata Kunci*: Tata Kelola Perusahaan Syariah, Dewan Pengawas Syariah, Rasio Pembiayaan terhadap Simpanan, Pembiayaan Bermasalah, Perbankan Syariah.*

INTRODUCTION

In recent years, the Islamic banking sector in Indonesia has experienced significant growth, marked by an expansion in both physical presence and financial assets. The number of Islamic Commercial Bank offices increased from 1,869 in 2016 to 2,035 in 2021, and assets surged by 60%, from IDR 405.3 trillion in 2017 to IDR 646.2 trillion in 2021, reflecting effective liquidity management and increased public trust. Despite these positive developments, the sector faces persistent challenges, particularly in managing Non-Performing Financing (NPF), which remains higher than in conventional banking (OJK, 2022).

The average Non-Performing Financing (NPF) rate in Islamic banking is 3.5%, surpassing the 2.75% rate observed in conventional banking (OJK, 2022). These persistently high levels of NPF pose a significant risk to the health of Islamic banks, necessitating effective risk management strategies. Previous studies have explored the impact of the Financing to Deposit Ratio (FDR) and the role of the Sharia Supervisory Board (DPS) in mitigating these risks, but findings have been inconsistent. While some research suggests that a higher FDR can reduce NPF (Aufa & Dja'akum, 2019; Dewi & Hakim, 2022; Kuswahariani et al., 2020; Munifatussa'idah, 2020; and Nasir et al., 2022), others have found no significant effect (Havidz & Setiawan, 2015; Mukhibad & Khafid, 2018). Similarly, the influence of DPS on financing risk has been debated, with studies showing both positive and negligible impacts (Sutedi, 2011; Darwanto & Chariri, 2019; Mukhibad & Khafid, 2018; and Nugroho, 2020).

Addressing these research inconsistencies, this study introduces Islamic Corporate Governance (ICG) as a novel mediating variable to examine its role in clarifying the relationships between DPS, FDR, and NPF. The study hypothesizes that effective ICG practices can serve as a critical mechanism in controlling risks associated with the financing aspects of Islamic banking. By incorporating ICG, this research fills a significant gap in the literature and provides a more comprehensive understanding of how governance structures can influence financial stability in Islamic banks.

The findings are expected to have significant implications for policymakers and banking practitioners, highlighting the importance of robust governance frameworks in mitigating financing risks. By examining the direct and indirect effects of FDR and DPS on NPF through ICG, the study seeks to provide a more nuanced understanding of how governance mechanisms can influence risk mitigation strategies. This is particularly crucial given the vulnerability of Islamic banking to various risks and the absolute necessity of good governance in ensuring healthy bank performance.

The findings contribute to the literature by introducing Islamic Corporate Governance (ICG) as a mediating variable to explain the inconsistent relationships between the Sharia Supervisory Board (DPS), the Financing to Deposit Ratio (FDR), and Non-Performing Financing (NPF). This study provides empirical evidence on the role of governance in risk management within Islamic banking, offering insights that could inform regulatory frameworks and banking practices to enhance the stability and performance of Islamic financial institutions. By addressing these critical issues, this research aims to advance the understanding of risk management in Islamic banking and contribute to the development of more effective governance strategies in this growing sector.

LITERATURE REVIEW

Agency Theory

Agency theory explains the contractual relationship in which the Principal delegates authority to another party (Agent) to make strategic decisions for the company (Jensen & Meckling, 1976). The Principal assigns responsibilities to the Agent according to the duties, authorities, rights, and responsibilities stipulated in a mutually agreed work contract. Management, acting as the Agent, is professionally responsible for carrying out their duties to ensure optimal operational activities and company profits.

The separation of ownership by the Principal and control by the Agent in a company tends to cause agency problems. The Principal, as the owner of capital, aims to increase the value of the company's shares from the investment results, while the management, delegated by the Principal to manage the company, seeks high compensation. This difference in goals can lead to management making policies that are not aligned with the interests of shareholders. The desire to maximize individual welfare sometimes raises agency problems due to policy-making that does not align with the company's objectives.

Agency theory assumes that individuals are fully rational, have clear preferences, and always seek to fulfill their own desires to achieve wealth (Verbeeten, 2008). It also assumes that there is information asymmetry between management and shareholders, allowing managers to take opportunistic actions for personal gain. Therefore, Principals need to provide a system or mechanism that directs the company to achieve its goals. One such mechanism is corporate governance, which in the context of sharia banking, is known as Islamic Corporate Governance.

Sharia Supervisory Board

One of the key organs responsible for supervision in Islamic Banks, alongside the Board of Commissioners, is the Sharia Supervisory Board (DPS). According to Bank Indonesia Regulation No.11/33/PBI/2009, the Sharia Supervisory Board is tasked with providing advice and recommendations to the board of directors and overseeing bank activities to ensure compliance with Sharia principles.

The presence of the DPS in Islamic banking is expected to facilitate the implementation of good corporate governance, thereby enhancing public trust in Islamic banks and the national banking sector as a whole (Qoyum et al., 2017; Ibrahim & Kamri, 2016). According to Nomran et al. (2018), Safiullah & Shamsuddin (2018), and Shittu et al. (2016), the Sharia Supervisory Board can influence both profitability and risk. Specifically, the Sharia Supervisory Board can impact the profitability and financing risk of Islamic banks.

Non-Performing Financing

Non-Performing Financing (NPF) refers to the amount of credit or financing that is problematic and unlikely to be collected (Fahmi, 2014). According to Financial Services Authority Regulation (POJK) No. 15 of 2017, "non-performing loans (NPL) or non-performing financing (NPF)" are defined as loans or financing that have substandard, doubtful, or loss quality, as stipulated in the provisions of laws and regulations regarding the assessment of asset quality for commercial banks and Islamic commercial banks, as well as Sharia business units.

Law No. 10 of 1998 and the explanation of Article 37 of Law No. 21 of 2008 state that financing by Islamic banks, which is carried out based on Sharia principles, inherently contains risks. Therefore, in its implementation, banks must adhere to financing principles based on sound Sharia practices (Bank Indonesia, 2009). NPF serves as one of the benchmarks for assessing a bank's health, which can be evaluated based on the smoothness and success of financing returns to the public.

Djamil (2012) asserts that sound financing principles aim to minimize potential risks associated with provided financing, thereby allowing banks to mitigate potential losses. Conversely, if a bank disregards these principles, it may face various risks, including non-payment of debt or principal financing obligations, non-payment of margins or profit sharing or fees, escalation of incurred costs, and deterioration of financing soundness.

The emergence of these risks can significantly impact the performance of Islamic banking financing. If not managed properly, the risk of financing distribution will result in an increase in non-performing financing values. An increasing Non-Performing Financing (NPF) ratio serves as a reference and indicator that the bank is unable to manage its financing activities effectively. The higher the NPF ratio, the lower the quality of Islamic bank financing (Lusian et al., 2017; Muarif et al., 2021; Sari et al., 2024; Nisak & Ibrahim, 2014).

Islamic Corporate Governance

The National Committee on Governance Policy defines corporate governance as a process and structure implemented to direct and manage businesses, aiming to achieve business progress and corporate accountability. Ultimately, it strives to create sustainable corporate value and shareholder wealth while considering stakeholder interests (Utama et al., 2022). Various definitions highlight that corporate governance is a system designed and implemented to control companies, fostering transparent, fair, and mutually beneficial relationships among involved parties (Priyono, 2019). Robust and effective corporate governance implementation leads to well-managed business activities, resulting in improved financial and non-financial performance (Brown & Caylor, 2009).

Within Islamic banking, Islamic Corporate Governance (ICG) implementation is comprehensively formulated and regulated by Bank Indonesia Circular Letter No. 12 of 2010. It is primarily based on five principles: transparency, accountability, responsibility, professionalism, and fairness (or equality). Good corporate governance is instrumental in anticipating and mitigating various risks, including financial and reputational risks. This function is crucial for establishing superior and resilient Islamic banks (Priyono, 2019).

Therefore, ICG is indispensable in Islamic banking to ensure the fulfillment of diverse stakeholder interests. Islamic banks operate within large communities where individuals may not be personally acquainted. This aspect can potentially raise concerns among customers and depositors regarding the security of their investments. Notably, poor corporate governance is a contributing factor to elevated financing risk, represented by Non-Performing Financing (NPF), a key indicator for measuring financing risk (Al Arif & Rahmawati, 2018; Ibrahim & Kamri, 2017).

Hypothesis Development

The Influence of the Sharia Supervisory Board on IICG

Hassan et al. (2017) assert that the Sharia Supervisory Board is the backbone of Islamic Banks, aiming to enhance the concepts of justice and equality in society. This concept contributes to improving the financial performance of Islamic Banks. Bank Indonesia regulation No. 11/33/PBI/2009 stipulates that the Sharia Supervisory Board (DPS) plays a key role in implementing Islamic Corporate Governance (ICG), focusing on adherence to sharia principles. The DPS must ensure ICG implementation by overseeing internal and external audit functions and conducting specialized sharia audits. Additionally, the DPS is responsible for monitoring and ensuring that bank operations and products conform to sharia principles as outlined in the Fatwa of the National Sharia Council (DSN) (Rahmat, 2017).

The DPS is an integral part of bank management. The Board of Directors can seek advice from the DPS regarding compliance with sharia principles, which is inextricably linked to the bank's business performance. The DPS is tasked with ensuring that the bank fulfills sharia principles in accordance with customer expectations (Mukhibad & Khafid, 2018). Furthermore, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) expects Islamic banks to have DPS members who are skilled in both finance and Sharia law. Based on this information, the following hypothesis is proposed:

H1: The Sharia Supervisory Board has a negative effect on financing risk.

Effect of FDR on Financing Risk

According to Gurley & Shaw (1956), within the perspective financial intermediation theory, financial intermediaries provide optimal methods to connect units with excess funds (deficit) to units requiring funds (surplus). This connection considers aspects of capital structure as a source of lending or financing to operate optimally. A well-structured capital process must be accompanied by an effective process of fund distribution to the public (Kurniawan et al., 2016). This emphasizes the importance of banking liquidity, as continuous fund collection without optimal distribution may indicate issues that could disrupt banking liquidity.

Bank Indonesia has established the Financing to Deposit Ratio (FDR) as a performance indicator for Islamic banks. PBI No. 9 of 2007 identifies liquidity as a vital aspect in the financing process, proxied by FDR. The FDR ratio measures the amount of funds distributed by Islamic banking relative to the funds collected. It serves as a reference for how well Islamic banking performs its function as a financial intermediary institution (Al Arif & Rahmawati, 2018).

A higher FDR ratio indicates better management of the bank intermediation function. Conversely, a lower ratio suggests suboptimal management of this function. However, it is important to note that a higher ratio may decrease the bank's liquidity due to increased fund allocation to financing (Somantri & Sukmana, 2020). While a lower ratio indicates higher liquidity, excessive liquidity can minimize the bank opportunity to generate greater revenue. Therefore, banks must optimally manage funds to maintain adequate liquidity (Somantri & Sukmana, 2020). Bank Indonesia Regulation sets the FDR standard between 80% - 100%. A higher FDR value is expected to reduce non-performing financing (NPF), assuming that the distribution of financing by Islamic banks is accompanied by improved financing quality. Sipahutar (2007) stated that good FDR quality contributes to increased bank profits through expanded financing distribution, thereby decreasing the level of non-performing financing.

The statements are supported by many previous studies, such as Aufa & Dja'akum (2019), Dewi & Hakim (2022), Kuswahariani et al. (2020), Munifatussa'idah (2020), and Nasir et al. (2022) support this theory. An increase in the FDR ratio is associated with a reduced level of non-performing financing, attributed to stable banking liquidity conditions as reflected by the increasing FDR value. This positive outcome is contingent upon a selective financing distribution process adhering to strict procedures. Selective financing aims to mitigate the impact of defaults, which can negatively affect the NPF value. Based on this analysis, the following hypothesis is proposed:

H2: Financing to Deposit Ratio has a negative effect on Non-Performing Financing in Indonesian Islamic banking.

The Effect of Islamic Corporate Governance on Financing Risk

Agency theory suggests that there is a separation of duties between principals and agents, leading to an imbalance in information control, known as information asymmetry. This results in agents having more comprehensive information about the organization than principals (Yuliani & Fithria, 2022). Such asymmetry can have negative consequences, including moral hazard or adverse selection, which can affect the company, particularly impacting the level of non-performing financing in banking (Al Arif & Rahmawati, 2018).

The implementation of effective Islamic Corporate Governance (ICG) that adheres to prudential principles can positively influence the reduction of financing risks (Yuliani & Fithria, 2022). The involvement of internal and external audit functions in ICG is also a strategy to mitigate financing risk. Additionally, the presence of ICG practices in banking can enhance public trust, as low financing risk in Islamic banks indicates a healthy condition, thereby encouraging public confidence in depositing funds (Budiman, 2016). ICG within an organization serves as a risk management mechanism through a system designed to identify and analyze potential risks (Budiman, 2016). Moreover, Bank Indonesia has established rules and policies for ICG implementation to mitigate risks.

Several studies, including those by Budiman (2016), Darwanto & Chariri (2019), Fadhillah (2018), Pudail et al. (2018), and Siswanti (2016), confirm these findings. Good corporate governance practices, measured through ICG composite value ratings, can address and reduce high indications of financing risk, as reflected in the NPF value. ICG is particularly focused on anticipating various risks, including default or non-performing financing (Mersni & Ben Othman, 2016). Furthermore, the Sharia Supervisory Board (DPS) influences the disclosure of Good Corporate Governance within banks. More active DPS members tend to promote better ICG practices (Nurkhin et al., 2019).

Sarhan & Ntim (2018) found that the Islamic value index positively and significantly affects the Good Corporate Governance Index (ICGDI). These results align with Farook et al. (2011), who state that Islamic governance, in terms of DPS characteristics, positively affects the level of voluntary disclosure by Islamic banks. Additionally, Albassam & Ntim (2017) reported that companies demonstrating a greater commitment to incorporating Islamic values into their operations engage in higher voluntary ICG disclosures than those that do not. Based on this analysis, the following hypothesis is proposed:

H3: Islamic Corporate Governance has a negative effect on the financing risk of Indonesian Islamic banking.

The Effect of DPS on NPF through ICG

The DPS is an integral part of bank management. The Board of Directors can seek advice from the DPS on fulfilling sharia principles, which are closely linked to the bank's business performance. The DPS ensures that the bank adheres to sharia principles in line with customer expectations (Mukhibad & Khafid, 2018). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) expects Islamic banks to have DPS members skilled in both finance and Sharia law (Mersni & Ben Othman, 2016). Darwanto & Chariri (2019) found that the Sharia Supervisory Board (DPS) negatively affects NPF, indicating that the presence of DPS reduces financing risk in Islamic banks. More active DPS members tend to promote better ICG practices (Nurkhin et al., 2019). Furthermore, well-implemented corporate governance practices reduce non-performing financing (Ahmad et al., 2016). Based on this analysis, the following hypothesis is proposed:

H4: DPS has a negative effect on NPF through ICG.

The Effect of FDR on NPF through ICG

Sound financing principles aim to minimize risks associated with provided financing, thereby reducing potential losses. Neglecting these principles can lead to various risks, including unpaid debt/principal financing obligations, unpaid margins/profit sharing/fees, increased costs, and decreased financing health (Djamil, 2012). Studies of Aufa & Dja'akum (2019), Dewi & Hakim (2022), Kuswahariani et al. (2020), Munifatussa'idah (2020), and Nasir et al. (2022) demonstrate that increasing the FDR ratio impacts financing risk by reducing the level of non-performing financing (NPF). Furthermore, good financial performance is associated with good governance (Utama et al., 2022). FDR is an indicator of the financial performance of the Islamic banking industry. Thus, a high FDR ratio encourages the implementation of good governance (ICG), which in turn reduces NPF (Ahmad et al., 2016).

H5. FDR has a negative effect on NPF through ICG

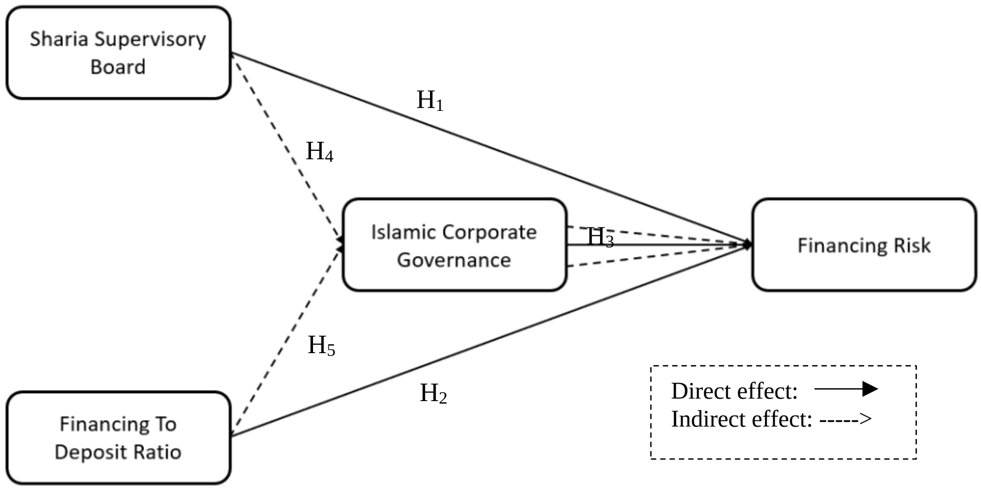

Figure 1. Research framework

METHODOLOGY

Research Design

This study adopts a quantitative research design using panel data analysis to explore the mediating role of Islamic Corporate Governance (ICG) in the relationship between the Sharia Supervisory Board (DPS), Financing to Deposit Ratio (FDR), and Non-Performing Financing (NPF) in Islamic Commercial Banks in Indonesia. The research framework is designed to test direct and indirect effects, employing panel multiple regression and the Sobel test for mediation analysis.

Data Collection

Population and Sample

The population targeted in this study consists of all Islamic commercial banks in Indonesia, totaling 12 banks over the observation period from 2016 to 2021. A judgment sampling technique was employed to select the sample. This nonprobability sampling method was chosen as it allows for the selection of cases that are particularly informative. Out of the 12 banks in the population, 7 banks were selected based on the availability and completeness of the necessary data for the designated study period.

Data Sources

Data was collected through secondary sources, primarily from the official websites of the Financial Services Authority (OJK) and Bank Indonesia. These sources provided access to the financial statements and reports required for the analysis. The documentation method was utilized for data collection, ensuring that all relevant data pertaining to the variables of interest—DPS, FDR, NPF, and ICG—were accurately obtained and recorded.

Variables and Measurements

The independent variables in this study include the Sharia Supervisory Board (DPS), which is measured by the number of board members overseeing compliance with Islamic principles, and the Financing to Deposit Ratio (FDR), calculated as the ratio of total financing provided by the bank to the total third-party funds collected. The dependent variable is Non-Performing Financing (NPF), measured by the ratio of non-performing financing to total financing, indicating the level of credit risk. Additionally, the mediating variable is Islamic Corporate Governance (ICG), assessed using the ICG self-assessment composite value as outlined in Bank Indonesia Circular Letter No. 12 of 2010.

Analytical Procedures

Prior to the main analysis, assumption tests were conducted to ensure the validity of the regression analysis. These tests included assessments for normality, multicollinearity, and homoscedasticity. The statistical analysis involved several key methods. Panel data regression was employed to assess the effect of the Sharia Supervisory Board (DPS) and the Financing to Deposit Ratio (FDR) on Non-Performing Financing (NPF), both directly and through Islamic Corporate Governance (ICG). Mediation analysis was conducted using the Sobel test to evaluate the mediating effect of ICG on the relationships between the independent and dependent variables. Given the limited sample size, bootstrapping with 5,000 subsamples was applied to enhance the robustness and reliability of the regression results. The analysis was conducted using the SPSS software package, which facilitated the execution of complex statistical tests and the handling of panel data.

Hypothesis Testing

Hypotheses were tested using a significance level of 10% ($\alpha = 0.10$). The t-test was applied to determine the significance of individual predictors, with hypotheses accepted if the p-value <0.10. The overall model fit was evaluated using the R-squared value, and the significance of the regression model was assessed using the F-test.

RESULTS AND DISCUSSION

Descriptive Statistics Analysis

The study utilized descriptive statistics to analyze the research variables, which include DPS, FDR, ICG, and NPF. The objective of this analysis is to understand the characteristics of these variables, such as their distribution, maximum and minimum values, mean, and standard deviation. Table 1 presents a descriptive analysis of these variables. The average DPS for Islamic commercial banks in Indonesia is 2, with the lowest being 1. The ICG self-assessment composite value averages at 1.9, suggesting that the typical Islamic bank in Indonesia has implemented the ICG principles, which encompass several factors. The average NPF, a ratio that compares total non-performing financing (substandard, doubtful, and loss) with total financing in Indonesian Islamic banks, is relatively low.

Table 1. Descriptive Analysis

	N	Minimum	Maximum	Mean	Std Deviation
Code	42	1.00	7.00	4.0000	2.02424
DPS	42	1.00	3.00	2.1429	.41739
Financing To Deposit Ratio (FDR)	42	.00	507.00	102.9602	87.84583
Corporate Governance (ICG)	42	1.00	3.00	1.9274	.64036
Non-Performing Financing (NPF)	42	-43.99	.00	-4.4914	6.93984
Valid N (listwise)	42				

(Source: Processed Research Data, 2023)

Model Summary and Interpretation

The study also investigated the influence of DPS, ICG, and FDR on NPF. As shown in Table 2, the R-Square value is 0.249 or 24.9%. This implies that the DPS, FDR, and ICG variables can predict the NPF variable by 24.9%. The significance value in the simultaneous model test is 0.012, which is less than 0.1. This suggests that the independent variables (DPS, FDR, and ICG) have a significant effect on the NPF variable when considered together. Therefore, this research model is considered to be robust and reliable.

Table 2. Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.499[a]	.249	.190	6.24753	1.898
2	.315[a]	.099	.053	.62312	1.147

(Source: Processed Research Data, 2023)

However, when examining the effect of DPS and FDR on ICG, the R-Square value is 0.099 or 9.9%. This indicates that the DPS and FDR variables can only predict the ICG variable by 9.9%. The simultaneous model test significance value is 0.130, which is greater than 0.1. This suggests that the independent variables (DPS and FDR) do not have a significant effect on the ICG variable when considered together. Consequently, this research model is deemed to be less reliable.

Hypothesis Testing Results

The study examined several hypotheses related to Islamic banking in Indonesia, focusing on the relationships between DPS, FDR, ICG, and NPF. The hypothesis testing results, as summarized in Table 3, reveal significant insights into the relationships between the variables studied. Out of the five hypotheses tested, three were found to be significant, while two were not supported by the data. This analysis provides a deeper understanding of the dynamics within Indonesian Islamic banking.

Testing Results

The analysis of significant hypotheses reveals several key relationships. Firstly, the DPS has a significant positive effect on NPF, with a significance level of 0.085 ($p < 0.1$). This suggests that the presence and activities of the Sharia

Supervisory Board may influence the level of non-performing financing in Islamic banks. Additionally, DPS shows a significant positive effect on ICG, with a significance level of 0.052 ($p < 0.1$). This indicates that the Sharia Supervisory Board plays a crucial role in implementing and maintaining good corporate governance practices in Islamic banks. Lastly, ICG demonstrates a significant negative effect on NPF, with a high significance level of 0.001 ($p < 0.1$). This strong relationship suggests that better corporate governance practices in Islamic banks are associated with lower levels of non-performing financing.

Table 3. Hypothesis Testing Results

Hypothesis		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Finding
		B	Std. Error	Beta			
H_1	DPS → NPF	4.358	2.465	.262	1.768	.085	Supported
H_2	FDR → NPF	.006	.011	.075	.527	.601	Not Supported
H_3	ICG → NPF	-5.569	1.605	-.514	-3.469	.001	Supported
	DPS → ICG	.470	.234	.306	2.008	.052	Supported
	FDR → ICG	.001	.001	.105	.691	.493	Not Supported

(Source: Processed Research Data, 2023)

The analysis of non-significant hypotheses reveals that the FDR does not have a significant effect on NPF, with a p-value of 0.601 (> 0.1). This finding contradicts some previous studies but aligns with others, suggesting that the relationship between FDR and NPF may be more complex than initially thought. Similarly, FDR does not demonstrate a significant effect ICG, with a p-value of 0.493 (> 0.1). This indicates that the level of financing relative to deposits may not directly influence the quality of corporate governance in Islamic banks.

Indirect Relationships

The study also explored indirect relationships, as shown in Table 4. The indirect effect of DPS on NPF through ICG was significant, supporting the hypothesis that ICG mediates the relationship between DPS and NPF. This underscores the role of ICG in translating the influence of DPS into improved financial outcomes. Conversely, the indirect effect of FDR on NPF through ICG was not significant, suggesting that ICG does not mediate the relationship between FDR and NPF. This further supports the notion that FDR impact on NPF is limited in this context.

Table 4. Indirect relationship between DPS and FDR

	Hypothesis	Direct Effect	Indirect Effect	Total Effect	Finding
H_4	DPS → ICG → NPF	.306	-.134	.172	Supported
H_5	FDR → ICG → NPF	.105	-.054	.051	Not Supported

(Source: Processed Research Data, 2023)

Figure 2 presents the relationships among the variables in accordance with the hypothesis testing results.

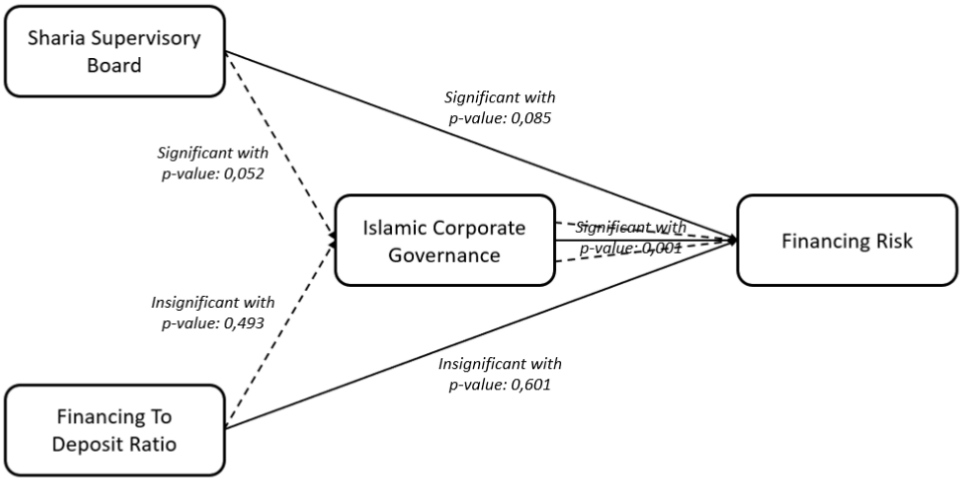

Figure 2. Hypothesis testing result

Discussion

Role of Islamic Corporate Governance

This study found that Islamic Corporate Governance (ICG) has a significant negative effect on Non-Performing Financing (NPF), aligning with previous studies that underscore the importance of good corporate governance practices in Islamic banks for reducing financing risk, such as Grassa & Matoussi (2014), Budiman (2016), Darwanto & Chariri (2019), Fadhillah (2018), Pudail et al. (2018), and Siswanti (2016). This finding can be attributed to ICG emphasis on risk anticipation and the implementation of precautionary principles, which are fundamental to Islamic finance.

ICG frameworks, often guided by principles outlined in regulations like Bank Indonesia Circular Letter No. 12 of 2010, prioritize proactive risk management. This encourages banks to identify and assess potential risks early on and implement appropriate mitigation measures, thereby reducing the likelihood of financing defaults. This risk-averse approach is further strengthened by the emphasis on Sharia-compliant financing practices, which discourage excessive risk-taking and promote ethical considerations in financial decision-making (Chapra & Ahmed, 2002).

The negative effect of ICG on NPF also aligns with the agency theory perspective. This theory suggests that information asymmetry between principals (shareholders) and agents (management) can lead to opportunistic behavior by agents that might not align with the best interests of the principals (Jensen & Meckling, 1976). ICG mechanisms, such as transparency in financial reporting, accountability among bank management, and the involvement of the Sharia Supervisory Board (DPS) in overseeing bank operations, help mitigate this information asymmetry and reduce the potential for moral hazard.

Furthermore, robust ICG practices can foster greater public trust in Islamic banks. When stakeholders perceive a strong commitment to good governance, transparency, and risk management, they are more likely to have confidence in the bank financial stability and ethical conduct. This enhanced trust can lead to increased deposits, greater access to funding, and a stronger reputation, all of which contribute to the long-term sustainability and growth of Islamic banks.

The findings emphasize the crucial role of ICG in Islamic banking. By promoting risk anticipation, implementing precautionary principles, mitigating information asymmetry, and fostering stakeholder trust, ICG contributes significantly to reducing financing risk and ensuring the stability and resilience of the Islamic finance sector. These results have important implications for policymakers, regulators, and Islamic bank managers, highlighting the need for continued focus on strengthening ICG frameworks and practices to maintain the health and growth of the Islamic banking industry.

Sharia Supervisory Board and Its Impact

This study found a positive effect of DPS on both NPF and ICG, a finding that contradicts the initial hypothesis but reveals the critical and multifaceted role of Sharia supervision in Islamic banking. While seemingly contradictory, this result can be understood by examining the specific responsibilities of the DPS and their impact on bank operations.

DPS members are mandated by Bank Indonesia Regulation No. 11/33/PBI/2009 to ensure compliance with Sharia principles and the implementation of good governance practices (Bank Indonesia, 2009). DPS must ensure the implementation of ICG by conducting internal and external audits, as well as performing unusual Sharia audits. Additionally, DPS must monitor and ensure that bank operations and products conform to Sharia principles as regulated in the Fatwa of the National Sharia Council (DSN) (Rahmat, 2017). This dual role positions them as guardians of both Sharia compliance and strong corporate governance within Islamic banks.

The positive relationship between DPS and NPF might seem counterintuitive at first. However, it could be attributed to the rigorous scrutiny of financing applications that a larger, more active DPS might undertake. This enhanced scrutiny, while aiming to minimize risk by ensuring strict adherence to Sharia principles, could result in a higher rejection rate for financing proposals, even those that might be considered viable under slightly less stringent criteria. This interpretation aligns with the finding that a larger DPS is also associated with better ICG practices.

The positive relationship between DPS and ICG confirms that a more active DPS contributes significantly to strengthening corporate governance practices within Islamic banks (Nurkhin et al., 2019). A larger and more engaged DPS can more effectively oversee Sharia compliance and ensure that all bank operations are conducted with transparency, accountability, responsibility, and fairness (Rosidi et al., 2023). This finding underscores the DPS vital role in promoting a culture of good governance within Islamic banks.

However, the simultaneous positive influence of DPS on both NPF and ICG suggests a complex dynamic. While a robust and active DPS is crucial for ensuring ethical and responsible banking practices, a balance must be found to prevent excessive risk aversion that could hinder financial inclusion and the growth of the Islamic finance sector. Future research should explore this dynamic further by investigating the optimal size and composition of the DPS, taking into account factors such as bank size, risk appetite, and market dynamics. Such research would provide valuable insights for policymakers and regulators seeking to establish a framework that balances Sharia compliance, effective risk management, and sustainable growth within the Islamic banking sector.

Financing to Deposit Ratio and Its Implications

This study found no significant effect of FDR on either NPF or ICG. This suggests that the relationship between liquidity management, financing risk, and corporate governance in Islamic banking is more nuanced than previously thought. While FDR is a common indicator of liquidity, this study indicates that simply maintaining a specific FDR ratio might not be sufficient to effectively mitigate financing risk or ensure good corporate governance practices (Rosidi, Rizky, & Putri, 2023). These results do not support the findings of Aufa & Dja'akum (2019), Dewi & Hakim (2022), Kuswahariani et al. (2020), Munifatussa'idah (2020), and Nasir et al. (2022), who demonstrated that increasing the FDR ratio impacts financing risk by reducing the level of NPF.

Although a high FDR can indicate a bank's efficiency in utilizing its deposits for financing activities, it could also potentially contribute to higher NPF levels if not managed prudently. A high FDR implies a larger portion of deposits are allocated to financing activities, potentially exposing the bank to higher credit risk if those financings are not properly assessed and monitored. While a high FDR might seem positive in terms of utilizing funds for profit generation, it can also lead to liquidity constraints, especially during unexpected economic downturns or a sudden surge in withdrawal requests. This liquidity crunch might force banks to make riskier financing decisions to maintain liquidity, potentially increasing NPF.

The finding that FDR does not significantly affect ICG suggests that liquidity management, as reflected by the FDR, is not the sole driver of good corporate governance practices. While maintaining a healthy FDR is important for a bank financial condition, other factors are equally crucial for ensuring robust ICG. A well-defined and implemented corporate governance framework, including effective board oversight, risk management policies, and transparency mechanisms, plays a crucial role in shaping ICG practices. Additionally, ICG in Islamic banking goes beyond financial performance and emphasizes ethical conduct and adherence to Sharia principles. This includes promoting fairness, transparency, and social responsibility in all banking operations. As this study suggests, an active and engaged DPS is crucial for promoting good ICG practices within Islamic banks.

The findings emphasize the importance of optimal fund management in Islamic banking. Banks should not solely rely on FDR as an indicator of liquidity and performance. Instead, they should adopt a comprehensive approach to liquidity risk management that considers various factors like asset-liability matching, diversification of financing portfolios, and robust risk assessment procedures (Qwader, 2019). Additionally, maintaining a high FDR should be accompanied by strong prudential regulations, effective supervisory oversight, and sound risk management practices to mitigate potential risks and ensure sustainable growth.

While FDR remains a relevant indicator of a bank financial position, this study suggests that its relationship with NPF and ICG is not straightforward (Nasir et al., 2022). Optimal fund management, strong corporate governance frameworks, and effective Sharia supervision are crucial for mitigating financing risk and ensuring the long-term stability and ethical conduct of Islamic banks.

The findings highlight the critical role of governance and oversight in managing financial risks within Islamic banks. The positive impact of DPS on both NPF and ICG suggests that effective Sharia supervision can enhance governance practices and potentially mitigate financial risks. However, the lack of significant impact from FDR on both NPF and ICG indicates that liquidity ratios alone may not be sufficient to predict or influence financial performance and governance quality.These results align with some previous studies while contradicting others, emphasizing the complexity of financial dynamics in Islamic banking. The study suggests that a comprehensive approach, incorporating both governance and financial metrics, is essential for understanding and improving the performance of Islamic banks.

CONCLUSION

This research explored the mediating role of Islamic Corporate Governance (ICG) in the relationship between the Sharia Supervisory Board (DPS) and the Financing to Deposit Ratio (FDR) on Non-Performing Financing (NPF) in Indonesian Islamic banks. The findings present several key insights. Firstly, ICG was found to mediate the effect of DPS on NPF, highlighting the importance of good governance practices in mitigating financing risks. This indicates that active and effective ICG practices can enhance the positive influence of DPS on reducing NPF levels. Secondly, DPS was shown to have a positive effect on NPF through ICG, signifying that while DPS plays a crucial role in ensuring Sharia compliance, its effectiveness in reducing financing risks is significantly enhanced when paired with strong ICG practices. Lastly, the study concluded that FDR does not significantly affect NPF through ICG, suggesting that liquidity management alone, as measured by FDR, is insufficient to directly influence financing risk without the support of robust governance frameworks.

These findings underscore the critical role of ICG in the Islamic banking sector, particularly in risk management. Strengthening ICG practices can potentially amplify the effectiveness of DPS in reducing NPF, thereby contributing to the stability and resilience of Islamic banks. Moreover, the results suggest the need for a holistic approach to risk management that integrates both governance and liquidity considerations.

However, the study faced limitations, including the small sample size of DPS members across the banks studied, which may affect the generalizability of the results. Furthermore, the research did not account for macroeconomic factors that could also influence NPF, potentially limiting the scope of the findings. Future studies could expand on this research by including a broader range of macroeconomic variables to better understand their impact on NPF. Additionally, examining the role of DPS with a larger sample size or across different cultural contexts could provide deeper insights into its effectiveness. Further investigation into the interaction between governance practices and liquidity management strategies could also offer valuable contributions to the field.

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