Minimizing Frauds on the Indonesian Islamic Banks

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ABSTRACT
This paper examines the issue of fraud and discusses two ways to minimize frauds in Indonesian Islamic banks; they are compliance to sharia principles in muamalah and profit distribution management by Islamic bank managers to fulfill their obligation to their customers. By observing eight Islamic banks from 2013 to 2017, a total of 40 data were collected from the banks' websites, and they were analyzed using Sobel test. The results show that sharia compliance and profit distribution management are able to minimize frauds, and profit distribution management mediate the influence of sharia compliance on fraud.
Keywords: *fraud, sharia compliance, profit distribution management, Islamic bank*

1. INTRODUCTION

Fraud is the deliberate deviation or refraction to deceive or manipulate banks, customers, or other parties which takes place in bank environment that results in damages to the banks, customers, or other parties for direct or indirect financial profit [1] on letter number 13/28/DPNP. Skousen et al. [2] stated that undetectable fraud can develop into a major scandal that harms many parties. According to Crassey, pressure, opportunity, and rationalization always appear in fraud situations. Fraud triangle generally consists of three conditions: Incentive/pressure, opportunity, and attitude/rationalization [2]. Therefore, entity with special character, sharia finance business, has a high risk in management, and it takes the precautionary principle of the actors in sharia compliance aspect as the preventive effort in fraud possibility [3].

Customers of conventional banks began to see Islamic banks due to the application of sharia principles. Sharia compliance is the compliance of Islamic banks to sharia principles, which means that banks follow Islamic provisions in their operations, especially when related with muamalah in Islam [4]. In general, customers of Islamic banks want to conduct business or transactions in halal ways. However, Islamic banking practices are currently still less concerned with sharia principles. One of the appeals for a person to make financial investments in Islamic banks is profit distribution or revenue sharing. Profit distribution or revenue sharing is the profit or income obtained from fund management for investments and commerce transactions provided to the customer [5]. According to Bank Indonesia, the distribution of revenue sharing is the monthly share of Islamic bank profit to the customer based on the agreed ratio. It can be concluded that profit distribution is the activity of managing profit distribution by managers in fulfilling the obligation to the outcome of its customers. Farook et al. [6] suggested that most Islamic banks manage their profit distributions with the extent of profit distribution directly related to religiosity, financial development, asset composition, and the existence of discretionary reserves, and it is inversely related to the market familiarity with Islamic banking, market concentration, depositor funding reliance, and the age of the Islamic bank.

In fact, sharia does not guarantee that an institution is free from fraud. It is proven by cases of frauds in sharia institutions. The fraud cases in Indonesia involve bank's internal parties. They fictionalized 102-billion-rupiah credit distribution to 197 fictional clients. Due to the credit distribution, Islamic banks have a potential loss of 59 billion rupiahs (Bank Indonesia). Next case is related gold pawn. This case arose when a customer filed a lawsuit after being harmed by the gold pledge. Not only in Indonesia, some fraud cases related to Islamic banks also occurred in other countries, such as in Dubai Islamic Bank that lost about USD 300 billion due to improper financial statements and in Islamic Bank of South Africa that went bankrupt in 1997 with debts of between R50 and R70 million caused by poor management and improper accounting and management systems [3].

Furthermore, frauds in banking activities also occur because of low risk and low compliance culture, poor integrity and weak supervision, incomplete standard operational procedure, down-date banking activities, transactions complexity and poor human resources in regards to procedures and provisions, poor employee rotation and mutation, low fragile reward and punishment system, and weak information technology system. Many fraud cases in Islamic banks affect the trust of their customers and harm their financial ability. All of which proves that there is no guarantee that sharia institutions, especially sharia-based banks, are free from fraud. Each organization has fraud risks in any kinds. Depositors withdraw their money if the banks cannot generate income from their deposited money; interest rate goes up, and total deposits tend to decrease. Hence, Islamic banks have to anticipate this withdrawal behavior by doing two actions: reserving some liquidity and adjusting return sharing ratio to depositors [7].

1.1 The Relationship Between Sharia Compliance and Fraud

To ensure the application of sharia principles in banking institutions, sharia supervision played by sharia supervisory board is required [4]. Bank Indonesia stated that customers who use the services of Islamic banks partially have the tendency to stop becoming customers, one of which is due to the doubt regarding the consistency of sharia principle implementation. It implicitly shows that Islamic banking practices is less concerned with sharia principles, which can affect community's reputation and trust in Islamic banks and affect people's loyalty in using Islamic bank's services.

The empirical proof of sharia compliance disclosure in Islamic bank's financial reporting in Indonesia is still low. Allegedly, the trust of accountants and managers of Islamic bank towards the use of sharia compliance disclosure practices as the responsibility of Islamic banks is still low. Rini et al. [3] also stated that the low compliance to sharia principles provides the opportunity for fraud in Islamic banks. Therefore, the guarantee on the fulfillment of sharia principles to all customer's fund management activities by Islamic banks is very important in Islamic bank business activities. Not many studies have tested the effect of sharia compliance on fraud.

Studies on sharia compliance is dominated by assessing sharia compliance with the performance or health level of Islamic banks, while the assessment of sharia compliance with fraud is low in number. Hameed et al. [4] stated that the performance of Bahrain Islamic Bank (BIB) is better than Bank Islam Malaysia Berhad (BIMB). The findings are supported by Fouad and Mohamed [8], showing that consumers of sharia-compliant financial products in Kuwait can be clustered into three distinct segments: enthusiasts, laggards, and rejectors. The enthusiasts represent the largest cluster with a frequency of around 66 percent, while the rejectors represent the smallest segment with a frequency of 10 percent. Samy [9] said that Islamic financial institutions (IFIs) maintain a better control over their transactions than conventional financial institutions (CFIs) through Sharia Supervisory Board (SSB) and Sharia Control Department (SCD).

H_1: Sharia compliance has a positive negative relationship with fraud

1.2 The Relationship Between Sharia Compliance and Profit Distribution Management

Sharia compliance is the compliance of Islamic banks to sharia principles, which means that banks in their operations follow Islamic provisions, particularly concerning the Islamic principles [4]. The higher sharia compliance in Islamic banks, the higher the Islamic banks share the results with internal and external parties. Africano [5] stated that profit sharing is derived from the management of investment and commerce transactions for the customers. Anna et al. [10] argues that most sharia-compliant companies agree that the most relevant sharia-related information is most commonly understood as the information found in the financial statement and its notes (accounting-related disclosures). Their responses indicated that there is a disjoint between the conventional disclosure practices on corporate social responsibility items and the sharia-related information.

H_2: Sharia compliance has a positive influence on profit distribution management

1.3 The Relationship Between Profit Distribution Management and Fraud

Profit distribution or profit sharing is obtained from the management of investments and commerce transactions for the customer [5]. It means that profit distribution is an activity that manages the distribution of profit by the manager in fulfilling the obligation to the outcome of its customers. If the management is done properly and transparently, there will be no frauds such as deception, obscurity, and dishonesty in ways that are unworthy/reasonable to deceive others that profit one party and harm others. Wafaretta et al. [11] stated that PDM has a negative effect on fraud. It means that, the greater the PDM is distributed, the smaller the fraud culture in Islamic banks becomes.

H_3: Profit distribution management has a negative relationship with fraud

2. RESEARCH METHODS

The population of this study is all Islamic banks registered in Bank Indonesia from 2013 to 2017. This study uses purposive sampling technique with the criteria of (1) Islamic banks that are registered in Bank Indonesia during the period of 2013-2017, (2) Islamic banks that published annual reports from 2013 to 2017 in rupiah; and (3) Islamic banks that have complete data related to the variables used in the study. The data of this study are secondary, obtained from Bank Indonesia's website (www.bi.go.id) and Islamic banking statistics through documentation method.

Variables and indicators for each of the variables in this study are fraud, sharia compliance and profit distribution management. The first variable is fraud. Fraud is an action that includes deception, deceitfulness, and dishonesty in ways that are unworthy /reasonable to deceive others which give self-benefit but harm other parties [12, 13]. It is measured by the amount of internal fraud that occur in Islamic banks disclosed in the annual report of corporate governance of each Islamic bank. Second variable is sharia compliance, which means Islamic bank compliance towards sharia principles, which means, the bank operation follows the provisions of Islamic sharia especially concerning on Islamic muamalah. It is measured by Islamic Income Ratio (IsIR). IsIR is obtained from ratio comparison between Islamic income with total income. The last variable is profit distribution management; activities undertaken by the manager to manage the profit distribution management is measured by using asset spread. Asset spread is the difference between ROA and ROIAH average.

Regression analysis is used to test the empirical research model by using data from the Islamic bank annual report in Indonesia. Three regression models were established, first, multiple regression variables sharia compliance and profit distribution management with fraud. Second, a simple regression of sharia compliance to profit distribution management to explain the influence of both. Third, the mediation analysis of profit distribution management in the influence between sharia compliance and fraud with the Sobel Test [14].

3. RESULTS

Regression analysis for the first model shows a good "goodness of fit model" because the Anova test produces a value of F = 124.551 and p-value of 0.000 (less than 1%). The coefficient of determination for this model is shown by adjusted R2 of 0.5621. This means that 56.21 percent of data variation in fraud can be explained by variations in data in sharia compliance and profit distribution management; while the remaining 43.79 percent explained variations in other variables outside the model.

Simple regression analysis on model two shows a good "goodness of fit model" because the Anova test produces F = 55.76 and p-value 0.000 (less than 5%). The coefficient of determination for this model is shown by R2 0.5410. This means that 54.10 percent of the variation in data in the profit distribution management can be explained by variations in data in sharia compliance, while the remaining 45.9 percent is explained by variations in other variables outside the model.

With regard to hypothesis testing, research findings confirm that regression sharia Compliance (SC) → Fraud (β = -0.152, p-value < 0.05), sharia compliance (SC) → Profit Distribution Management (PDM) (β = 0.314, p-value < 0.01), and Profit Distribution Management (PDM) → Fraud (β = -0.688, p-value < 0.10). This result provides support for H1, H2, and H3.

Table 1. Hierarchical Regression Analysis

Hypothesis	Regression	Beta	t	p-value	Decision
H1	SC → Fraud	-0.152	-.344	.001**	Accepted
H2	SC → PDM	0.314	3.616	.000***	Accepted
H3	PDM → Fraud	-0.688	-4.99	.062*	Accepted

1. Adj R^2 = 0.5621, F = 124,551, *p-value* = 0.000
2. R^2 = 0.5410, F = 55,76, *p-value* = 0.000
3. ***) significance in 1%
 **) significance in 5%
 *) Significance in 10%

SC = Sharia Compliance
PDM = Profit Distribution Management

Source: processed data

4. DISCUSSION

Sharia compliance that is proxied by Islamic Income Ratio has a negative effect on fraud. It can be interpreted that when the value of Islamic Income Ratio is high, the amount of fraud that occurs is low. The higher Islamic Income Ratio indicates that the more transactions with the principle of the results carried out by Islamic banks, it can minimizing the fraud because the principle of Islamic income is one of the principles in the operation of Islamic banks which is basically a differentiator between Islamic banks and conventional banks. The principle of Islamic income in Islamic banks is also expected to drive the real sector more because it closes the possibility of disbursing funds to consumptive interests. In addition, it is necessary to control the activities in Islamic financial institutions such as sharia supervision that can be done by other companies, for instance sharia consulting firms and Sharia advisors in order to be assured that Sharia financial institutions have carried out transactions in accordance with sharia principles [15]. Sherif and Khaled [16] finds that the average compliance level based on AAOIFI standards concerning the Sharia Supervisory Board (SSB) is 68 percent. They analysis also shows that size, existing Sharia-auditing department, age and Corporate Governance of Sharia Supervisory Board (SSB) are the main determinants of compliance levels. So that when the principle of Islamic income is dominant in Islamic banks, the gap for fraud is getting smaller, thus the condition of Islamic banks will be better.

Sharia compliance that is proxied by Islamic Income Ratio also has a positive effect on profit distribution management. It indicates that bank in the Profit Distribution is influenced by Islamic Income vs. Non-Islamic Income (IsIR). Based on the stakeholder theory, Bank management must provide benefits to stakeholders. Empirical Data indicates that Islamic banks consider Islamic Income vs. Non-Islamic Income (IsIR) in revenue sharing. It can be caused of Islamic banks consider more income gained from halal transactions compared to transactions containing interest, gharar and gambling in the revenue sharing. Anna et al., [17] found that an Islamic-based organization used accounting procedures and practices that are not contrary to sharia principles. The study also found that accounting practices, adopted to reveal the financing and investment of Sharia-based money funds. It is in line with the previous research results by Faarook et al. [6], Lahrech et al., [18]; and Africano [5]. Sharia Compliance is a referral to the moral of an Islamic organization, and result a better sharia compliance in an organization, so it can reduce the employee's rationalization of organization to conduct fraud. Statistical test results showed that Profit Distribution Management has effect on Fraud. Motivation is an important element in the occurrence of cheating, but in this research. Profit Distribution Management as profit management sharing from business result to the customer as the capital owner, and the employees are motivated to give their best towards the customer. This can minimizing the fraud action of the employees, where fraud used as a measuring instrument on this research is internal fraud done by employees. The results of this study are supported by Wafaretta et al. [11] stated that profit distribution management negatively affected fraud. It means that the greater Profit Distribution Management then the smaller culture of fraud occurs in Islamic banks.

5. CONCLUSION

This study found that sharia compliance represented by Islamic Income vs Non-Islamic Income (IsIR) has relationship with Fraud and Profit Distribution Management, and the Profit Distribution Management variable has relationship with Fraud and the mediation occurs. The implication of this research for Islamic banks is to pay more attention to Islamic Income vs. Non-Islamic Income (IsIR), as it affects fraud. Sharia compliance and Profit Distribution Management variables in this study provided a better model in predicting the fraud by providing a coefficient of determination of 56.21%. The limitation in this research is the suggestion that can be considered for further research that is the use of indicators Islamic Disclosure Index (IDI) as a proxy of sharia compliance. The future research can use other indicators to explain fraud, such as corporate governance and social/environment disclosure.

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