

# The Role of Corporate Governance in Managing the Risk in Islamic Banks in Indonesia

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**Abstract**— Financing risk in Islamic banks is associated with the type of financing distributed. The risk must be managed carefully to build effective risk management. Corporate governance is one tool to influence the management of risks in Islamic banks. Corporate governance mechanism will build adequate policy and procedure in identifying and monitoring the risks. This paper aims to describe the role of corporate governance in managing the financing risk in Islamic banks in Indonesia. Using literature-based method, effective risk management needs the active supervision of the board of director, board of commissioners and sharia supervisory board. The study is expected to contribute in enhancing the role of corporate governance in Islamic financial institution.

**Keywords**—financing risk, Islamic bank, corporate governance

## I. INTRODUCTION

The main role of a bank is to channel between the parties who have excess fund and the parties in need of fund. In doing its function, bank faces many risk such as credit risk, operational risk, market risk, and liquidity risk. Banks should manage the risks because they can inhibit the banking operational activities. Credit risk in Islamic bank (financing risk) is associated with the type of financing distributed. Those types influence the level of credit risk existing in banking sector.

Credit risk in Islamic bank must be managed well to maintain the performance of Islamic bank. According to [1], the main causes of financial instability in banking industry is credit risk. High credit risk may also influence the ability of Islamic banks to compete with conventional bank. Reference [2] stated that Islamic banks are more vulnerable to higher credit risk than conventional ones. Therefore, effective credit risk management should be implemented by Islamic banks.

Corporate governance is one tool to influence the risk management in Islamic banks. Corporate governance (CG) has strong relationship with credit risk in Islamic banks [3]. Reference [4] stated that governance mechanism will impact on the credit policy in banking sector. Risk management is the responsibility of management. However, other CG structures, such as board of commissioners and sharia supervisory board, also influence the implementation of risk management. The effectiveness of the relationship between these boards will influence the risk-taking behavior in Islamic banks [5].

This study aims to describe the role of corporate governance in managing the financing risk in Islamic banks in Indonesia. The reasons behind this topic are as follows: first, in Indonesia, Islamic banks show rapid growth as a part of the development of Islamic finance. The report of ICD-Thomson Reuters 2017 (cited in [6]) stated that from the total Islamic financial assets, Indonesia ranked 7th out of Islamic financial assets in the world with total assets of US\$ 81 billion, increasing from the previous position which was ranked 9th in the previous year. Financial service of authority (FSA/OJK) of Indonesia [6] also reported that the market share of Islamic banking assets has reached 5.78% of the total national banking assets. The asset growth, third party funds, and disbursed financing of Islamic banks are still maintained at a fairly high (two digit) figure, i.e. 18.97%, 19.83%, and 15.24% respectively (yoy). The quality of non-performing financing (NPF) has improved from 4.15% in the year of 2016 to 3.19% in the year of 2017.

Second, previous studies concluded that the boards in corporate governance influence risk-taking behavior in Islamic bank such as the board of directors [4, 7, 8] and sharia supervisory board [3, 9]. Although those studies have different results, the general discussion can be concluded that the boards in CG have effect on the credit risk in Islamic banks. Indonesian Islamic banks can learn about effective CG to influence the credit risk management in order to maintain good financial performance of Islamic banks. Third, the study will give benefit to the parties related to the performance of Islamic banks. Investigating the role of corporate governance on the credit risk management is important for the management of Islamic banks as well as the regulator [10]. Those parties can find out the effectiveness of the boards' roles in CG to influence credit risk.

The remainder of the study is organized as follows: the literature reviews about corporate governance and credit risk are presented in section 2, followed by research methodology in section 3. The subsequent section describes the discussion about the topic, and the conclusion will be provided in the final section.

## II. LITERATURE REVIEW

### A. Corporate Governance in Islamic banks

Islamic financial institution (IFI) has many stakeholders that have different interest and there are possibilities of conflict of interest between them. Corporate governance has crucial role to resolve the conflict and protect the interest of each stakeholder [11]. Some previous studies have

mentioned the role of CG in IBs [9, 11, 12]. First, CG helps IBs to maintain the credibility and reputation of Islamic banks by ensuring the consistency of the sharia implementation. Second, corporate governance will strengthen Islamic banks to perform effectively and expand rapidly. Third, some stakeholders such as investors, regulators, and Islamic communities have direct interest to the stability of Islamic banking sectors and corporate governance help to maintain it.

In Indonesia, corporate governance for Islamic banks is regulated in the regulation of the Indonesian Central Bank Number 11/33/PBI/2009 regarding the Implementation of Good Corporate Governance for Islamic Commercial Bank and Islamic Business Unit. The regulation of [13] stated that corporate governance for Islamic banking industry aims to protect the interest of stakeholders and improve compliance with applicable laws and regulations as well as ethical values. The structure of CG in IB consists of the board of directors, board of commissioners, and sharia supervisory board. The board of directors is fully responsible of managing the company in order to achieve the company's objectives. The board of Commissioners has the obligation to implement supervision and provide advice to the board of directors. The Sharia Supervisory Board is the board whose duty is to provide advice to the Board of Directors and oversee that the activities of the Islamic bank are implemented in accordance with Sharia Principles.

#### *B. Financing Risk in Islamic banks*

Islamic banks face risks related to their function as a financial intermediary, such as liquidity risk, market risk, operational risk, and credit risk. Definition of credit risk according to Indonesian central bank is "any risk which occurs as a result of the failure of the customer or other parties to fulfill the obligations to the bank in accordance with the agreement which has been agreed to". Credit risk arises from the financing distributed by Islamic banks, such as Musharaka, mudharaba, salam, istisna', mudharaba, and ijarah. Reference [3] argued that credit risk mostly happen in the musharaka and mudharaba financing (profit and loss/PLS financing), while in murabaha and ijarah, market risk is greater than credit risk.

Reference [14] revealed that credit risk in Islamic banks is greater than in conventional ones because of the complexity of Islamic financing contracts, limited penalties for financing default, and moral risks from the debtors. A similar argument by [10] revealed that credit risk is caused by bad financing quality, which can increase the default of financing. In addition, poor credit risk management will impact negatively on the economy [1] According to [15], credit risk arises from customers who do not want to fulfill their obligations to Islamic banks because of three reasons: the belief that their contracts are not in accordance with sharia principles, the feeling that they are betrayed by the institution, or losing trust to the institution.

In term of sharia risk, there are several factors that influence sharia risks in Islamic banks. Reference [15] divided it into two aspects, i.e. internal and external. Internal aspects include people, internal processes, and systems, while external aspect comprises external events. The factor of people refers to parties inside the Islamic banks who may make mistakes due to miscommunication, misinterpretation

of fatwa, inadequate human resources, and unsegregated duties. Internal processes may give rise to higher risks due to unclear processes, policies, procedures or responsibilities, inadequate tools, and insufficient disclosure and transparency. Meanwhile, systems can be a cause of risk because of mismatches of process and system accounting, inadequate product modules, poor reporting and unapproved software, and system mistakes.

External aspects relate to external events that can lead to sharia risks such as fatwa risk, conflict of interest between auditing, consulting, and legalizing duties, and inadequate sharia governance regulations and unclear laws and regulations.

Islamic banks must realize that the quality of financing distribution and risk management will contribute to the performance of not only Islamic bank itself but also the economy of the country. Therefore, risk management should be a main activity in the financial institution [16]. Risk management can be defined as a procedure of identifying, measuring, monitoring and controlling risks that arise from the business activities of the banks [17]. Reference [4] stated that the management of credit risk is assigned to the board of directors. However, other boards in the corporate governance structure can influence the effectiveness of monitoring by BOD. Analyzing the relationship between these boards is very important to assess and evaluate the level of performance of each board.

### III. METHOD

This paper uses descriptive method to discuss the role of CG in managing credit risk in Islamic bank in Indonesia. Secondary data such as literatures and documentation related to the topic are used to analyse the condition of the Islamic banks. The study by [15] about the factors that influence the sharia risk in Islamic banks will be used in this paper by relating them to credit risk and also considering the role of corporate governance in Islamic banks in Indonesia.

### IV. DISCUSSION

There are three factors of internal aspects that influence the level of sharia risks in Islamic banks [15], namely people, process, and system. Those factors and the relation with credit risk will be discussed below.

#### *A. Internal Factors*

##### *1) People*

This factor points out that the internal parties in Islamic bank can influence the risk because of miscommunication, misinterpretation of fatwa, inadequate human resources, and unsegregated duties [15]. Those errors should be resolved by establishing clear rules regarding the responsibilities of each individual, committee, and board in the institution.

Risk management in Islamic bank needs active supervision from the boards. The main structure of corporate governance in Indonesia consists of three boards, i.e. the board of directors, board of commissioners, and sharia supervisory boards. The Indonesian regulation number 13/23/PBI/2011 concerning the Implementation of Risk Management in Islamic Commercial Banks and

Islamic Business Units explains the role of each board in risk management.

*a. Board of Directors*

The regulation defines the responsibilities of BOD related to risk management, among others: (1) to prepare written and comprehensive risk management policy and strategy, (2) to be accountable for the risk management policy implementation and risk exposure taken by the Bank as a whole; and (3) to ensure that the function of risk management is conducted independently in its operation.

Islamic bank establishes risk management committee to help BOD. This committee provides recommendation to BOD at least in terms of (1) the arrangement of policy, strategy, and guidelines of the risk management implementation, (2) the improvements of risk management implementation based on the results of the evaluation and (3) the justification of business decision making that is not through normal procedures.

Credit risk causes vulnerable to banking industry when the financing decisions made by the management do not go through adequate due diligence and results in poor asset quality [18]. Therefore, [16] argued that the Board of Directors (BOD) should have comprehensive understanding about risks and the measurement of risk exposure to make effective decision making related to the risk.

*b. Board of Commissioners (BOC)*

The function of BOC is to supervise and give advice to the board of directors. In order to support the effectiveness of its duty, BOC should establish the committees which, at least, should consist of risk committee, remuneration and nomination committee, and audit committee. In relation with risk management, BOC has responsibility and authority to: (1) approve and evaluate the policy on risk management, and (2) evaluate the accountability of the board of directors regarding the implementation of risk management policy.

*c. Sharia Supervisory Board*

Sharia supervisory board (SSB) has main function to ensure the compliance of services, product, and operational activities in accordance with sharia principles [18]. Sharia Supervisory Board's roles related to risk management as follows: (1) reviewing that the risk management policy in accordance to Sharia Principles, and (2) evaluating the accountability of the implementation of risk management by BOD in accordance with Islamic principles.

According to [15], the function of each board will be effective if accompanied by adequate ability, capability, and experience. Therefore, members of the board should possess adequate knowledge regarding finance and business field in general [7, 19]. Even for members of SSB, it is important to have finance and business knowledge besides *fiqh muamalah* and sharia knowledge [5, 18]

In summary, there are some strategies to eliminate the error from people factor. Miscommunication can be prevented by organizing regular meetings to discuss risk management. Each board should hold meetings to discuss

matters under its respective responsibility. The SSB should also meet regularly so that misinterpretation of fatwa can be avoided. The frequent meeting indicates that the board implement monitoring of the bank's activities [20]. In addition, coordination between the committee and the boards, or between the boards, can also be held regularly. Reference [18] argued that the interaction of CG structure will support the better achievement of CG's objectives rather than by relying on single element of CG. The regulation has set provision for a minimum number of meetings for committees and the boards.

Other factors which influence the higher credit risk are inadequate human resources and unsegregated duties. Sufficient knowledge must be possessed by each member of the board as well as employees of the bank. Such knowledge can be obtained from education and training program held by the Islamic bank itself or other institution. Several studies stated that education of the board has a negative relationship with the risk faced by Islamic banks [5, 7]. Training related to the prevention and management of credit risk will enhance the prudence of Islamic banks in channeling financing. Clear provisions regarding each responsibility for the members will eliminate unsegregated duties so that every member understands their tasks and duties.

*2) Internal Processes*

Internal processes refer to unclear processes, policies, procedures or responsibilities, inadequate tools, and insufficient disclosure and transparency which can increase risks [15]. Islamic bank needs to establish clear rules regarding policies and procedures of financing proposals and requirements. Openness and transparency must be prioritized so that the underlying reasons by which certain customers receive financing can be utilized as a basis for risk mitigation in Islamic banks. It is in accordance with the CG principle, namely transparency and accountability principles. Reference [10] stated that there is a positive relationship between financing quality report and credit risk. Such report will indicate whether a bank has problem of financing quality because it has impact on the default financing.

The establishment of certain committees such as risk management committee and audit committee will ensure that financing proposal has gone through appropriate selection process. In general, the committees review the efficiency and effectiveness of governance framework [15]. Risk management committee is important to "protect the interest of bank stakaholder from exposure to unnecessary and excessive risks" (Srinivas et al., 2015 cited in [18], while audit committee functions to minimize financial errors [21].

In general, five characteristics of financing requirements i.e. character, capacity, capital, condition, and collateral, should be fulfilled by the customers. However, some scholars argued that collateral requirement is not an effective way to mitigate credit risk because PLS financing based on partnership and Islamic bank cannot control the

management of the projects (Errico and Farrahbakhs, 1998 cited in [14]. The argument is supported by [18], who revealed that, in terms of PLS financing, Islamic banks can only ensure rigorous credit evaluation and business feasibility to reduce the risk of losing capital contribution.

### 3) Systems

The usage of IT system to process transactions will accelerate the activities of Islamic banks. Database of customers can provide information on the capability of customers and the track records of financing history. BOD needs the complete information to make any decision related to the risk faced by Islamic banks. According to [15], the lack of system will result in inaccuracy and inadequacy of the information presented and can result in incorrect decisions. However, the usage of IT in Islamic banks related to risk management tool and system is inadequate [22].

### B. External factor

External aspects relate to external events that can lead to credit risks, such as economic growth, inflation, exchange rate, and unclear laws and regulation. Those factors influence the level of credit risk in term of inability of the debtors for timely repayment as contractually agreed. The studies about NPF in Islamic banks in Indonesia stated that those factors have influence on the NPF level [23, 24]. Although Islamic banks cannot control external factors, selecting the right debtors can at least help to minimize the potentials of financing default.

## V. CONCLUSION

This paper aims to describe the role of corporate governance in managing the financing risk in Islamic banks in Indonesia. Internal factors such as people, processes, and systems and external event can influence the level of credit risk. Corporate governance mechanism will eliminate the factors and build adequate policy and procedure in identifying and monitoring the risks. The study is expected to contribute in enhancing the role of corporate governance in Islamic financial institutions.

There are limitations of this study. First, this study discusses specifically the main corporate governance structure of Islamic banks in Indonesia and thus, the results cannot be generalized in other countries that may have different regulations. Second, this study refers to the research by [15] which discussed limited internal aspects such as people, process, and system. Other factors may be added to future research such as performance of Islamic bank or the level of competition with conventional bank.

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