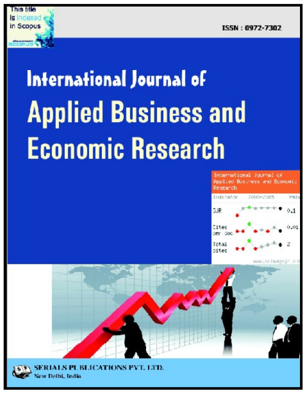

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The Effect of Islamic Corporate Governance (ICG) and Islamic Corporate Social Responsibility (ICSR) Disclosures on Market Discipline with Financial Performance Used as Intervening Variables (Empirical Study on Shariah based Banks Operating in QISMUT Countries)

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Abstract: This research aim to determine the effect of Islamic Corporate Governance (ICG) and Islamic Corporate Social Responsibility (ICSR) disclosures on market discipline using financial performance as intervening variable. The magnitude of ICG and ICSR disclosures are represented by the disclosure rate taken from the IFSB and AAOIFI annual reports, as well as relevant prior standard researches. The deposits growth ratio is used to measure Market discipline and financial performance is measured by two profitability ratios namely ROA and ROE. Our research sample is made of 42 Islamic Banks operating in the six QISMUT countries, in a study period of 2013 to 2015; those banks were selected using purposive sampling method. The hypothesis testing we run is path analysis using trimming model. We found out that the disclosure rates of ICG and ICSR are quite high, 62% and 60% respectively. The empirical test results have shown that the disclosure rates of ICG and ICSR have a direct and positive effect on the financial performance and the market discipline of Islamic Banks. However, the variable financial performance has no significant effect on market discipline, meaning that the variable financial performance cannot be use as intervening variable for ICG and ICSR disclosures toward market discipline in Islamic Banks Industry.

INTRODUCTION

The so-called Islamic banks or Shariah based banks are institutions that are not high profit oriented, but institutions created in order to drive Muslims in particular as well as other users, into a healthy financial system with respect of all the rules and requirements that are in line with Islamic law. They are created to provide financial services in accordance with the principles of Shariah (the Islamic jurisprudence). Islamic

Banks constitute a financial system that is free from the practice of usury, Maysir, and Gharar. The fast development of Islamic Banks over the world is also considerate as a response of the global financial crisis repeatedly caused by wrong behaviors of economic actors who have indecently violated the code of ethics, religion, and moral values of the banking sector (Hasan Z., 2009).Globally Islamic finance has experience significant growth in recent years. On the IFSB 2016, report it is stated that on the year 2015 the value of Shariah based global finance asset has reached 1.88 trillion USD. Regionally, Islamic finance is still concentrated in the Middle East region of the Gulf region or commonly referred to as the GCC (Gulf Cooperation Council)[3] and the Middle East region other than the GCC countries or the so-called MENA (Middle East and north Africa). Another area where Islamic finance is quite developed is Asia with countries like Malaysia, Indonesia, Pakistan and Bangladesh leading the practice. Finally, we also can find Islamic finance practice in some European countries such as Britain, Turkey and Germany.

According to Ernst & Young who stated inside *the world Islamic banking competitiveness report 2013-2014*, Islamic banks serve about 38 million peoples worldwide, with two-thirds of customers concentrated in seven countries: Qatar, Indonesia, Saudi Arabia, Malaysia, UAE, Turkey and Bahrain. Excluding Bahrain, the six other countries cited above are among the 25 fastest growing markets in the world regarding Islamic banks. These six countries are now known through a new term because of the speed under which they show dominance regarding Islamic based financial Industry, they are known under the appellation of "QISMUT": Qatar, Indonesia, Saudi Arabia, Malaysia, UAE, and Turkey. In 2012, QISMUT was controlling 78% of the world global Shariah based banking assets for over 567 billion USD. The growth of CAGR of Shariah based banks in 5 years (2008-2013) is amounted to 16.4%. By 2018, it is predicted that QISMUT Shariah based banks assets will reach 1.6 trillion USD and in the range of 2013-2018 CAGR would growth by 19.7%. These six countries are therefore considered as key countries regarding the growth of global Islamic finance (Lackmann, 2014) as well as major players driving the movement of the global Shariah based banking industry awareness.

Qatar: Qatar belongs to the GCC country. By 2014, the total assets of Shariah based banks in Qatar has reached 72 billion USD, which was the fourth highest rate among QISMUT countries. The average growth of Qatar Shariah based banks assets between 2010 and 2014 was 22%. The national market share of Shariah based banking industry in Qatar was 26%, while the global market was 8% and the share among QISMUT countries was 10% (Ernst & Young, 2016).

Indonesia: The evolution of Shariah based banking industry in Indonesia began in 1992 with the first Islamic based bank call Bank Muamalat Indonesia (BMI). Until now Shariah, based banking sector in Indonesia continues to experience growth, with a yearly average increasement of 33.2% over the last 10 years. In 2015, the number of Shariah based banks in Indonesia was amounted to 13 BUS (Shariah based Commercial Bank) and 26 UUS (Shariah Business Unit). The Shariah based banking Industry assets in 2014 were estimated of 22 billion USD with a national market share of 4.8%, which represented 3% QISMUT market share, and 2.5% of the global market share, which was the lowest rate among QISMUT countries.

Saudi Arabia: Saudi Arabia is the country with the biggest assets of Shariah based banks in the world reaching 291 billion USD in 2014 with a national market share of 51.2%, 41% of QISMUT market share, and a global market share of 33%. The growth rate of Shariah based banks in Saudi Arabia averages 20% per year in the 2010-2014 range. The largest Islamic based banks in the world are also located in Saudi Arabia, namely Al-Rajhi and Islamic development Bank (IDB).

Malaysia: Malaysia is the center of Islamic finance in East Asia and even globally with 10 local Shariah based banks and seven foreign banks that open Shariah based services. The value of Malaysia's Islamic finance assets has reached 137 billion USD in 2014 with a national market share of 21%, QISMUT countries market share of 20%, and global market share of 16% which is the second highest among QISMUT countries. The average growth of Malaysia's Shariah based banks is 14% between 2010 and 2014, which was two times higher than conventional banks growth that was only 6% at the same period.

Turkey: As a country with a strong Islamization history, Turkey also does not want to be left behind regarding Islamic Finance Industry. In recent years, Shariah based banks have begun to grow quite well in Turkey. The total assets of Shariah based banks Industry in Turkey has reached 45 billion USD in 2014 with a national market share of 6%, a 6% market share of QISMUT countries and a global market share of 5%. The average growth of Shariah based banks during the period between 2010 and 2014 was amounted to 12%, compared to conventional bank which growth of 7%.

UEA: The UAE is as well one of the Islamic based financial centers in the bay area, along with Saudi Arabia, Bahrain, and Qatar. The total assets of Shariah based banks industry in 2014 has reached 136 billion USD with a national market share of 22%, and 19% of QISMUT countries market share, and a global market share of 15% which is the third highest among QISMUT countries. The average growth of Shariah based banks in the UAE has reaches 13% per year between 2010 and 2014, higher than the conventional banks that has grown only 9%.

The enhancement of the of concept of CG in the banking industry is quite extensive and deep, especially in conventional banking industry, ranging from the Anglo-Saxon model which is more likely to consider shareholders' interests, and the European Model which is more oriented to consider the interests of many stakeholders. On the other hand, very few discussions had been raised on CG regarding the Islamic finance sector perspective or Islamic Corporate Governance (ICG), especially in the context of Islamic banking, whereas the so-called Shariah based banking has started to show significant developments since the 1970s. (Yunis, 2007).

CG can't now be separated from the development of a company, especially for the Islamic financial system and more specifically Shariah based banking companies. The challenge of implementing ICG for Shariah based banking companies are however much more greater than conventional banking system, the use of Shariah based contracts have different characteristics of risks. Such as the application of mudharabah or musyarakah based contracts with depositors (Chapra M., 2007). Therefore, Shariah based banking must be able to apply GCG well in order to grow and develop better.

LITERATURE REVIEW

Several previous studies have shown that the levels of CSR disclosure in Shariah based banks are still low (below 50% average). Hassan & Harahap (2010) 38%, Farook, Hassan & Lanis (2011) 16.8%, Aribi & Gao (2011) 30%, Mosaid & Boutti (2012) 25%, Kamla & Rammal (2013) 39%, Farag, Mallin, & Ow-Yong (2014) 44%, El-Halaby & Hussainey (2015) 26%. Only a small proportion of studies have shown high level of CSR disclosure in Islamic banks (above 50%) such as Sofyani, Ulum, Syam, & Wahjuni (2012) and Rahman & Bukair (2013) 83%.

Disclosure of CSR can also improve a company's financial performance. Arshad, Othman, & Othman (2012) has examined the annual report of 17 Shariah based banks in Malaysia from 2008 to 2010. The results of their research have shown that CSR activities published in annual reports, significantly affect the company's reputation and performance. These results suggest that CSR activities and their disclosures in Islamic perspectives are as important as business strategies in creating sustainable competitive advantage.

CSR in Shariah based banks also gets responses and inputs from stakeholders as part of market discipline mechanism. The results of Dusuki & Dar (2007) research have shown that customers and depositors react to CSR in Shariah based banks. Most of the customers (51%) and depositors (53%) give their opinion regarding the implementation of CSR in Shariah based banks; they would even punish Islamic banks if they do not run CSR programs by withdrawing their funds and switch them to other Shariah based banks that are more socially responsible. These results have shown that CSR is one of the factors affecting reputation of Shariah based banks in the eyes of depositors. In other words, the implementation and disclosure of CSR will enhance the reputation of Islamic banks (Arshad, Othman, & Othman, 2012).

Disclosure of information required by corporate stakeholders is a form of transparency in the improvement of market discipline. Market discipline in the banking sector can be interpreted as a situation where private sector agents face costs because of banks taking risky actions, and taking action on a cost basis. One of the prerequisites of an effective market discipline is the transparency of bank information to depositors. Where from the received information, depositors act by taking decision regarding their funds. Several empirical research have indicated the presence of market discipline, where depositors whose deposits were not guaranteed, have responded by withdrawing them (quantity mechanisms) or demanding high returns (pricing mechanisms) (Alaeddin, Abojeib, & Shah, 2015).

Market transparency and market discipline in Shariah based banks are important as an application of profit sharing system, whereby Islamic bank depositors will face a higher risk than conventional bank customers who receive clear results and fixed benefits (Hasan, 2013). With the profit-sharing agreement, the mater of uncertainty plays a role, so the risk is higher than the conventional banks where the investment results are certain with the use of interest rate. This statement is reinforced by the results of the perceptional empirical research conducted by Ariffin, Archer, & Abdel Karim (2007), who have stated that the disclosure of risk and transparency in Shariah based banks associated with the profit-sharing system are more emphasized than in the conventional banks. On the other hand, the results of their research also have shown that Islamic banks are still lacking of transparency and disclosure of risks to the public, or in other words, transparency is not optimal. These findings have highlighted the importance of increasing transparency and market discipline in Shariah based banking sector. More specifically, IFSB (2016) has stated that disclosure by Islamic banks of both financial and non-financial information to depositors may increase transparency and market discipline.

One of the factors affecting market discipline is financial performance. Riandika & Taswan's research (2015) has shown that ROA and CAR have a positive effect on market discipline with the growth of bank deposits as a proxy.

1. Corporate Governance (CG)

The official OECD (2004:11) definition of corporate governance is "*a set of relationships between a company's management, its board, its shareholders and other stakeholders*".

BCBS (2006:4), inside his report entitled 'Enhancing Corporate Governance for Banking Organizations' has defined corporate governance in banking sector by these terms:

> *"the manner in which the business and affairs of individual institutions are governed by their BOD and senior management affecting how a bank sets its corporate objectives, daily business, interest of the stakeholder, to align corporate activities operate in a safe and sound manner and to comply with laws and regulations, and to protect the interest of depositors".*

This definition explain more specifically corporate governance in banking sector. BCBS gave the explanations that 'stakeholder' of a bank are supervisors, government, depositors, customers, and employees.

However corporate governance in Islamic Finance Institution (LKS) especially Shariah based banks from IFSB 03 inside the Guiding Principles On Corporate Governance For Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions And Islamic Mutual Funds) is defined as follow:

> *(i) a set of organizational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders; (ii) provision of proper incentives for the organs of governance such as the Board of Directors, SSB and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging IIFS to use resources more efficiently; and; (iii) compliance with Islamic Shariah rules and principles.*

In the Islamic perspective, several studies attempt to provide an alternative corporate governance model for Shariah based companies. Those studies have shown that Shariah based firms can adopt corporate governance models based on Islamic teachings, which are completely different from western models such as the Anglo-Saxon model and the European model (Hamid, Haniff, Othman, & Salin, 2011).

Some researchers such as Lewis (2005), Hasan (2009), (Abu-Tapanjeh, 2009) and (Bhatti & Bhatti, 2010) had introduced the term of corporate governance in an Islamic perspective by Islamic Corporate Governance (ICG). This study also uses the term Islamic Corporate Governance (ICG) to describe corporate governance in Islamic perspectives on Shariah based banks.

Bhatti & Bhatti (2010) explains that ICG tries to guide economic agents, legal systems and corporate governance to apply moral and social values based on Shariah's law. Various economic activities of corporates and several business activities are based on the ethnoreligious paradigm with the sole aim of the wellbeing of individuals and the society as a whole. ICG refers to the values of Islam; it tries to integrate Islamic law with the stakeholder model in corporate governance.

According to Lewis (2005), there are two properties of ICG. First, internal ethics and social aspects of the company should refer to Islamic law. Secondly, ICG should also refer to business ethics and principles of Islamic economics and finance such as zakat, riba prohibition, ban on speculation, and to develop an economic system based on profit and loss sharing.

There are two Modes of ICG, Choudhury developed the first one Choudhury & Hoque (2006) based on the principle of Shura / Musyawarah where all stakeholders have the same goal of Tawheed and unity of Allah. While the second mode is a modification of the stakeholder model developed by Iqbal & Mirakhor (2004) and Chapra & Ahmed (2002).

IFSB 10 in 2009 Guiding Principles on Shariah Governance System in Institutions Offering Islamic Financial Services it is given the following definition of Shariah Governance:

> "a set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information and an internal Shariah compliance review".

To understand more about Shariah governance, there are at least three major components from this definition above:

i) The set of institutional and organizational arrangements: Institutions and organizations in question here are the Shariah Supervisory Board (DPS) and other relevant institutions such as the Department of Internal Audit and Shariah Division.

ii) Effective independent oversight of Shariah compliance: Shows that the purpose of Shariah governance is to provide effective Shariah compliance mechanism.

iii) Shariah pronouncements, dissemination of information and an internal Shariah compliance review: Includes a comprehensive process of Shariah governance that includes ex post and ex-ante the framework of Shariah compliance.

From this definition, we can observe that DPS has an important role in Shariah governance system as a functioning agency to ensure Shariah compliance. DPS can be interpreted as an independent body entrusted to direct, supervise, and review the activities of LKS are in accordance with the principles of Shariah and by providing guidelines on the issues of Shariah.

Shariah governance is a unique and distinctive tool of corporate governance systems in general in financial institutions management. Generally the corporate governance regarding the banking system consists of BOD, internal / external Auditors, and Department / division / regulatory compliance finance officers, who act each as governance unit, control unit, and compliance unit. Regarding Shariah banking it should be added special institution of each of these above functions to ensure that the Shariah compliance unit run well, it consist of DPS unit, Internal and external Shariah review unit, and Division of internal Shariah compliance unit.

2. Corporate Social Responsibility (CSR)

The term CSR refers to the activities of an outside company, for a profit oriented, such as protecting the environment, employee attention, ethics in business transactions, and corporate engagement in local community activities. The European Commission (2001) defines CSR as "a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis". This definition provides an explanation that CSR is an effort to integrate social aspects to a company's business activities. Mcwilliams & Siegel (2001) have defined CSR "as actions that appear to further some social good, beyond the interests of the firm and that which is required by law".

Carroll (1979; 1991) has described the concept of CSR with four main components or known as concepts "The Pyramid of Corporate Social Responsibility" which is composed of Economic, legal, ethical and philanthropic responsibilities.

i) Economic responsibilities require companies to be profitable, to provide job opportunities with good wages for employees, and be able to produce goods and services needed by the community.

ii) Legal responsibilities Requires the companies to work in accordance with the legal framework applicable in a country. The legal liability of companies is not limited to shareholders and investors, but includes employees, communities, and the environment.

iii) Ethical responsibilities demonstrate the need for high ethical business practices, doing the right thing, fair actions, and avoid various causes of social conflict. Ethical responsibilities are a positive practice for companies although not specifically legislated.

iv) Philanthropic responsibilities reflect the company's contribution to community activities and programs in addition to its economic, legal and ethical responsibilities. Such as donations to social organizations and scholarships for students.

Various Western theories seek to offer theoretical, moral and ethical reasons for CSR development. However, this effort has been heavily criticized for issues related to justification, clarity of the concept, the possibility of occurrence of inconsistency and failure to provide sufficient ethical guidance to business executives for increasing their level of professionalism and commitment. Therefore, there is a need to enhance the concept of CSR, which can be recognized and gained wide acceptance among Western and Islamic business societies, especially from an Islamic perspective (Khurshid, Al-Aali, Soliman, & Amin, 2014).

Several previous studies have attempted to develop the concept of ICSR as an attempt to reduce the weaknesses of conventional CSR concepts and create Islamic CSR-based concepts of CSR, such as (Farook, 2007) (Dusuki & Abdullah, 2007); (Dusuki, 2008); (Williams & Zinkin, 2010); (Khurshid, Al-Aali, Soliman, & Amin, 2014); and (Yusuf & Bahari, 2015).

Williams & Zinkin (2010) had compared the principles of Islam with the CSR concept of the UN inside the Global Compact that includes human rights, labor rights, environmental issues and anti-corruption principles. They argued that the concept of Islam has a wider scope than the Global Compact. First, Islam has a wider scope, for example in terms of human resource development and in terms of transparency of transactions. Second, Islam has clear provisions regarding what is allowed (halal) and what is forbidden (haram). Thirdly, Islam has a proper Shariah enforcement mechanism.

Farook (2007) has explained that there are three basic principles of ICSR derived from one concept of the Qur'an that is Caliphate (vicegerency), divine accountability, and amar ma'ruf nahi munkar (Enjoining Good and Forbidding Evil). According to the principle of Caliphate, man is created as the leader and the responsible, held by Allah SWT to prosper the earth (QS 2:30, 6: 165). As a Khalif, mankind have a great responsibility; after he has been given the ability to take advantage of everything that Allah SWT make available for him as a means of maximizing his own added value and for the whole society (Elasrag, 2015).

The principle of divine accountability comes from the principle of Caliphate where humankind will be held accountable in the Hereafter for the trust, which Allah has given to him (QS 4:86, 99: 7-8). Divine accountability encompasses all human activity, which in turn represents an organization (Farook, 2007). The principle of amar ma'ruf nahi munkar (Enjoining Good and Forbidding Evil) is the issue of perfecting those two principles, in which Allah Almighty commands people to do good and avoid bad deeds (QS 9:71). (Dusuki, 2008) had added two key principles of ICSR, Shariah and the paradigm of piety. Shariah is the Islamic law that must be obeyed by individuals. While the paradigm of piety is the key to Shariah compliance.

Furthermore, Dusuki & Abdullah, (2007) have explained the concept of ICSR with the approach of Maqashid Shariah and Mashlahah. The Maqashid Shariah approach was introduced by Al-Ghazali (1322) to align the purpose of implementing the ICSR with the five Shariah objectives; Religion (Diin), Soul (Nafs), Reason (Aql), Descendants (Nasl), and Property (Maal). The Mashlahah concept refers to Al Shatibi known as "the Mashlahah Pyramid", making the practice of CSR divided into three categories based on need; Dharuriyyah (primary), Hajiyyah (secondary), and Tahsiniyyah (tertiary). This category can be used by companies and managers to consider the facts and situations of the companies in implementing CSR, and can be a good framework for management in dealing with conflicts that may arise from the stakeholders.

Dharuriyyah is the basic need of a person that, if ignored, can compromise his life main component, such as religion, soul, intellect, decency, and wealth. Hajj is a complementary need that if ignored can cause life difficulties but not to interfere with survival. Tahsiniyyah is an ornament that if it can be realized will lead to perfection.

In a more comprehensive way (Yusuf & Bahari, 2015) have explained that ICSR can be categorized into three dimensions in Shariah entity relationship responsibility, that is responsibility to Allah, to mankind, and to the environment. To fulfill that responsibility it requires four principles of unity of Allah, caliphate, justice, and brotherhood to create mashlahah for society and environment. Mashlahah is the main goal of ICSR. Implementation of ICSR must meet the halal requirements and leave all haram elements. The basic principles of ICSR practice are expected to meet the needs of all stakeholders of Shariah based entities

3. Market Discipline

Lane (1993) had defined market discipline with "financial markets provide signals that lead borrowers to behave in a manner consistent with their solvency" That is to say financial markets provide signals that direct the borrower to behave consistently with the condition of its ability to repay debt. Moderate market discipline can be done by several parties, especially depositors, debt-holders, and equity holders. (Stephanou, 2010) defines market discipline as a mechanism whereby market participants monitor and discipline excessive risk-taking behavior by banks.

Market discipline can also be understood from signaling theory which shows that when a bank (as a company) performs well, the bank will give signal by providing quality information that shows their high performance to the market. Thus, disclosure of information submitted to the market is expected to encourage markets to discipline management (Ariffin, Archer, & Abdel Karim, 2007). From this definition can be concluded that market discipline is a process where there is customer response to the disclosure of information submitted by a company.

Empirical researches related to market discipline in Shariah based financial institutions are still relatively small. Some of the previous studies that are related to market discipline in Islamic based banks such as (Ariffin, Archer, & Abdel Karim, 2007) who tried to investigate the level of transparency and market discipline of Shariah based banks of 14 countries, have shown that Islamic based banks are still low regarding risk disclosure assessment. On the other hand, Aysan et al (2015, 2016) have examined market discipline in Shariah based banks in Turkey, and they have concluded that deposits guarantors could influence market discipline. Moreover, (Hasan & Tandelilin, 2012) have tried to compare market discipline in Shariah banks and conventional banks.

METHODS

Research Framework

Based on the literature review above, our research framework is as follows:

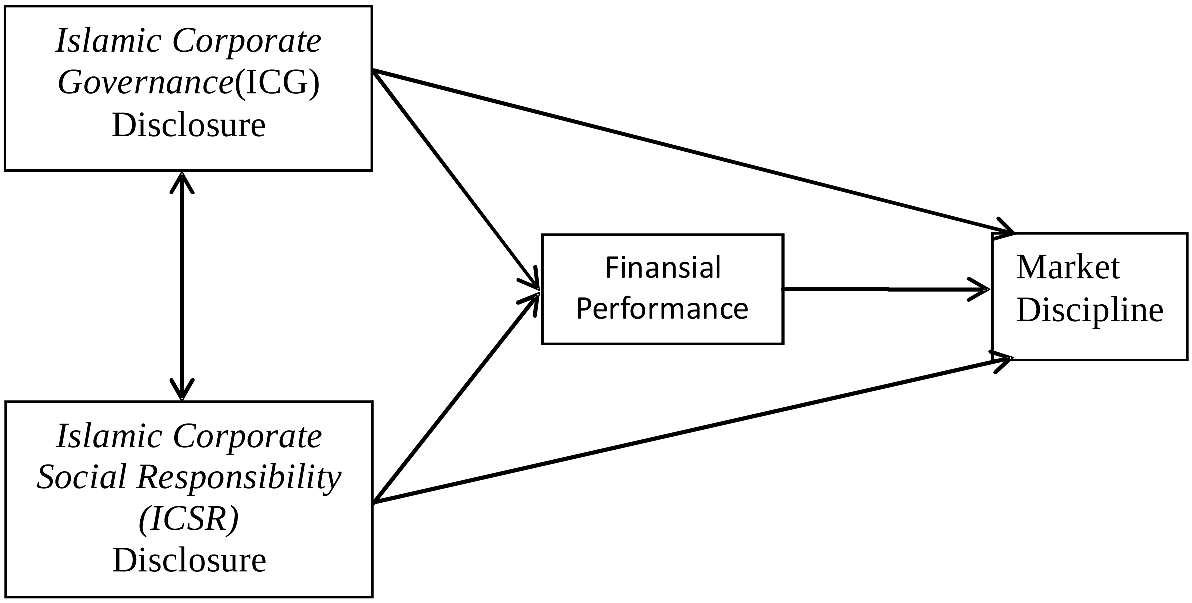


Figure 1.1: Research Framework

This study attempts to measure the level of disclosure of Islamic Corporate Governance (ICGD) and Islamic Corporate Social Responsibility (ICSRD) in Shariah based banks through annual reports published by each bank. ICGD and ICSRD become an important part of Shariah based banks to provide stakeholder information on the implementation of CG and CSR with dimensions of Islamic values. Good disclosure by Shariah based banks is expected to be able to answer the public expectations, especially depositors related to fund management in accordance with Shariah principles and prudential principles. The depositors' response to information disclosed by Shariah based banks is part of the market discipline. The wider the level of disclosure, the better the depositor's 'response, the trust of their depositors will be better, with good response, the greater the depositors' trust will be the more depositors who do transaction with Shariah based institutions, with a high degree of trust and fidelity, which will increase indirectly the performance of the Shariah based banks.

The ICG or ICG Disclosure Indexes (ICGDI) in this research were developed from the corporate governance standards of international Shariah based financial institutions issued by the IFSB. The IFSB has issued 2 special standards of CG for Shariah based banks ie IFSB No.3 about the Guiding Principles On Corporate Governance For Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions And Islamic Mutual Funds) and IFSB 10 regarding Guiding Principles On Shariah Governance Systems For Institutions Offering Islamic Financial Services.

In addition, the determination of ICGDI in this study also refers to previous relevant studies such as Majid, Sulaiman, & Ariffin, (2011), Darmadi (2013), Abdullah (2013), and Grassa & Matoussi (2014). ICG in this study cover two main categories: Shariah Governance (SG) and General Governance (GG). SG consists of 3 dimensions: Shariah Supervisory Board, Shariah Compliance Internal Unit, and Internal Unit of Shariah Review / audit that describes the system of governance based on Shariah. While GG consists of 7 dimensions that describe the general Islamic banking governance system, namely board of commissioners, board of directors, committee board, internal control and external audit, risk management, Investment Account Holders (IAH) and CG reporting. So the total ICGDI consists of 8 dimensions that includes 58 disclosure items.

Table 1.1
ICG Disclosure Indexes

No	*Disclosure Dimension*	*Number of Items*
A	Shariah Governance	
1	Shariah Supervisory Board	9
2	Internal Shariah Compliance Unit	3
3	Internal Shariah Review/audit Unit	3
B	General Governance	
4	Board of Director	7
5	Board Committees	10
6	Internal Control and External Audit	7
7	Risk Management	10
8	Investment Account Holders (IAH)	9
	Total	58

Source: Author‘s Processed data

The ICSR disclosure index in this study adopted the Islamic Social Reporting (ISR) model developed by Haniffa (2002) which refers to the AAOIFI standard. ISR consists of five main themes that are finance and investment, products and services, employees, society and environment. From those 5 ISR themes developed there are 38 sub-items that refer to Haniffa‘s (2002) research and the empirical research of Othman, Thani, & Ghani, (2009) and Othman & Thani, (2010).

Table 1.2
ICSR Disclosure Indexes

No	*Disclosure Dimension*	*Number of Items*
1	Finance and Investment	6
2	Product and Services	3
3	Employees	13
4	Society	11
5	Environment	5
	Total	38

Source: Author‘s Processed data

The formula used to determine the extent of disclosure of ICG and ICSR indices is as follow:

$$\text{ICG \& ICSR Indexes :} \frac{J\ The\ number\ of\ Sub - Items\ disclosed}{Total\ Maximum\ Score} \times 100\%$$

To quantify the variable Market Discipline we measured using the ratio of change of deposit to total deposit (DEPG), with the formula:

$$DEPG = \frac{Dep_t - Dep_{t-1}}{Total\ Dep}$$

The size of the market discipline with the volume of deposits has been widely used by previous research such as the one conducted by Aysan, Disli, Duygun, & Ozturk, (2016).

The moderating variable in this study is Financial Performance, the moderating variable can show whether the financial performance can strengthen or weaken the influence of the independent variable toward the dependent one. The indicator used for financial performance is the profitability ratio of Return on Assets (ROA) and Return on Equity (ROE).

Hypotheses

The hypotheses of the study are as follows:

H_1: Islamic Corporate Governance (ICG) Disclosure and Islamic Corporate Social Responsibility (ICSR) have influence on financial performance of Shariah Based Banks.

H_2: Islamic Corporate Governance (ICG) Disclosure and Islamic Corporate Social Responsibility (ICSR) have influence on market discipline through the financial performance of Shariah based banks.

H_3: Islamic Corporate Governance (ICG) Disclosure and Islamic Corporate Social Responsibility (ICSR) have direct influence on market discipline of Shariah Based Banks.

Data

The data used in this study cover a period from 2013 to 2015, period chosen because it describes a relatively new condition. By using this sample period it is expected that the results of our research will be more relevant in understanding the actual condition of Shariah based banking system in QISMUT countries. The hypothesis testing and data analysis used in this research was conduct using path analysis method. According to Bohrnstedt (in Somantri & Mohidin, 2006), path analysis is an extension of the regression model used to analyze the relationship between variables with the aim to determine whether or not there is direct or indirect effect of the set of independent variables (exogenous) on dependent variables (endogenous).

The type of data used in this study are secondary data. Those Secondary data were taken from the annual report of Shariah based banks for the period of 2013 to 2015, which has been published on the official website of each bank. They are made of financial reports, management reports, GCG implementation reports, and reports of CSR into either a single unit report or a separated one.

The populations of this study constitute Shariah based banks operating in QISMUT countries (Qatar, Indonesia, Saudi Arabia, Malaysia, UAE, and Turkey). Ernst & Young (2013) has predicted that those six countries will be the main drivers of the global Islamic finance in the future. We therefore targeted a population with certain criteria we applied for the process of selecting our population: (1) Shariah base banks operating in QISMUT countries at least from 2013 until 2015, (2) Shariah based banks that consistently present annual report from 2013 until 2015 published on their official website, and (3) annual reports that are available in English.

Based on these sample selection criteria's, we obtained a sample of 42 Shariah based banks, listed on Table 1.3.

Table 1.3
Research Sample

Countries	*Total*	*Shariah Based Bank's Name*
Qatar (Q)	4	1. (QIB) Qatar Islamic Bank,
		2. (MAS) Masraf Al-Rayan,
		3. (QIIB) Qatar International Islamic Bank,
		4. (ABQ) Ahli Bank Qatar
Indonesia (I)	11	1. (BMI) Bank Muamalat Indonesia,
		2. (BSM) Bank Syariah Mandiri,
		3. (BMS) Bank Mega Syariah,
		4. (BRIS) Bank Rakyat Indonesia Syariah,
		5. (BBS) Bank Bukopin Syariah,
		6. (BNIS) Bank Negara Indonesia Syariah,
		7. (BJBS) Bank Jawa Barat Banten Syariah,
		8. (BCAS) Bank Central Asia Syariah,
		9. (BVS) Bank Victoria Syariah,
		10. (MBS) Maybank syariah,
		11. (BPDS) Bank Panin Dubai Syariah
Saudi Arabia (S)	9	1. (ARB) Al Rajhi Bank
		2. (AB) Alinma Bank,
		3. (BAJ) Bank AlJazira,
		4. (RB) Riyad Bank
		5. (GIB) Gulf International Bank
		6. (BSF) Banque Saudi Fransi
		7. (BAB) Bank Al Bilad
		8. (NCB) National Commercial Bank,
		9. (SHB) Saudi Hollandi Bank
Malaysia (M)	12	1. (AIBB) Affin Islamic Bank Berhad
		2. (ALIBB) Alliance Islamic Bank Berhad
		3. (BIMB) Bank Islam Malaysia Berhad,

contd. table 1.3

Countries	*Total*	*Shariah Based Bank's Name*
		4. (M5) Kuwait Finance House (Malaysia) Berhad
		5. (M6) Bank Muamalat Malaysia Berhad
		6. (M7) CIMB Islamic Bank Berhad,
		7. (M8) Hong Leong Islamic Bank Berhad,
		8. (M9) HSBC Amanah Malaysia Berhad
		9. (M10) Maybank Islamic Berhad,
		10. (M11) OCBC Al-Amin Bank Berhad,
		11. (M12) Public Islamic Bank Berhad,
		12. (M13) RHB Islamic Bank Berhad
UEA (U)	3	1. (U1) Dubai Islamic Bank,
		2. (U2) Emirates Islamic Bank,
		3. (U3) Al Hilal Bank
Turkey (T)	3	1. (T1) Albaraka Turk Participation Bank
		2. (T2) Türkiye Finance Participation Bank,
		3. (T3) Kuwait Turk Participation Bank
Total		42

Source: Author's Processed data

The research sample was taken among Shariah based banks of six countries namely Qatar, Indonesia, Saudi Arabia, Malaysia, UAE, and Turkey. These six countries are known as QISMUT. Banks that was selected based on some criteria described in chapter 3, we therefor had a samples of 42 Shariah based banks that have complete data along each of the 3 years of the research. Details about the number of banks per country figure in Table 1.4.

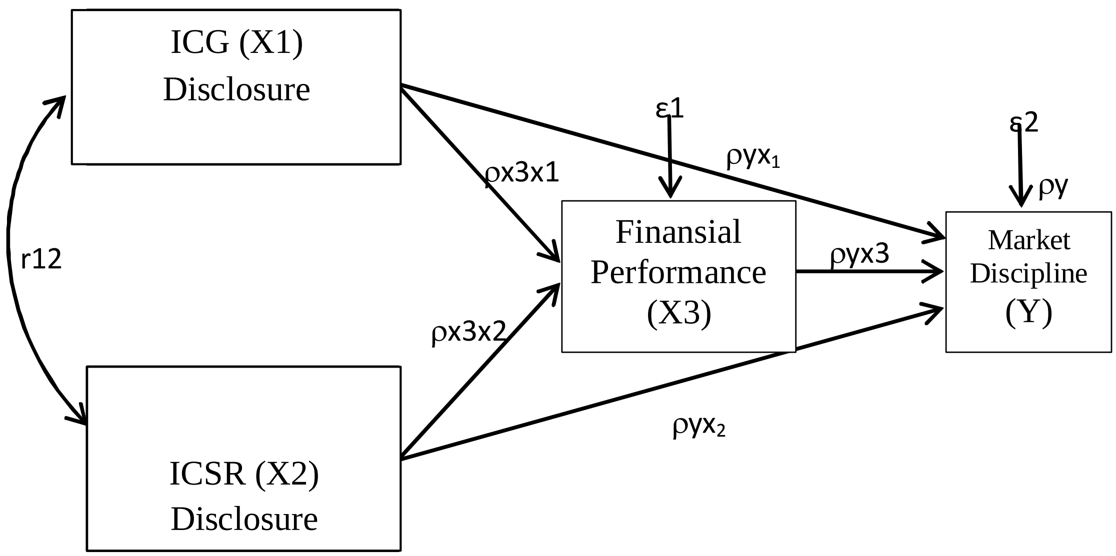
Table 1.4
Sample Distribution by Country

No	*Countries*	*Number of Banks*	*Percentage*
1	Qatar (Q)	4	10%
2	Indonesia (I)	11	26%
3	Saudi Arabia (S)	9	21%
4	Malaysia (M)	12	29%
5	UEA (U)	3	7%
6	Turkey (T)	3	7%
	Total	42	100%

Source: Author's Processed data

Furthermore, after we determine the ICG and ICSR disclosure index items, we run the score determination by giving a score for each index disclosed in annual report of Shariah based bank. For a sub-item disclosed, we gave a score of "1", and if not then we give a score of "0".

The pathway design we obtained is as follow:



The model's equations are as follow:

$X_3 = \rho_{x3X1}X_1 + \rho_{X3X2}X_2 + \rho_{X3}\varepsilon_1$

$Y = \rho_{YX1}X_1 + \rho_{YX2}X_2 + \rho_{YX3}X3 + r_Y\varepsilon_2$

$Y = \rho_{YX1}X_1 + \rho_{YX2}X_2 + \rho_Y\varepsilon_2$

To determine which variables are statistically significant, we used path analysis testing with a trimming model approach. The trimming model is a method used to refine a pathway structure model by removing from a model, an exogenous variable whose path coefficients are insignificant (Ridwan & Kuncoro, 2012). How to use the trimming model is to recalculate the path coefficient without including the exogenous variables whose path coefficients are not significant. The trimming model in this study will be tested using SPSS software (Statistical Package for Social Science).

FINDINGS AND DISCUSSIONS

Findings

Disclosure of ICG, ICSR, Financial Performance, and Market Discipline of Shariah based Banks in QISMUT Countries.

This study aims to measure the effect of ICG and ICSR disclosures on market discipline of Shariah based banks by assessing the information contained inside the bank's annual report. Disclosure of ICG and ICSR is determined by scoring the disclosure items in the bank's annual report. Financial performance is measured by the profitability ratios of ROA and ROE, and Market Discipline is measured by the growth ratio of the value of bank deposits.

ICG Disclosure

Table 1.5
Score of ICG Shariah Banks Disclosure in QISMUT Countries

	DIMENSIONS	*Q*	*I*	*S*	*M*	*U*	*T*	*Σ*
A	Shariah Governance (SG)							
D1	Shariah Supervisory Board	84%	94%	80%	87%	78%	0%	71%
D2	Internal Shariah Compliance Unit	40%	55%	35%	56%	32%	0%	37%
D3	Internal Shariah Audit Unit	38%	36%	22%	37%	22%	0%	26%
	Average SG	54%	62%	46%	60%	44%	0%	44%
B	General Governance (GG)							
D4	Board of Directors	86%	94%	82%	83%	80%	84%	85%
D5	Board of Committees	76%	80%	70%	82%	91%	85%	80%
D6	Internal Control and External Audit	80%	71%	74%	71%	65%	66%	71%
D7	Risk management	71%	80%	62%	68%	74%	68%	70%
D8	Investment Account Holders (IAH)	66%	69%	58%	51%	52%	32%	55%
	GG Average	76%	79%	69%	71%	72%	67%	72%
	ICG Average	68%	72%	60%	67%	62%	42%	62%

Source: Author‘s Processed data

The ICG disclosure used in this study consists of Shariah Governance (SG) and General Governance (GG) which overall has eight dimensions of disclosure. Based on Table 1.5 we can see that the disclosure of ICG Islamic banks in QISMUT countries is quite good with a score of 62%. Indonesia is the country with the highest ICG score, 72%, while the country with the lowest score was Turkey 42%.

The disclosure of SG of Islamic banks is 44% which is still below the GG disclosure score, 72%. The low SG disclosure score is due to the lack of information disclosed by Shariah based banks through their annual report related to the aspects of Shariah compliance, especially those conducted by the internal Shariah Compliance Unit and the Internal Shariah Audit Unit. Even Shariah based banks in Turkey do not disclose information related to Shariah governance (score of 0%). This is because Turkey as a secular country and do not regulate the Shariah aspects of Shariah based banks.

These results indicate that in general, ICG disclosure is quite high, but SG disclosure is still low compared to GG disclosure. The Shariah aspect must be improved by Shariah based bank, because it is an added value for Shariah based bank compared to conventional one. In addition, customers are also concerned about Shariah compliance. According to Chapra & Ahmed, 2002 customers will withdraw their funds from a Shariah based banks in case the bank violate the principles of Shariah.

ICSR Disclosure

Table 1.6
Score of ICSR Shariah based bank Disclosure in QISMUT Countries

	Dimensions	*Q*	*I*	*S*	*M*	*U*	*T*	*Σ*
D1	Investment and Finance	77%	91%	91%	70%	85%	74%	81%
D2	Products and Services	60%	81%	54%	66%	91%	69%	70%
D3	Employees	47%	61%	53%	61%	32%	33%	48%
D4	Society	68%	74%	64%	74%	50%	60%	65%
D5	Environment	32%	43%	42%	41%	22%	22%	34%
	Rata-rata ICSR	57%	70%	61%	63%	56%	51%	60%

Source: Author's Processed data

The disclosure of ICSR in this study consists of five dimensions as shown in Table 1.6. from where we can see that the overall disclosure rate of Shariah based bank is 60%. Indonesia is the country with the highest ICSR score with 70%.

The country with the lowest score is Turkey with 51%. The highest ICSR disclosure dimension is the Investment and Finance dimension with 81%. The lowest is the Environmental dimension with only 34%. These results are in line with the results of Harahap & Hasan (2010) and Yusuf et.al (2013) researches which have shown that the lowest level of accountability of Shariah based banks is in the field of environment. This may be because the banking industry doesn't intersect with the environmental aspect, such as natural exploration, for that reason the environmental aspect is not the main priority of Shariah based banks CSR programs.

These results indicate that the disclosure of Shariah based bank ICSR is quite good (above 50%). But in certain aspects, especially the Environment and Employees aspects are still low (below 50%). Islamic banks should therefor continue to increase their social responsibility in all aspects. For Shariah based banks as commercial institutions, they also have a function and responsibility. The social aspect of Shariah based banks is part of the accountability of the ummah.

Financial Performance

Financial performance in this research is measured by profitability ratios precisely ROA and ROE. These ratios are used to measure the ability of a company to generate profits through their owned assets and capital.

Market Discipline

Market discipline in this study is represented by the growth ratio of Shariah based banks deposits. Between 2013 and 2019, the average growth of Islamic bank deposits was 13.1%. The highest market discipline rate was localized in Turkey with 21.6%, followed by Indonesia 16.1%, UAE 12.1%, Qatar 11.7%, Saudi Arabia 9.4% and Malaysia 7.9%. The high market discipline of Turkey and Indonesia shows that there is still large market potential in these two countries.

Correlation Test

Correlation analysis tests are performed in order to get an overview of the relationship between variables used in a given research. In present this research we will also analyze if there is correlation between variables by using Pearson Correlation Test. The correlation test results are presented in Table 1.7.

Table 1.7
Pearson Correlation Test Results

		ICG	*ICSR*	*Financial Performance*	*Total*
ICG	Pearson Correlation	1	.654**	.066	.934**
	Sig. (2-tailed)		.000	.679	.000
	N	42	42	42	42
ICSR	Pearson Correlation	.654**	1	-.313*	.859**
	Sig. (2-tailed)	.000		.044	.000
	N	42	42	42	42
Financial Performance	Pearson Correlation	.066	-.313*	1	.028
	Sig. (2-tailed)	.679	.044		.860
	N	42	42	42	42
TOTAL	Pearson Correlation	.934**	.859**	.028	1
	Sig. (2-tailed)	.000	.000	.860	
	N	42	42	42	42

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

Source: Author's processing data results, using SPSS

We have obtained a correlation value between ICG (X1) and ICSR (X2) of 0.654 which is significant at a significance value level of at á = 0.01. The correlation value between ICG (X1) and ICSR (X2) has shown a strong relationship between these two variables.

The simultaneous test is used to test the hypothesis of coefficient (slope) regression whether the exogenous variables as a whole have influence on the endogenous variable.

Table 1.8
ANOVA[b]

	Model	*Sum of Squares*	*Df*	*Mean Square*	*F*	*Sig.*
1	Regression	.011	2	.006	5.686	.007[a]
	Residual	.039	39	.001		
	Total	.051	41			

a. Predictors: (Constant), ICSR, ICG

b. Dependent Variable: FINANCIAL PERFORMANCE

Source: Author's processing data results, using SPSS

The ANOVA table that chows the simultaneous test results gives information that exogenous variables (ICG and ICSR) as a whole, have significant (α = 0,05) effect on the intervening variable (financial performance). The significance value is (0.007) which is lower than the alpha degree of significance level specified in this study (α = 0.05).

Table 1.9
t-Test Result
Coefficients[a]

	Model	*Unstandardized Coefficients*		*Standardized Coefficients*			*Collinearity Statistics*	
		B	*Std. Error*	*Beta*	*t*	*Sig.*	*Tolerance*	*VIF*
1	(Constant)	.092	.033		2.825	.007		
	ICG	.156	.062	.473	2.538	.015	.573	1.746
	ICSR	-.218	.065	-.622	-3.340	.002	.573	1.746

(a) Dependent Variable: FINANCIAL PERFORMANCE
Source: Author's processing data results, using SPSS

Based on the coefficients shows on the Table 1.9, ICG (X1) and ICSR (X2) tested toward the financial performance (X3), we can see that both exogenous variables have a significant effect on the endogenous variable. This can be explained by the significance value in both exogenous variables has lower significance value (0.015 and 0.002) than the significance level specified in this study (á = 0.05). To see which exogenous variables have the greatest influence on the intervening variables, we can look at the t test results: the coefficients variables that have larger t test results are variables that have greater influence on the intervening variables. The ICG (X1) variable has a value of T of (2538) which is larger than the one of the ICSR variable (X2) which has a T-value of (-3.340).

Sub-Structure 1 path Coefficients Summary

Path	*Path Coefficient*	*t*	*Sig* $\alpha = 0.05$	*R2*	*Observation*
Sub Structure 1					
ρ_{x3X1}	0.473	2.538	0.015	0.226	Significant
ρ_{X3X2}	-0.622	-3.34	0.002		Significant

Source: data processed, 2017

Mathematical equations we use was:

$$X_3 = \rho_{x3X1}X_1 + \rho_{X3X2}X_2 + \rho_{X3}e_1$$
$$= 0.473X_1 - 0.622X_2 + 0.879e_1$$

Sub-Structure 2 path Coefficients Summary

Path	*Path Coefficients*	*t*	*Sig* $\alpha = 0.05$	*R2*	*Observation*
ρ_{YX1}	-0.515	-2.473	0.018	0.191	Significant
ρ_{YX2}	0.628	2.873	0.007		Significant
ρ_{YX3}	0.143	0.861	0.395		Not Significant

Source: Author‘s processing data results,using SPSS

We concluded based on the substructure 1-analysis results:

1- The total effect of the variable X1 toward variable X3 is 0.032. Because X1 directly affects the change of X3 of (3.2%) which directly affects the change of the variable X3 of 0.224 (22.4%) and whose relationship with X2 is -0.192 (-19.2%).

2- The total effect of the variable X1 toward variable X3 is 0.194 (19.4%). Because X2 directly affects the change of X3 of 0.386 (38.6%) and whose relationship with X2 is -0.192 (-19.2%), therefor the total effect of X2 to X3 is 0.194 (19.4%).

3- X1 and X2 as a whole, affect X3 R2X3(X1X2) by 0.032 + 0.194 = 0.226 (22.6%) or equal to the R square (R2) value. The magnitude of the effect proportionately caused by other variables other than X1 and X2, is expressed by r2X3e1, ie (0.879)2 = 0.774 (77.4%). These results are relevant to the explanations presented on the coefficient of determination test results.

4- The magnitude of effect received by X3 from X1 and X2 and of all variables other than X1 and X2 (expressed by residual values of e) is R2X3(X1X2) + r2X3e1 = 0.226 + 0.774 = 1.00 (100%)

And based on the substructure 2 analysis results:

5- The total effect of the variable X1 toward the variable Y is 0.043 (4.3%). Because X1 affects the changes of Y of 0.200 (20%) whose relationship with X2 is -0.157 (-1.92%).

6- The total effect of the variable X2 toward the variable Y is 0.133 (13.3%) because X2 affects the change of Y by 0.291 (29.1%) and whose relationship with X1 is -0.192 (-1.92%), therefor the total effect of X2 toward Y is 0.133 (13.3%).

7- X1 and X2 as a whole affect Y R2Y(X1X2) by 0.043 + 0.133 = 0.176 (17.6%) or equal to the R square (R2) value. The magnitude of the effect proportionately caused by other variables other than X1 and X2, is expressed by r2Ye2, which is (0.907) 2 = 0.824 (82.4%). These results are relevant to the explanations presented on the coefficient of determination test results.

8- The magnitude of effect received by X3 of X1 and X2 and of all variables other than X1 and X2 (Expressed by the residual value e) is R2Y(X1X2) + r2Ye2 = 0.176 + 0.824 = 1.00 (100%).

Discussions

The Influence of ICG and ICSR Disclosures on Shariah based Banks Financial Performance.

The test of the hypothesis 1 is intended to examine the effect of ICG and ICGR disclosures in annual report on the financial performance of Shariah based banks, by looking at the relationship between ICG disclosure scores and ICSR disclosure toward ROA and ROE. Based on the results of statistical tests, we can concluded that the disclosure of ICG and disclosure of ICSR have a significant influence on ROA and ROE in Shariah based banks in QISMUT countries. Thus, the results of statistical tests support the hypothesis 1, therefor the ***hypothesis 1 is accepted***: *Islamic Corporate Governance (ICG) Disclosure and Islamic Corporate Social Responsibility (ICSR) have influence on financial performance of Shariah Based Banks.*

This result support the findings of several previous studies. Srairi (2015) has stated that the disclosure of ICG has a significant effect on the financial performance of Shariah based banks in the GCC region countries. Farag, Mallin, & Ow-Yong (2014) have shown that the disclosure of ICSR has a significant effect on the financial performance of Shariah based banks in Asian countries and GCC.

The result we obtain indicates that the implementation of GCG and CSR based on Islamic values accompanied by communicating through the annual report can be a separate business strategy for Shariah based banks in the eyes of stakeholders, to improve financial performance.

The Effect of ICG and ICSR Disclosure on Market Discipline with Financial Performance as Intervening Variable.

The test of the hypothesis 2 is intended to examine the effect of financial performance as intervening variable on market discipline of Shariah based banks, by looking at the relationship between profitability ratios (ROA and ROE) and deposit growth ratio. Based on the results of statistical tests we can conclude that financial performance has no significant effect on market discipline of Islamic based banks in QISMUT countries. Therefore, the results of statistical tests do not support the ***hypothesis 2, which is rejected***. *Islamic Corporate Governance (ICG) Disclosure and Islamic Corporate Social Responsibility (ICSR) does not have influence on market discipline through the financial performance of Shariah based banks*.

With this result, the financial performance proxied by ROA and ROE cannot be used as an intervening variable linking ICG and ICSR to market discipline, because in this study financial performance has no significant effect on market discipline.

This result is in line with findings of Aysan, et al (2015) who have stated that the ratio of finance in the form of ROA does not significantly affect the growth of Islamic bank deposits, while CAR has a significant effect. However, this result is slightly different from the findings of Riandika & Taswan (2015) who have stated that the financial ratios of CAR and ROA have a significant effect on market discipline, while the LDR and NPL have no significant effect.

This result we obtain indicates that the financial performance is not fully used as a reference by customers to save their funds in Shariah based banks. Therefore, in addition, to improve financial performance, Islamic banks should continue to build a positive image with non-financial aspects, such as aspects of Shariah compliance and implementation of social programs.

The Influence of ICG and ICSR Disclosure Directly to Bank Shariah Market Discipline

The test of the hypothesis 3 is aimed to examine the direct effect of ICG disclosure and ICSR disclosure in annual report on market discipline of Shariah based banks, by looking at the relationship between ICG disclosure score and ICSR disclosure to Shariah based banks deposit growth ratio. Based on the results of statistical tests we can conclude that the disclosure of ICG and the disclosure of ICSR have a significant influence on market discipline of Islamic banks in QISMUT countries. Therefore, the results of statistical tests support the ***hypothesis 3, who is then accepted***: *Islamic Corporate Governance (ICG) Disclosure and Islamic Corporate Social Responsibility (ICSR) have direct influence on market discipline of Shariah Based Banks*.

This finding is in line with the results of a survey conducted by Chapra & Ahmed, (2002) on Shariah based banks deposit customers in Bahrain, Sudan and Bangladesh, indicating that the majority of deposit customers would transfer their funds to other Shariah based banks if they know that their initial bank is not running the bank with Shariah principles. Implementation of good Shariah principles is part of the implementation of good ICG in Shariah based banks.

This result, we obtained, is also similar to the findings of Dusuki & Dar (2007) study, who stated that Shariah based banks deposit customers react to ICSR conducted by the banks. Most deposit customers agree with the implementation of ICSR in Shariah based banks, they would punish their Shariah based banks if the bank do not run ICSR, by withdrawing their funds and switch them to other Shariah based banks that are more responsible to socially aware.

This result also imply that every Shariah based bank should try to build a good reputation to attract and retain customers. This can be achieved by the implementation and disclosure of ICG and ICSR to the stakeholders. Disclosure of information will increase transparency and promotion of market discipline of Shariah based banks.

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