

Mediating Role of Islamic Social Reporting on the Nexus Between Sharia Supervisory Board Characteristics and Islamic Banks' Financial Performance in Indonesia

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ABSTRACT

Purpose: The Sharia Supervisory Board (SSB) plays a significant role in Islamic banking. Therefore, it is important to examine how the characteristics of the SSB influence financial performance, particularly when mediated by Islamic Social Reporting (ISR).

Method: This study adopts a quantitative approach. We analyze the annual financial statements of 13 Islamic commercial banks in Indonesia from 2019 to 2023, focusing on how SSB characteristics affect financial performance through ISR. Structural Equation Modelling (SEM) is used to test the proposed hypothesis, utilizing SEM-PLS with Smart-PLS 4 as the analysis tool.

Result: The analysis reveals that SSB characteristics do not significantly impact financial performance, suggesting that the role of the SSB has not sufficiently influenced financial outcomes. However, SSB characteristics significantly affect ISR, which in turn has a significant impact on financial performance. The mediation analysis shows that ISR fully mediates the relationship between SSB characteristics and financial performance. Therefore, ISR is a crucial factor in improving the financial performance of Islamic banks.

Practical Implications for Economic Growth and Development: This study recommends that Islamic banks enhance the role of the SSB, particularly in ensuring transparent and effective social disclosures. Strengthening ISR practices can improve financial performance, thereby increasing Islamic banking's contribution to community financing and fostering broader economic growth.

Keywords: *sharia supervisory board, financial performance, islamic social reporting, islamic banking*

INTRODUCTION

Islamic banking in Indonesia has shown significant growth over the past two decades (Aziz & Saoqi, 2017). Indicators such as total assets and financing disbursed demonstrate this growth. Total Islamic banking assets increased by 15.63% in 2022, compared to 13.11% in 2021 and 13.94% in 2020. Financing disbursed also rose by 20.44% in 2022, up from 6.90% in 2021 and 8.08% in 2020. The growth of financing in 2020 and 2021 experienced a slowdown due to the Covid-19 pandemic (OJK, 2022).

This growth indicates that people are beginning to recognize the importance of Islamic banking as an alternative to conventional banking (Hassan & Aliyu, 2018). Islamic banks play a crucial role in economic development (Hudayati et al., 2023), but without effective and efficient governance, they could hinder economic progress (Moustafa & Mohamed, 2016). Essentially, the governance of Sharia banking mirrors that of conventional banking (Bhatti & Bhatti, 2010), with the key difference being the existence of a Sharia Supervisory Board (SSB) (Lewis, 2010; Ashraf et al., 2015; Haddad & Bouri, 2022).

Islamic banks must adhere to Sharia restrictions, such as the prohibition of excessive risk-taking, interest-based transactions, and dealings with companies whose core business is prohibited in Islam (Hassan et al., 2019). To ensure compliance with these principles, Islamic



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banks establish a Sharia Supervisory Board (SSB). The SSB plays a major role in ensuring banks' adherence to Islamic law (IFSB, 2009; Alamer, 2022). It monitors and certifies various financial instruments and products, as well as governance compliance with Sharia principles (Farag et al., 2018). According to Farag et al. (2018), the SSB also provides advice and guidance to managers and the board of directors on Sharia-compliant products and instruments. This, in turn, positively influences the long-term performance of Islamic banks.

If the SSB performs poorly, it can negatively affect Islamic banking performance. For instance, failure to adhere to Sharia provisions could undermine financial performance, jeopardize the survival and growth of Islamic banks, and lead to reputational risks that can severely impact the trust of customers, investors, and stakeholders (Baklouti, 2022; Bhambra, 2007). A loss of trust could result in fewer customers, reducing the profitability and financial performance of Islamic banks. Therefore, the role of the SSB is crucial in maintaining the stability and financial performance of Islamic banks (Hamza, 2013; Safiullah, 2021). Additionally, when the SSB performs well in ensuring Sharia compliance, it positively impacts the creditworthiness and financial performance of Islamic banks (Mollah & Zaman, 2015; Haridan et al., 2018).

In addition to financial performance, the SSB also plays a critical role in achieving social performance (Antonio et al., 2012; Mollah & Zaman, 2015). Social responsibility is essential for maintaining public trust in Islamic banking. Increased trust in Islamic banking encourages people to use its products, ultimately improving the financial performance or profitability of Islamic banks. Thus, it is vital to understand how the role of SSB characteristics influences financial performance, particularly by considering social performance, which can be proxied by Islamic Social Reporting (ISR) as a mediating variable.

Several prior studies have demonstrated that aspects of the Sharia Supervisory Board (SSB), including membership count, meeting frequency, competency, and reputation, positively enhance the financial performance of Islamic banking. Researchers such as Meslier et al. (2020), BenSaid (2023), Baklouti (2022), and Farag et al. (2018) examined the features of SSBs, including membership count, meeting frequency, competence, reputation, and the proportion of women within the group. They discovered that these criteria positively influenced the financial success of Islamic banks, although the proportion of women members had no impact. Safiullah and Shamsuddin (2019) found that the membership size and educational attainment of the SSB might mitigate operational and default risks in Islamic banking while enhancing profitability (Buallay, 2019). Consequently, it can be concluded that the attributes of the SSB influence financial performance.

In addition, several studies have shown a positive relationship between governance and social performance (Harjoto et al., 2019). In this context, Islamic banking governance includes the role of the SSB in ensuring Sharia compliance. Furthermore, governance through the SSB can also improve social performance (Harjoto et al., 2019; Kyazze et al., 2017). Islamic banking is likely to perform better financially if it has better social performance, as demonstrated by increased discussion of Islamic Social Reporting (ISR) (Sunarsih & Ferdiansyah, 2016; Nasution et al., 2019; Hosen et al., 2019; Mubarak, 2020). Thus, the role of the SSB in improving financial performance is closely tied to its role in increasing the disclosure of social performance, particularly through Islamic social reporting.

However, research has not yet identified the role of ISR in influencing the relationship between SSB characteristics and financial performance. Therefore, this study will consider ISR as a mediator between SSB characteristics and financial performance. Additionally, this study differs from previous research, which typically focused on testing the characteristics of the SSB in relation to financial performance using only one specific variable, such as the number of members or other individual SSB characteristics. In contrast, this study aims to combine various SSB characteristics into a single variable and examine how it impacts the financial performance of Islamic banking.

For this reason, we investigate how SSB traits, mediated by ISR, affect financial performance. We anticipate that this research will contribute to the development of Islamic banking in the future.

METHOD

This study employs a quantitative approach to examine the relationship between SSB characteristics and Sharia Banking financial performance through Islamic Social Reporting (ISR) mediation. The research uses all Islamic Commercial Banks (IB) in Indonesia as the population. Currently, there are 13 Islamic banks in Indonesia. The list of IBs in Indonesia is as follows: (1) PT. Bank Syariah Indonesia; (2) PT. BCA Syariah; (3) PT. Bank Muamalat Indonesia; (4) PT. Bank Victoria Syariah; (5) PT. Bank Mega Syariah; (6) PT. Bank Panin Dubai Syariah; (7) PT. Bank KB Bukopin Syariah; (8) PT. BTPN Syariah; (9) PT. Bank Aladin Syariah; (10) PT. Bank Aceh Syariah; (11) PT. Riau Riau Islands Syariah BPD; (12) PT. BPD NTB Syariah; and (13) PT. Bank Jabar Banten Syariah.

The sampling method used is purposive sampling. The sample criteria for this study are as follows: (1) IBs that consistently report their financial data from 2019 to 2023, and (2) IBs that consistently report their social responsibility in their financial statements from 2019 to 2023. The data used in this study is secondary data taken from the BUS Annual Financial Reports for the 2019-2023 period. SSB characteristics and financial performance are based on several previous studies, such as Meslier et al. (2020), BenSaid (2023), Baklouti (2022), and Farag et al. (2018). Meanwhile, the ISR variable is analyzed using content analysis for each indicator by comparing the met and unmet indicators. The indicators used in ISR refer to studies conducted by Sofyani et al. (2012) and Gustani (2013). The variables used in this study are shown in Table 1.

Table 1. Variables Measurement

Variables	Indicators	Data Scales	Codes
SSB Characteristics	Number of SSB Members	Number of members in the DPS structure at the end of each year (nominal)	Ssb ₁
	SSB Education Level	Number of SSB members with doctoral degree (S3) / number of members (%)	Ssb ₂
	Dual SSB Positions	SSB members who hold concurrent positions in other Islamic banking / number of members (%)	Ssb ₃
	Female's members in the SSB Structure	Number of female members in the SSB structure / number of members (%)	Ssb ₄
Islamic Social Reporting (ISR)	Finance & Investment	Number of indicators met / indicators not met on finance & investment indicators (%)	Isr ₁
	Products & Services	Number of indicators met / indicators not met on the product & service indicator (%)	Isr ₂
	Workforce	Number of indicators met / indicators not met on the labor indicator (%)	Isr ₃
	Social	Number of indicators met / indicators not met on social indicators (%)	Isr ₄
	Environment	Number of indicators met / indicators not met on	Isr ₅

Variables	Indicators	Data Scales	Codes
		environmental indicators (%)	
	Corporate Governance	Number of indicators met / indicators not met on corporate governance indicators (%)	Isr ₆
Financial Performance	Return on Asset (ROA)	Net profit / total assets (%)	Fp ₁
	Return on Equity (ROE)	Net profit after tax / shareholder equity (%)	Fp ₂

Source: Authors' compilation (2024)

The data analysis technique in this study uses the Structural Equation Modeling - Partial Least Squares (SEM-PLS) method, implemented with Smart-PLS 4 software. The steps used to analyze the data are as follows: (1) Outer Model analysis to assess the reliability and validity of indicators through several tests, namely indicator reliability, composite reliability, convergent validity, and discriminant validity; (2) Inner Model analysis to examine the relationships between constructs, both direct and indirect effects, using several tests, namely the R-Square test and path significance. The direct effects to be examined are (1) the direct influence of DPS on financial performance and (2) the direct influence of SSB on Islamic Social Reporting. The indirect effect to be assessed is the influence of SSB on financial performance mediated by Islamic Social Reporting.

Hypotheses Development

SSB Characteristics on Islamic Banks' Financial Performance

The Sharia Supervisory Board (SSB) is an independent body composed of scholars with expertise in Sharia law and is regarded as one of the most critical elements of Sharia governance (Khalil & Taktak, 2020). In Islamic banking, the SSB plays a pivotal role in issuing fatwas for financial products under development, conducting Sharia audits, guiding banks in their broader social responsibilities, and serving as the backbone for maintaining Sharia compliance (Khan & Zahid, 2020). According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards, the SSB's characteristics enable effective monitoring of Sharia banking's adherence to existing Sharia regulations. Quality control in this context requires a substantial number of advisors, such as those on the SSB, to fulfill all supervisory functions (AAOIFI, 2004). The SSB also promotes better governance disclosure and higher levels of Sharia compliance (Maali et al., 2006). By ensuring the Sharia-compliant status of banking products, the SSB contributes to increased product availability, enhancing customer satisfaction by offering options that meet their specific needs. This, in turn, boosts the profitability of Sharia banking institutions (Nomran et al., 2018).

H1: SSB characteristics influence Islamic banks' financial performance.

SSB Characteristics on Islamic Social Reporting

Agency theory emphasizes the need for extensive performance disclosure, including social performance in this context (Hariyanti & Annisa, 2021). The Sharia Supervisory Board (SSB) functions to oversee Islamic banking, ensuring that both its social and financial performance align with Sharia principles (Antonio et al., 2012; Mollah & Zaman, 2015). Through its supervisory role, the SSB helps enhance social performance, leading to increased disclosure of Islamic Social Reporting (ISR) in Sharia banking. Enhanced ISR disclosure is crucial for maintaining public trust in Sharia-compliant financial institutions (Sofyani et al., 2012; Handayani & Budi Yanti, 2023).

H2: SSB characteristics influence Islamic Social Reporting.

Islamic Social Reporting on Islamic Banks' Financial Performance

Islamic Social Reporting (ISR) is one of the indices used to assess the reporting of Sharia-based corporate social responsibility (Mubarok, 2020). ISR, as an extension of social reporting, addresses not only the expectations of the board of directors but also the fulfillment of spiritual perspectives. The ISR Index serves as a measure of the ethical and social responsibility of Islamic banks. It incorporates standard ethical guidelines established by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and has been further refined by researchers who examined additional ethical aspects that Islamic businesses are required to disclose (Sunarsih & Ferdiansyah, 2016). ISR plays a key role in enabling the public to evaluate the social performance of banks, which in turn influences customer loyalty. Greater customer loyalty ultimately contributes to improved financial performance (Shabbir et al., 2018).

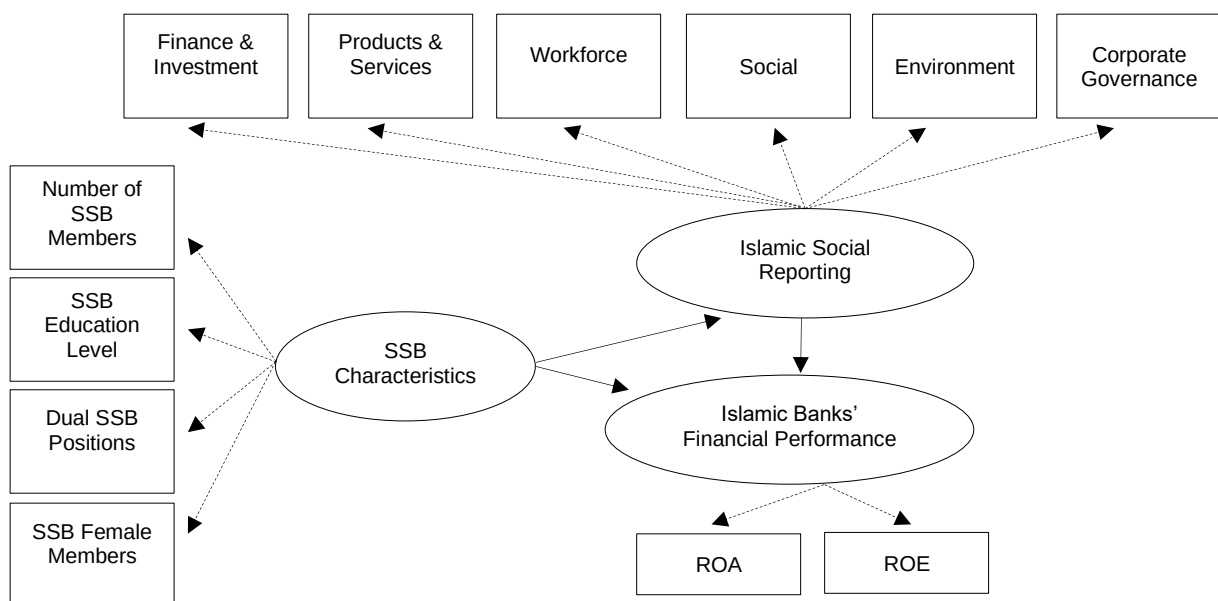
H3: Islamic Social Reporting influences Islamic banks' financial performance.

SSB Characteristics on Islamic Banks' Financial Performance through Islamic Social Reporting

Social responsibility plays a vital role in maintaining public trust in Islamic banking. Trust in Islamic banking encourages people to use its products and services, which ultimately enhances the financial performance and profitability of Islamic banking (Antonio et al., 2012; Mollah & Zaman, 2015). Therefore, examining the role of Sharia Supervisory Board (SSB) characteristics in influencing financial performance is crucial, particularly by considering social performance, represented by Islamic Social Reporting (ISR) as a mediating variable.

H4: Islamic Social Reporting mediates the influence of SSB characteristics on Islamic banks' financial performance.

Figure 1. Research Framework



Source: Developed by the authors (2024)

RESULT AND DISCUSSION

Outer Model Analysis

The outer model test evaluates the reliability and validity of the indicators and variables used in the analysis. The assessments in the outer model analysis include: (1) convergent validity, measured using loading factors and Average Variance Extracted (AVE); (2) discriminant validity, assessed through the square root of AVE and correlations among latent constructs; and (3) composite reliability and Cronbach's alpha values (Hair et al., 2022).

Convergent validity is employed in the initial reliability test to examine the loading factor of each indicator, which measures the strength of the correlation between an indicator and its latent variable. An optimal loading factor exceeds 0.7, indicating a valid indicator for evaluating constructs (Ghozali, 2021). However, loading factor values between 0.5 and 0.7 are still acceptable (Memon & Rahman, 2014). Therefore, this study applies a minimum loading factor threshold of 0.5 for each indicator.

We utilized the PLS algorithm in the SEM-PLS 4 software to determine the loading factor values of each indicator. In this study, all indicator values exceeded the 0.5–0.7 range in the fourth iteration of the PLS-Algorithm. The fourth iteration also provided Cronbach's alpha, AVE, and composite reliability values. Table 2 summarizes the results of the PLS-Algorithm test. According to Hair et al. (2022), the standard AVE value must exceed 0.50, and composite reliability must be greater than 0.70. As shown in Table 2, all variables achieved AVE values above 0.50 and composite reliability values above 0.70. Therefore, it can be concluded that all variables successfully passed the reliability and validity tests.

Table 2. Outer Model Test Result

Variable	Code	Factor Loading	Cronbach's Alpha	AVE	Composite Reliability
SSB Characteristics	Ssb ₄	1.000	1.000	1.000	1.000
Islamic Social Reporting	Isr ₁	0.813	0.902	0.719	0.981
	Isr ₂	0.934			
	Isr ₃	0.828			
	Isr ₄	0.907			
	Isr ₆	0.741			
Financial Performance	Fp ₁	0.956	0.879	0.891	0.911
	Fp ₂	0.931			

Source: Processed data (2024)

Variable validity is further assessed using discriminant validity, which is evaluated by analyzing cross-loading values. Cross-loading serves as a comparative metric, measuring the correlation of each indicator with its respective construct as well as with other constructs (Fornell & Larcker, 1981). The discriminant validity values are presented in Table 3. Discriminant validity is confirmed when the cross-loading value of an indicator is higher for its own construct than for any other construct. If this criterion is satisfied, the model can proceed to the next phase of evaluation, which is the structural model (inner model) analysis.

Table 3. Discriminant Validity

Variables	SSB Characteristics	Financial Performance	Islamic Social Reporting
SSB Characteristics	1.000		
Financial Performance	-0.145	0.944	
Islamic Social Reporting	0.357	-0.296	0.848

Source: Processed data (2024)

Inner Model Analysis

The structural or inner model in SEM-PLS is analyzed using the bootstrapping procedure. This test assesses the impact of exogenous (independent) variables on endogenous (dependent) variables. In this study, both the direct effects and the mediating effects of Islamic Social Reporting (ISR) factors were examined. A variable is considered to have a significant effect if the t-statistic exceeds 1.96 (>1.96) and the p-value is less than 0.05 (<0.05). The results of the direct effect test are summarized in Table 4.

Table 4. Direct Effect

Direction	Original Sample	T-stat	p-values
SSB Characteristics → Financial Performance	-0.045	0.544	0.586
SSB Characteristics → ISR	0.357	4.322	0.000
ISR → Financial Performance	-0.280	3.008	0.003

Source: Processed data (2024)

The data in Table 4 indicates that the direct influence of SSB characteristics on financial performance is not significant, as evidenced by a t-statistic of 0.544 (less than 1.96) and a p-value of 0.586 (greater than 0.05). However, ISR is significantly influenced by SSB characteristics, demonstrated by a t-statistic of 4.322 (greater than 1.96) and a p-value of 0.000 (less than 0.05). Additionally, ISR has a significant impact on financial performance, supported by a t-statistic of 3.008 (greater than 1.96) and a p-value of 0.003 (less than 0.05).

Table 5 presents the findings on the mediating effect of ISR on the relationship between SSB characteristics and financial performance. A t-statistic of 2.432 (greater than 1.96) and a p-value of 0.015 (less than 0.05) indicate that the impact of SSB characteristics on financial performance through ISR is statistically significant.

Table 5. Indirect Effect

Direction	Original Sample	T stat	p-values
SSB Characteristics → ISR → Financial Performance	-0.100	2.432	0.015

Source: Processed data (2024)

Discussion

The Influence of SSB Characteristics on Islamic Banks' Financial Performance

The financial performance of Islamic banks is not significantly influenced by the characteristics of their SSBs. The results contradict the premise that SSB attributes affect financial performance. These findings differ from previous studies by Hanifah & Rahadi (2020), Grassa & Matoussi (2014), Garas (2012), Mukhibad & Anisykurlillah (2020), Liu (2018), and Talpur et al. (2018), which argued that the attributes of SSBs significantly influence the financial success of Islamic banking.

However, the findings of this study align with research by Aisyah et al. (2022) and Pramestia & Adityawarman (2024), which concluded that SSB attributes do not have a significant effect on financial performance. Factors such as the number of members, their educational qualifications, concurrent roles, and the participation of women in SSBs do not enhance financial performance. Similarly, Slamet & Rosadi (2024) found no relationship between SSB size and financial performance. In Islamic banking, the composition of SSBs generally

complies with the minimum requirement set by Bank Indonesia, which mandates at least two members. Furthermore, many SSB members hold multiple roles across different Islamic banks, reducing the number of members available for each board. This practice may compromise the independence of SSB members, as outlined by AAOIFI standards (Baklouti, 2022).

These results also highlight a disconnect between the financial outcomes of Islamic banking operations and SSB performance. SSB oversight of Islamic banks appears insufficient in fulfilling key responsibilities such as coordination, supervision, and reporting (Satifa & Suprpto, 2020). This inadequate oversight negatively affects public perception and trust in Islamic banking services, ultimately impacting financial performance (Hikmah & Oktaviana, 2019). Therefore, strengthening the role of SSBs is essential to improve the financial performance of Islamic banking institutions.

The Influence of SSB Characteristics on Islamic Social Reporting

The findings revealed that the characteristics of the SSB significantly impact the Islamic banking industry's ISR. This conclusion is supported by the observations made during the study. According to the theory that SSB characteristics can influence ISR, these results align with the hypothesis. The findings are consistent with earlier studies by Othman and Thani (2010), Sutapa and Hanafi (2019), Farook et al. (2011), Rahma and Bukair (2015), Amran et al. (2014), and Ullah et al. (2019), all of which suggested that SSB characteristics can affect the disclosure of ISR in Islamic banking.

The involvement of women in the SSB significantly influenced the study's results. Liu (2018) highlights the positive impact of gender diversity in companies. Previous research has shown that female board members contribute to more extensive disclosure practices (Fernandez-Feijoo et al., 2012). Additionally, the presence of women on the board can enhance an organization's commitment to corporate social reporting and disclosures (Amran et al., 2014; Ullah et al., 2019). Therefore, the inclusion of women in SSB memberships may lead to increased ISR disclosure within the banking sector.

The SSB plays a vital role in ensuring compliance with Islamic laws and principles, fostering social responsibility, and promoting the disclosure of Islamic bank (ISR) information (Musa et al., 2023). From an agency theory perspective, the role of the SSB as a principal requires Islamic bank management to disclose ISR information. Transparent ISR disclosure builds public trust, ultimately leading to improved profitability and financial performance for Islamic banks (Hariyanti & Annisa, 2021).

The Influence of Islamic Social Reporting on Islamic Banks' Financial Performance

The findings of this study demonstrate that the Islamic Social Reporting (ISR) variable significantly influences financial performance. This result affirms the theoretical proposition that ISR can impact the financial performance of Islamic institutions. The outcome aligns with previous research, including studies by Sunarsih and Ferdiansyah (2016), Nasution et al. (2019), Hosen et al. (2019), and Mubarak (2020), all of which highlight the relationship between ISR and the financial performance of Islamic banks.

The evidence suggests that Islamic banks can enhance their financial performance by increasing transparency in their social and environmental disclosures. The disclosure of social responsibility, which is a fundamental obligation for banks, promotes economic sustainability and fosters public trust, thereby influencing consumers' decisions to select particular financial services. As such, the profitability of banks is positively affected by their social initiatives (Adisaputra & Kurnia, 2021).

This study further examines the social roles of Islamic banks through the frameworks of positive law and Islamic principles. The results indicate that Islamic banks fulfill their societal responsibilities effectively, as evidenced by the disclosure of ISR indicators in their annual

financial reports. Therefore, enhancing transparency in the reporting of social initiatives may have a favorable impact on the financial success of Islamic banks.

The Influence of SSB Characteristics on Islamic Banks' Financial Performance through Islamic Social Reporting

The characteristics of SSB significantly mediated the impact on financial performance through ISR. Hair et al. (2022) categorize the effects of mediation into two types: partial mediation and full mediation. Mediation is considered partial when the mediator variable affects a portion of the relationship between the independent and dependent variables. Although the independent variable significantly affects the dependent variable, the mediator further clarifies the variance in the dependent variable. This suggests that most of the effect of the independent variable on the dependent variable is conveyed through the mediator, but direct influences persist.

Full mediation occurs when the mediator provides a comprehensive explanation of the connection between the independent and dependent variables. When the direct influence of the independent variables on the dependent variable is not significant, but the effect becomes significant upon including the mediator variable, all of the influence of the independent variables on the dependent variables is transmitted through the mediator variable (Hair et al., 2022).

The analysis indicates that the mediation effect in this study is full. The direct impact of SSB characteristic factors on financial performance is negligible. However, upon the inclusion of ISR as the mediator, the significance level becomes substantial. Consequently, it can be inferred that the impact of SSB on financial performance will be realized if ISR in Islamic banking is sufficiently disclosed.

CONCLUSION

The purpose of this study is to investigate how SSB characteristics, as mediated by ISR, affect the financial performance of Islamic banking. The results of this study found that the characteristics of SSB have no effect on financial performance but have a significant effect on ISR. Meanwhile, the ISR variable has a significant effect on financial performance. The mediation analysis of the ISR variable shows that full mediation occurs. These findings indicate that the role of SSB can improve the financial performance of Islamic banking if they can ensure that the social performance reflected in ISR improves. The study's findings suggest that improving the role of SSB in ensuring the social performance of Islamic banking is necessary. With the increase in social performance, public trust will rise, which can ultimately enhance the profitability of Islamic banking.

This study has several limitations. The data utilized is currently limited; therefore, future research should incorporate additional data by extending the observation period. Secondly, the performance measures employed remain constrained, allowing future studies to broaden the assessment of performance. Consequently, we anticipate further extensive discoveries in this domain.

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