Shariah’s compliance in bank operations guarantees that Islamic bank (IB) directors must maintain. The importance of shariah compliance has not been widely explained by previous researchers, especially the attribute factor of the Shariah Supervisory Board (SSB). Only Basiruddin and Ahmed (2020) have researched shariah compliance using the indicator or shariah non-compliant income (SNCI). This study uses zakat expenditure as an indicator to measure shariah compliance. The study aims to prove the role of the SSB attributes (the number of members, SSB expertise in finance/banking, experience, and educational background in shariah) on the risk of shariah compliance. This study uses a sample of 9 Islamic banks in Indonesia observed from 2010 to 2019. Using unbalanced data, the number of units of analysis is 102 bank years. Data were analyzed using panel data regression. We find that the number of SSB members and the educational background of SSB are proven to increase shariah compliance. However, SSB’s experience and expertise in finance/banking are not proven to affect shariah compliance. In general, SSB’s involvement in strategic bank policy-making to improve shariah compliance is evident.

Keywords: Risk of Shariah Compliance, Shariah Supervisory Board Attributes, Experience, Expertise

1. INTRODUCTION

The demands of Muslims to carry out transactions according to shariah are the primary basis for establishing Islamic banks. In shariah, Muslims are required to transact fairly, free from gharar, maysir usury (interest), transactions for buying or selling illicit goods, and cigarettes (Al Rahahleh, Bhatti, & Misman, 2019; Baydoun, Sulaiman, Ibrahim, & Willett, 2018). Islamic bank (IB) was established to provide banking services and run its business under Islamic law and provide investment instruments and banking services that are halal under shariah (Islamic law) (Šeho, Bacha, & Smolo, 2020).

The existence of the Shariah Supervisory Board (SSB) is required to ensure that the IB has complied with the shariah principles (Hassan & Lewis, 2007). SSB has duties as advisors and supervisors of bank operations and guarantees shariah compliance (Mukhibad & Anisykurlillah, 2020). The development
of bank business operations requires the development of new products to meet customer needs. The development of this new product involves SSB so that the products offered do not violate Shariah rules. Shariah compliance is a guarantee given by bank managers to consumers and is the main factor of customer satisfaction. Studies from Anouze, Alamro, and Awad (2012) for Ali and Raza (2017), Saqib, Farooq, and Zafar (2016) have proven that shariah compliance is a significant factor in customer satisfaction of Islamic banks.

The importance of shariah compliance in banking makes shariah compliance a unique type of risk faced by IBs. In the context of Indonesia, the Financial Services Authority (Otoritas Jasa Keuangan — OJK), the regulator of Islamic banks in Indonesia, has stated that shariah compliance is one of the unique types of IB risk (OJK, 2016). However, the importance of this type of risk has not made researchers explain the risk of shariah compliance and how the roles of BOD and SSB (as IS supervisor and advisor) control this type of risk. From our search, only Basiruddin and Ahmed (2020) have explained shariah compliance as measured by the ratio of non-halal income or shariah non-compliant income (SNCl). The assumption is that the greater the non-halal income obtained by the IB, the less shariah compliance.

Shariah’s non-compliant income is the IB’s income derived from Conventional Bank (CB) interest income (Rosman, Che Azmi, & Amin, 2017). In dual system banking (as adopted by Indonesia), IB and CB can cooperate in providing banking services. The low number of IB branch offices in Indonesia causes IBs to cooperate with CBs by opening an IB service at the CB office. This collaboration allows the IB to earn interest income. The Fatwa of the Indonesian Ulama Council number 123DSN- MUYXV2018 states that interest income is income that cannot be avoided. IBs may accept it because it must be used as social funds and channeled for social activities. This means that SNCl can be purified by issuing its charity (Hanefah, Kamaruddin, Salleh, Shafii, & Zakaria, 2020). Rosman et al. (2017) and Omar and Hassan (2019) found that IBs use SNCl for charity. For this reason, we argue that SNCl is weakly used as an indicator of shariah compliance.

We argue that shariah compliance is more accurately measured by the bank’s concern for the poor by issuing a portion of the bank’s income (zakat). Although there is no consensus among scholars that issuing zakat is mandatory for Islamic banks, there are many verses in the Qur’an that emphasize the importance of paying zakat. Zakat is one of the pillars of Islam, which is mentioned in the Quran in 24 verses (Darussalam & Zulfiqar, 2014). Zakat is evidence of a Muslim’s concern for poverty (Salleh, 2017). IB is considered to carry out socio-economic functions in line with the Prophet’s social justice agenda (Hassan & Lewis, 2007). Zakat is evidence that a bank has carried out a social function (Abdullahi, 2019). Zakat is proven to reduce poverty, increase purchasing power and economic growth (Furqani, Mulyani, & Yunus, 2018; Ayuniyyah, Pramankit, Sadjid, & Rizkia, 2018; Sulaiman, Majid, & Widiastuti, 2021), and also develop small business entrepreneurship (Hoque, Khan, & Mohammad, 2015). The contribution of Muslims in alleviating poverty is also part of the duty of Muslims as *khilafah fill ard.* “The best of people bring the most benefit to the rest of mankind” (Ahmad, ath-Thabrani).

This study contributes in two ways. First, this study formulates a new indicator of shariah compliance. Shariah compliance guarantees that IB directors must maintain, but studies on shariah compliance are limited. We complement the study from Basiruddin and Ahmed (2020) in formulating indicators of shariah compliance.

Second, we evaluate the performance of SSB using four indicators: the number of members, SSB expertise in finance/banking, experience, and educational background in shariah. Following Mukhibad and Anisykuriliilah (2020), Elamer et al. (2020), Zeineb and Mensi (2018), Alnasser and Muhammed (2012), and Alman (2012), SSB has the main task of providing guarantees of compliance with Shariah rules and principles. However, previous studies have linked SSB attributes with IB’s financial performance. Ben Abdallah and Bahloul (2021), Baklouti (2022), Farag, Mallin, and Ow-Yong (2018), and Mollah and Zamani (2015) found that the number of SSBs improved financial performance. Ben Abdallah and Bahloul (2021), Baklouti (2022), and Almutairi and Quttainah (2017) found that expertise in finance/banking attributes improved financial performance. Nomran and Haron (2019) found that the experience attributed to improved financial performance. We expand on the previous literature by explaining the attributes of the number of members, SSB expertise in finance/banking, experience, and educational background to shariah compliance.

The remainder of this paper is structured as follows. The second section describes the theory, conceptual framework, and hypotheses. The third section presents the research sample, variable measurement methods, and data analysis methods. The fourth section presents the research results and the fifth section discusses the findings. The last section presents conclusions, practical implications for banks and regulators, and research limitations.

2. LITERATURE REVIEW

2.1. Agency theory

Based on the agency theory, SSB is a unique board in Islamic banks which acts as a supervisor, consultant to directors and other boards in managing bank assets to obtain bank income following shariah (Farag, Mallin, & Ow-Yong, 2018; Injas, Haron, Ramli, & Injas, 2016). Therefore, the presence of SSB in IB is to ensure that the bank’s operations are following shariah (Mukhibad & Anisykuriliilah, 2020; Elamer et al., 2020; Zeineb & Mensi, 2018; Alnasser & Muhammed, 2012; Alman, 2012). In addition, IB manages depositor funds, which mostly use *mudharaba* contracts, and places directors as investment managers required to manage public funds in profitable strategic projects according to shariah.

Implementing the *mudharaba* contract on savings and time deposits causes depositors to receive profit sharing according to the bank’s performance, and depositors can bear losses if the director fails to manage their funds. With this
To contribute, businesses in Islamic banks, thus SSB is recommended to have policies that are detailed. The presence of SSB as a supervisory director is expected to reduce agency problems in IB. The behavior of directors that are controlled by SSB is to make high-risk investments and even investments in sectors that are prohibited by shariah. Shariah restricts directors from making investments, but due to high liquidity and the high risk of withdrawing funds by the depositor, directors can make risky investments by ignoring the safety and shariah compliance aspects.

2.2. Hypothesis development

SSB has a duty as a supervisor to reduce agency problems in IBs. To increase the effectiveness of the SSB, an SSB requires certain specifications or attributes to finish the tasks (Anisykurilliah, Jayanto, Mukhibad, & Widyastuti, 2020). The first attribute is the number of SSB members. OJK has regulated that IB must have at least two people SSB members. IBs with a high number of SSBs allow IB to choose SSB members with different backgrounds, experiences, expertise, and considerations (Hamza, 2016), thus increasing the quality of strategic decisions (Mukhibad & Anisykurilliah, 2020). The quality of SSB’s supervision of risk-taking will increase because the IB has many SSB members. Safiullah and Shamsuddin (2018) and Al Abbad, Hassan, and Saba (2019) find that the number of SSB members negatively influences the bankruptcy risk and operational risk of Islamic banks. Thus, IBs with a high number of SSB members will increase their supervision (Bukair & Abdul-Rahman, 2013) so that directors take policies to improve shariah compliance.

H1: The number of SSB members negatively influences shariah compliance

SSB as a supervisor and consultant requires competence in financial/banking. These competencies are needed to improve SSB’s understanding of bank business operations. Thus, SSB can assess whether the policies taken by the board of directors include policies that are detrimental or beneficial to the bank. OJK and the Auditing Organization for Islamic Financial Institutions (AAOIFI) have required SSB competence in finance/banking. AAOIFI stated that as a consultant, SSB is recommended to have expertise in business, economics, law, and accounting to complement his expertise in Fiqh al-mu'amalat (Khalid, Haron, Sarea, & Masron, 2018). SSBs who have experience in finance/banking will carry out their duties effectively (Almutairi & Quttainah, 2017; Ghayad, 2008). Practical supervisory and consulting duties can reduce managers’ high-risk policies (Najwa, Ramly, & Haron, 2019), including avoiding the risk of shariah non-compliance. SSB’s expertise in finance/banking will make it easier for SSB to understand financial reports and allow SSB to access policies and issues related to financial reporting, including risk assessment and management (Basiruddin & Ahmed, 2020). Basiruddin and Ahmed (2020) found that SSBs with expertise in finance would increase shariah compliance.

H2: SSB’s expertise in finance/banking negatively influences shariah compliance

OJK and AAOIFI are argued that SSB must have competence in the field of shariah. SSB is an advisor to directors and other boards so bank operations comply with shariah rules and principles (Bukair & Abdul-Rahman, 2013). The board of directors requires SSB’s ability to explain transactions and business fields prohibited and permitted by shariah. Thus, directors need to be sure that policies are not in accordance with shariah can be avoided. SSB, which has an educational background in shariah, has more control over Fiqh al-mu'amalat (Khalid et al., 2018). This ability is needed as human capital in consulting with the board of directors in formulating strategies or developing new products. Following this argument, we developed the proposition that SSB with a shariah educational background encourages managers to improve shariah compliance.

H3: SSB’s educational background in Islamic law or shariah negatively influences Shariah compliance

The experience hypothesis theory reveals that long-term board involvement will increase experience, commitment, and greater competence and provide essential knowledge about the company and its business environment (Kor & Sundaramurthy, 2009; Vafeas, 2003). This knowledge and experience are essential for board members to contribute effectively to the company’s strategic growth (Kor & Sundaramurthy, 2009) and foster innovation (Kimberly & Evanisko, 1981). SSB, which has to control and provide business advice to directors, requires an understanding of the bank’s business environment. This understanding can be realized when SSB is involved in the company’s business decisions in the long term.

SSB’s experience in carrying out its duties can be measured by tenure (Anisykurilliah et al., 2020). SSB, with a long tenure, positively affects SSB’s knowledge of operations and the bank’s business environment. SSB tenure will improve SSB’s competence in providing supervision and consulting services because the solutions have been more concerned with the bank environment. The long tenure will cause SSB to have an excellent ability to control the director.

H4: SSB experience has a negative influence on shariah compliance

3. METHODOLOGY

This study uses Islamic banks in Indonesia with a total of 14 banks. Of the 14 Islamic banks, 2 Islamic banks do not report zakat expenditure. So, we use 12 Islamic banks as a research sample.
with an observation period of 10 years (2010–2019). We collect all data manually based on the annual reports issued by each bank and data analysis using a fixed-effect model.

The following methods measured the variables:
1. SSB size measured by the number of SSB members (Safiullah & Shamsuddin, 2018; Bukair & Abdul-Rahman, 2013).
2. SSB’s expertise in finance/banking (SSBFIN) is measured by the ratio of SSB members who have an educational background in finance/banking (Safiullah & Shamsuddin, 2018).

We argue that the expertise in finance/banking is 23.03%, while SSB with expertise in Shariah is 33.16%. Many SSB with expertise in Shariah has experience of 2.34, indicating that many IBs have an average tenure of 6.658 years (2010–2019). Financed by zakat received (21.25) greater than the average zakat distributed (20.95). The average number of SSB members is 2.34, indicating that many IBs have a minimum number of SSB members (two members). SSB with expertise in finance/banking is 23.03%, while SSB with expertise in Shariah is 33.16%. Many SSBs in Indonesia do not have Islamic education background or finance/banking from this outcome. Table 1 also shows that SSB members have an average tenure of 6.658 years. This tenure indicates that there is rarely a change in SSB members in IBs in Indonesia.

**Table 1.** Statistical descriptive

| LNZEXP | SSBSIZE | SSBFIN | SSBEXP | SSBSYA | BODINDEX | FTA | LEV | SIZE |
|--------|---------|--------|--------|--------|----------|-----|-----|------|
| Mean   | 20.9548 | 2.343137 | 0.230392 | 6.658497 | 0.331699 | 0.555556 | 145.7891 | 34.40374 | 29.61498 |
| Median | 21.84678 | 2.350000 | 0.006000 | 6.000000 | 0.331333 | 0.666667 | 705.1542 | 18.61464 | 29.49004 |
| Maximum| 24.65105 | 3.090000 | 0.666667 | 17.50000 | 1.000000 | 1.000000 | 3186.609 | 96.82249 | 32.33212 |
| Minimum| 12.88106 | 2.000000 | 0.000000 | 0.000000 | 0.000000 | 0.000000 | 0.000000 | 5.849910 | 25.93341 |
| Std. Dev.| 2.760070 | 0.477101 | 0.253734 | 3.833181 | 0.246533 | 0.195287 | 432.5018 | 29.80005 | 1.417645 |

**Table 2.** Matrix correlations

| SSBSIZE | SSBFIN | SSBSYA | SSBEXP | BODINDEX | FTA | LEV | LNASSETS |
|---------|--------|--------|--------|----------|-----|-----|----------|
| SSBSIZE | 1.0000 |   0.3764 |       |         |     |     |          |
| SSBFIN  | 0.3764 |   1.0000 |       |         |     |     |          |
| SSBSYA  | 0.2757 |   0.2923 |       | 0.3305 |     |     |          |
| SSBEXP  | 0.2923 |   0.3305 |       | 1.0000 |     |     |          |
| BODINDEX| 0.2007 |   0.1221 |       | 0.1904 | 0.2954 | 1.0000 |          |
| FTA     | -0.1138 | 0.0799 |       | 0.2042 | 0.0175 | -0.1624 | 1.0000 |
| LEV     | -0.0337 | 0.1262 |       | -0.1347 | -0.2076 | 0.0302 | 0.2318 | 1.0000 |
| LNASSETS| 0.3419 | 0.3408 | -0.1677 | 0.3444 | -0.1031 | -0.3041 | -0.3268 | 1.0000 |

**4.2. Model test results**

Table 2 shows the correlation test result between the independent variables of > 0.8 and shows no strong correlation between the independent variables. The Durbin-Watson test resulted in a Durbin-Watson statistic score of 1.869, Durbin-Watson (DW) score > Durbin Upper (U) (1.031) and indicates no autocorrelation. The Breusch pagan Godfrey test resulted in a probability chi-square (PCS) score of 0.601. PCS score > 0.05 and indicates that the regression model is homoscedastic.

The regression test result using fixed-effect are presented in Table 3 and show that SSBSIZE has a coefficient of 1.445453 and a probability of 0.000000 lower than 0.01. This result rejects H0 (null hypothesis) at 1% and indicates that SSBSIZE positively affects shariah compliance. SSBFIN returns
are -1.390248, and the probability is 0.1742. The probability score is greater than 0.1 and indicates that SSBFIN does not affect shariah compliance. SSBEXP produces a coefficient of 0.023383 and a probability of 0.5548. The probability score is greater than 0.1 and indicates that SSBEXP does not affect shariah compliance. SSSBFIN produces a coefficient score of -1.779872 and a probability of 0.0860. The probability value is < 0.1 and decides to reject H0 and indicates that SSSBFIN has a negative effect on shariah compliance.

### Table 3. Regression panel data

| Variable   | Coefficient | Std. Error | T-statistic | Prob.  |
|------------|-------------|------------|-------------|-------|
| SSBSIZE    | 1.443433    | 0.294001   | 4.906481    | 0.00000*** |
| SSBFIN     | -1.390248   | 1.010898   | -1.375260   | 0.1742 |
| SSBEXP     | 0.023383    | 0.039757   | 0.539307    | 0.5748 |
| SSSBFIN    | -1.779872   | 1.012725   | -1.743932   | 0.0860 |
| BODINDEX   | 0.039204    | 0.354375   | 0.110630    | 0.9123 |
| FTA        | 0.001004    | 0.000350   | 3.045553    | 0.0104*** |
| LEV        | -0.001133   | 0.000350   | -0.323452   | 0.7475 |
| LNASSETS   | 0.646531    | 0.234758   | 2.754028    | 0.0078*** |
| C          | -1.299988   | 0.719899   | -1.943435   | 0.0787*  |

Note: ***, **, * significant at 1%, 5%, and 10%, respectively.

### 4.3. Additional test

In this subsection, we summarize the four attributes of SSB by developing the SSB index indicator. We give a score of 1 if the bank has each SSB attribute greater than the average attribute score of the entire sample and vice versa, a score of zero. The scores of the four SSB attributes are calculated as the SSB index as a proxy for SSB diversity. This method was also used by Khan and Zahid (2020), Aljughaiman and Salama (2019), and Mollah, Hassan, Al Farooque, and Mobarek (2017). The results of the Hausman test produce the value of the chi-square statistic is 1.7253 with a probability of 0.8857. The results of the Hausman test recommend the random-effect model to analyze the data.

### Table 4. Additional test

| Variable   | Coefficient | Std. Error | T-statistic | Prob.  |
|------------|-------------|------------|-------------|-------|
| SSBINDEX   | 3.752533    | 1.430133   | 2.629094    | 0.1014*** |
| BODINDEX   | 0.117281    | 0.911113   | 0.129269    | 0.8975 |
| FTA        | 0.001529    | 0.000530   | 2.899348    | 0.0005*** |
| LEV        | 0.006159    | 0.006832   | 0.928641    | 0.3415 |
| LNASSETS   | 0.908131    | 0.276584   | 3.283384    | 0.0015*** |
| C          | -0.555274   | 8.133787   | -1.174763   | 0.2436 |

Note: ***, **, * significant at 1%, 5%, and 10%, respectively.

Table 4 shows that the SSB index positively affects compliance with shariah rules and principles (Bukair & Abdul-Rahman, 2013). These results confirm the role of SSB in shariah compliance. SSB encourages IBs to spend part of the income received as zakat and channel it to social activities. These results strengthen the findings of Mukhibad et al. (2017) that corporate governance improves the performance of bank zakat. SSB is one of the unique boards in the corporate governance structure of IBs and encourages IBs to comply with shariah.

### 5. DISCUSSION

Table 3 shows that the number of SSB members positively influences the risk of shariah compliance. This result is different from the findings of Mukhibad and Setiawan (2020), which found that the number of SSB members does not influence the distribution of zakat. IBs with many SSBs allow IBs to choose SSB members with various backgrounds (Hamza, 2016). In doing so, the IB can carry out this diversity of expertise, education level, experience, expertise, gender, age, and other backgrounds to provide consideration in making business decisions so that it impacts improving the quality of SSB decisions. For example, in making business decisions to distribute zakat, SSB members need considerations from the shariah aspect, and economic reasoning, customer trust, and regulations. So that this SSB diversity will increase business decisions (Mukhibad & Anisikyurillah, 2020). The results of this study indicate that IBs who have a high number of SSB members will advise the director to pay corporate zakat, collect professional zakat for employees, and zakat from customers, then distribute zakat according to shariah rules.

We find that SSB’s expertise in finance/banking does not affect shariah compliance. OJK and AAOIFI have suggested that IBs have SSB with expertise in finance/banking as a complement to SSB expertise in sharia. This expertise is essential because the task of SSB is involved in making bank business decisions in the form of evaluating the conformity of shariah on bank products. So, SSB requires expertise in sharia, finance/banking (Khalid et al., 2018; Isa & Lee, 2020; Najwa et al., 2019; Mukhibad & Anisikyurillah, 2020). However, SSB’s expertise in finance/banking did not direct the directors to increase the zakat distributed by banks. There is an allegation that the financial/banking background is more directed at making policies that can improve the economic performance of the bank, and the zakat distributed by IBs does not have an economic impact on the bank (Mukhibad, Anisikyurillah, Nurkhin, & Jayanto, 2019). Moreover, Mukhibad et al. (2019) found that zakat expenditure had no impact on return on assets and return on equity.
This study found that SSB’s expertise in finance/banking did not influence shariah compliance. OJK and AAOFI have suggested to IBs to have SSB with expertise in finance/banking as a complement to SSB expertise in shariah. This expertise is important because the task of SSB is involved in making bank business decisions in the form of evaluating shariah compliance for products developed by banks, and the task requires expertise in shariah and finance/banking (Khalid et al., 2018; Isa & Lee, 2020; Najwa et al., 2019; Mukhibad & Anisykurlillah, 2020). However, SSB’s expertise in finance/banking did not directly direct the directors to increase the zakat distributed by banks. There are possibilities that the financial/banking background is more directed at making policies that can improve the economic performance of banks. Zakat distributed by IB does not have an economic impact on the bank (Mukhibad et al., 2019).

The educational background of SSB in the field of shariah is proven to have a negative influence on shariah compliance as proxied by zakat expenditure. This means that SSB with Islamic education background has a negative impact on bank policies to distribute zakat. This is because the Indonesian Ulema Council ( Majelis Ulama Indonesia — MUI) has not issued a fatwa that requires IBs to issue part of their income as zakat. Zakat has been mentioned in the Quran in 24 verses (Darussalam & Zulfiquar, 2014) and is evidence of Muslim concern for poverty (Salleh, 2017). However, scholars have not classified IB as muzakki who are obliged to pay zakat. This is corroborated by the existence of Bukopin Syariah and Maybank Syariah, which do not publish reports on sources and uses of zakat funds.

SSB experience is not proven to influence shariah compliance. These results corroborate the findings Anisykurlillah et al. (2020), which found that SSB tenure has no effect on fraud prohibited in Islam. This finding contradicts the experience hypothesis theory, which reveals that the involvement of SSB in bank operations in the long term will increase experience, commitment, competence, and expertise. Furthermore, this competence has an impact on improving the quality of SSB outcomes, increasing bank performance, and increasing shariah compliance. The involvement of SSB in bank operations will provide important knowledge about the company and its business environment (Kor & Sundaramurthy, 2009; Vafeas, 2003). This knowledge and experience are essential for SSB in making strategic bank policies. However, the involvement of SSB does not encourage IBs to increase zakat expenditure.

6. Conclusion

In general, this study shows that SSB positively influences shariah compliance. However, when viewed from each SSB attribute indicator, the number of SSB members positively influences shariah compliance. SSB’s educational background in shariah negatively influences shariah compliance. SSB’s experience and expertise in finance/banking do not affect shariah compliance. However, in general, SSB has been shown to have a positive impact on shariah compliance.

The contribution of this research is that SSB should encourage directors to take bank policies to pay zakat for banks, employees, and customers and distribute zakat funds to charities. The activity of collecting and distributing zakat is proof that the IB carries out social functions as a complement to commercial activities. The IB is advised to appoint SSB members who have competencies that can support the bank’s performance, and it is necessary to evaluate the performance of the SSB. This action is to increase the effectiveness of SSB in carrying out its duties. Regulators need to encourage IBs to carry out their social functions by increasing zakat collection and distribution activities.

This study develops a measuring instrument for shariah compliance as measured by the distribution of zakat. Although no fatwa obliges IB to pay zakat, shariah compliance measurement tools must still be developed. Paying zakat is proof of IB’s involvement in reducing poverty and contributing to the development of the people’s economy, which is emphasized in the Qur’an. Other researchers can develop other zakat compliance proxies to complement this research.

The limitation of this study is that it uses one indicator (zakat compliance) to measure shariah compliance. Further study can develop and use several indicators that can explain shariah compliance in Islamic banks.

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