CHAPTER I

INTRODUCTION

1.1 Background

The banking sector is the driving force in advancing the economy of a nation. This is because banks are present as providers of funds, risk managers, and transaction facilitators that are crucial in supporting the wheels of the economy. The banking world is generally divided into two, namely conventional banking and Islamic banking which is run based on Islamic principles. The fundamental difference between conventional and Islamic financial institutions is in the mechanism of returns and profit-sharing between customers and financial institutions. Islamic banks operate based on the profit-sharing principle, avoiding the use of interest as a source of income or as a distinction in fund utilization and loans, as interest is considered usury, which is prohibited in Islamic law. Additionally, Islamic banks are supervised by a Sharia Supervisory Board, which does not exist in conventional banks. (Umardani & Muchlish, 2016).

According to the Republic of Indonesia Law Number 21 of 2008 Islamic bank is a financial institution that operates its business activities based on Sharia principles and is classified into Public Islamic Banks and Sharia Financing Banks. Islamic banks are banks that operate on the principle of profit sharing by providing an alternative banking system that is mutually beneficial for the community and the Bank. This principle also highlights aspects of fairness in transactions, ethical investment, promoting the values of togetherness and brotherhood in production, and avoiding speculative activities in financial transactions.

Islamic banking has significant growth in Asia that inserable from the increasing muslim population in the Asian region, especially at Southeast Asia (Komijani & Taghizadehhesary, 2018). In fact, the contribution of Islamic banking to the global economy is able to rival with conventional banking. According to IFD (2020), total global Islamic financial assets increased by 14%, reaching $2.88 trillion, with a contribution from Southeast Asia of $685 billion in 2019. In addition to asset growth, Islamic banking has also proven to be able to survive and continue operating during the global financial crisis that hit the world in 2008 (Muhammad & Triharyono, 2019). This fact shows that Islamic banks have great potential to continue to grow and have a wider impact on the world economy.

Islamic banking offers a more diversified portfolio of financial products and services, thus accommodating the diverse financial needs of all levels of Indonesian society (Arshed, Yasmin, & Gulzar, 2020). The flexibility of the financial schemes offered makes Islamic banking an inclusive alternative for solving financial issues in accordance with the principles and regulations of contracts in fiqh muamalah. This point become one of the key drivers of the development of Islamic banks, as it aligns with the community's need for financial institutions that comply with Islamic law and are free from prohibited practices, such as usury, gambling, and transaction related to haram goods and services (Imam & Kpodar, 2016). Hidayah, Lowe, and Woods (2019) define Islamic banking as a financial system that combines spiritual and material aspects with the main goal of Islamic banks is to achieve *falah* (victory in the world and the hereafter). In addition, principles such as *adl* (justice), *maslahah* (public interest), and tawhid are the main differentiators between Islamic and conventional banks (Laldin & Furqani, 2014; Zainuldin, Lui, & Yii, 2018).

Islamic banking operations are governed by Islamic Financial Accounting Standards that refer to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and International Financial Reporting Standards (IFRS). This standard includes detailed rules and components of islamic banking. With these standards, it is expected that the financial statements produced by Islamic banking can provide relevant and credible information so that it can be utilized by various stakeholders, such as Islamic banking management, investors, creditors, government, and society (Suryanto & Ridwansyah, 2016). This accounting standard also regulates the types of financial statements that must be presented, including the statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity, statement of cash flows, statement of reconciliation of income and profit sharing, statement of sources and distribution of zakat funds, statement of sources and uses of benevolent funds, and notes to financial statements.

The implementation of sharia principles along with values of justice, transparency, and honesty in the operations of Islamic banks does not necessarily eliminate the potential for fraudulent practices within Islamic banking. In fact, based on the Report to the Nations 2024 study conducted by the Association of Certified Fraud Examiners (ACFE) in 2024, the financial and banking sector is one of the industries with the highest number of fraud cases in the world, with 305 cases recorded. In addition, Islamic banking is considered a relatively new sector and has different characteristics, so it is considered more vulnerable to risk than conventional banking (Sulub et al., 2020). In Indonesia, several Islamic banks have also been involved in fraud cases, such as internal fraud cases that occurred at Bank

Jabar Banten Syariah, fictitious credit cases at Bank Syariah Mandiri, gold pawning at BRI syariah and alleged embezzlement of deposit funds at Bank Victoria Syariah.

The corruption case involving Bank Jabar Banten Syariah (BJBS) centers on the alleged fictitious credit provided to the debtor PT. Hastuka Sarana Karya between 2014 and 2016. The acting president director of BJBS, identified as YG, was named a suspect by the Criminal Investigation Department (Bareskrim). Commissioner General Indarto stated that the case resulted in losses amounting to IDR 628 billion. YG is suspected of being involved in granting a credit of IDR 566.45 billion for the purchase of Garut Super Blok kiosks without following the proper procedures. The credit was disbursed without collateral, even though PT. Hastuka Sarana Karya only provided evidence that the kiosks being built supposedly already had buyers, while in reality, the project was stalled (BJB Syariah, 2018).

The case at Bank Syariah Mandiri involving internal bank parties is the distribution of fictitious loans at BSM Bogor branch amounting to 102 billion rupiah to 197 fictitious customers. As a result of the loan disbursement, BSM potentially suffered a loss of 59 billion rupiah. For this case, the National Police Criminal Investigation Unit named four suspects, three of whom were BSM employees (Prabowo, 2013). In 2023 there was also a fraud case at the sub-branch office of Bank Syariah Indonesia Sumenep where the mode of alleged fraud was to debit BSI customer loan funds to an account named Subeki so that from this case the customer suffered a loss of 60 billion.

In addition, there are several cases where customers reported Islamic banks, as experienced by BRI Syariah and Bank Mega Syariah, both of which were affected by cases related to gold pawning. This case arose from the lawsuit of BRI Syariah and Bank Mega Syariah customers who felt aggrieved regarding the gold pawn at BRI Syariah and Bank Mega Syariah (Djumena, 2014). Not only in Indonesia, some cases in Islamic banks have also occurred in other countries, such as what happened to Dubai Islamic Bank which lost around US $ 300 billion due to improper financial statements and the Islamic Bank of South Africa which went bankrupt in 1997 with debts between R50 to R70 million caused by poor management and improper accounting and management systems (Rini, 2014).

In early 2024, there was also a fraud case at Bank Victoria Syariah where the Financial Services Authority (OJK) revealed that it received a report regarding the alleged embezzlement of deposit funds amounting to IDR 13.5 billion at Bank Victoria Syariah (BVS). In this case, the Criminal Investigation Agency of the Indonesian National Police (Bareskrim Polri) has named the former Branch Manager of the Bekasi Branch of BVS as a suspect for alleged Islamic banking crimes, fund transfers, embezzlement in office, forgery, and money laundering. the perpetrator, who last served as Senior Relationship Manager of BVS, allegedly caused losses of up to IDR 35 billion from various customers, both individuals and institutions (OJK, 2023). These fraud cases can reduce the trust and loyalty of the public and stakeholders to Islamic banking.

Fraud in the organization can be committed by various levels ranging from the lower level, management to the owner (Anugerah, 2014). For this reason, as an entity that has a special character, the Islamic financial business has a high risk in its management, so that it requires the prudential principles of the perpetrators in the aspect of sharia compliance as an effort to prevent the possible risk of fraud

(Sula, 2014). In order to fulfill the provision of information on Islamic banks' compliance with sharia principles, Hameed et al. (2004) recommended the Islamic Disclosure Index (IDI) which was developed based on three components of Islamic disclosure indicators, namely sharia compliance, corporate governance and social/environment disclosure (Asrori, 2011).

In an effort to increase company value, risk management and fraud prevention, it is necessary to pay attention to the implementation of good corporate governance. In 2009 Bank Indonesia stated that to encourage the practice and performance of healthy and financially resilient Islamic banking and always refer to sharia principles and protect the interests of stakeholders, Islamic banks are expected to apply the principles of Good Corporate Governance (GCG), namely transparency, accountability, responsibility, professionalism, fairness and must comply with sharia principles.

According to Algoud & Lewis (2001), governance issues in Islamic banking are very different from conventional banks. Islamic banks have an obligation to comply with sharia principles in carrying out their business activities. Bank Indonesia (2009) states that the implementation of sharia principles can be built with the implementation of Good Sharia Business Governance as stated in the General Guidelines issued by the National Committee on Governance Policy (KNKG) in 2011. Bank Indonesia (2009) not only can be implemented with sharia principles but also with sharia provisions. Bank Indonesia hereby publishes the Implementation of GCG in Sharia Commercial Banks and Sharia Business Units in Bank Indonesia Regulation No. 11/33/PBI/2009 and Bank Indonesia Circular Letter No. 12/13/DPbs dated April 30, 2010.

The regulation applies five principles of good corporate governance, namely transparency, accountability, responsibility, professionalism, and fairness. Research by Abdullah et al. in 2014 shows that the level of disclosure of Corporate Governance of Islamic commercial banks in the annual report is less than 50 percent using standards derived from Islamic values and adjusted to the rules set by the Accounting and Auditing Organization for Islamic Institutions (AAOIFI). The application of the concept of Islamic corporate governance will be one of the determinants of good performance. The assessment of Islamic corporate governance is important, as it is not only demanded by the customers of Islamic Financial Institution (IFIs), but also other stakeholders, including institutional investors and the Muslim community who are directly and indirectly involved with the institution (Ramli et al 2014). The main characteristic of weak corporate governance is selfish actions by ignoring the interests of investors, which will lead to the collapse of investors' expectations about the return on the investment they have invested (Sabrinna et al., 2010).

In Islamic finance literature, the concept of CG and GCG discussed using an Islamic perspective is known as Islamic Corporate Governance (ICG) (Choudhury and Alam, 2013; Mansour and Bhatti, 2018). The ICG concept has similarities with CG and GCG, but emphasizes the importance of Shariah Governance (SG). SG refers to institutional and organizational governance that ensures effective independent oversight of sharia compliance by institutions offering Islamic financial services (IFSB, 2009). Islamic Corporate Governance (ICG) is a system that includes structures and processes to direct, manage, and control the business in a transparent manner that refers to Islamic principles

(Mardiani, 2019). Good governance prevents conflicts among stakeholders, such as the Sharia Supervisory Board (SSB) and the Board of Directors (BOD), ensuring that all stakeholders in Islamic banks perform their respective duties and responsibilities effectively. The Sharia Supervisory Board in Islamic banks is responsible for overseeing the operations of these banks while adhering to Islamic business ethics. Meanwhile, the Board of Director is tasked with carrying out the management of Islamic banks that are oriented towards achieving profits. Good governance can avoid risks because management actions tend to benefit themselves. Good governance will create a control system to prevent misuse of resources so that good growth will be created which will have an impact on improving the performance of Islamic banks.

Fraud in the Islamic banking industry sector can be prevent with role that mandated to the party responsible for supervising and ensuring that all procedures and business operations in Islamic banking have been carried out in accordance with sharia principles. In this case, the Sharia Supervisory Board is a party trusted to direct, review, and supervise the activities of Islamic financial institutions, and ensure that Islamic financial institutions are in accordance with the rules and islamic principle (Khalid et al., 2018). This is in accordance with AAOIFI which explains the role and function of the Sharia Supervisory Board includes several things such as directing, reviewing, and supervising the activities of Islamic financial institutions. The roles and functions held by the Sharia Supervisory Board are very broad and involve many different activities (Al Amer, 2018). Therefore, the appointment of the Sharia Supervisory Board must consider several aspects including the Sharia Supervisory Board must be an independent party, have good morals, uphold integrity, and have no partiality in order to create objective assessment results and opinions on the application of sharia principles applied in Islamic banking, and have broad knowledge in accordance with their fields.

Various previous studies regarding the detection of financial statements are the basis for writing this thesis. Research by Musleh Alsartawi (2019) explains that the Sharia Supervisory Board has a role as an auditor who helps evaluate the overall performance of the bank, especially regarding the application of ethics in accordance with Islamic principles. In addition, research by Anisykurlillah et al. (2020) revealed that the expertise of the Sharia Supervisory Board in accounting or finance contributed to the effective detection of financial statement fraud. The Sharia Supervisory Board functions as an independent supervisory mechanism that ensures all bank activities are in accordance with Islamic law, thus preventing financial statement fraud. Furthermore, Ahadiah's research (2019) shows that the expertise of the Sharia Supervisory Board has a partial positive effect on earnings management. Furthermore, research from Fakhruddin (2024) shows that education and meetings of the sharia supervisory board have no significant effect on fraud that occurs in Islamic banks.

Another problem often faced by Islamic Banks is the lack of public confidence to entrust their funds due to doubts about sharia principles in Islamic Banks where Islamic bank management is unable to provide sharia compliance guarantees in every banking product and service provided (Anshori, 2014). Therefore, Sharia Compliance is a manifestation of Islamic banks on the application of sharia principles with credibility and integrity. According to Mulazid (2016), the level of public trust in Islamic banks can be measured by how well the bank applies

Islamic principles in the operations. This means that when an Islamic bank applies sharia compliance, it will gain public trust and influences people's decisions to use Islamic banking services. This trust will have a positive impact on the bank's financial performance. This statement in accordance with the results of research by Nasution et al. (2019) which proves that Sharia Compliance has a positive effect on profitability. Conversely, research conducted by Djuwita et al. (2019) proves that Sharia Compliance has a negative effect on the profitability of Islamic Commercial Banks.

Islamic corporate governance and sharia compliance have contributed to the development of Islamic banks which has implications for the increasing challenges that must be faced by Islamic banks, where the biggest challenge is to maintain an image and good name in the eyes of customers in order to maintain customer trust and loyalty to Islamic banks (Falikhatun, 2012). As is known, Islamic banks are banks that carry out their business activities based on sharia principles derived from the Al-Qur'an, Hadist and Ijmak of the scholars which are applied both inside and outside the company (Maradita, 2014).

The reason underlying this research is the emergence of issues regarding the weakness of corporate governance in the Islamic banking industry which has increasingly attracted the attention of Islamic economics and finance experts because there are two important issues related to the weakness of Islamic banking corporate governance. One of them concerns sharia compliance, where Islamic bank management is unable to guarantee sharia compliance in every banking product and service provided (Asrori, 2014).

This research was conducted to fill the gap in Islamic bank governance literature by referring to previous studies conducted by Anugerah (2014), Najib (2016), Muhammad (2019) and Wahyuni (2020), where research related to the influence of governance on fraud does not directly involve the ICG component, but uses a rating of the bank's GCG self-assessment. This research is also a development of research from Hidayah (2021) where ICG measurement is carried out directly using ICG components which are proxied by the number of Sharia Supervisory Board, Sharia Supervisory Board education, cross membership of Sharia Supervisory Board and the number of Sharia Supervisory Board meetings in one year which are collected and analyzed manually from the annual reports of Islamic banks in Indonesia. The use of ICG components directly can provide a clearer picture of each influence (Darwanto and Chariri, 2019).

The difference between this research and research conducted by Anugerah (2014) is in the population used, where Anugerah (2014) examines the role of Good Corporate Governance in preventing fraud in conventional institutions while this study examines the effect of corporate governance on fraud in Islamic banks. Furthermore, the difference between this research and that conducted by Najib (2016) is in the period starting from 2010 to 2014, while this study uses the research period 2019 to 2023. Furthermore, the difference between this research and research conducted by Muhammad (2019) also lies in the period where Muhammad (2019) starts from 2013 to 2017.

Based on the description above, research related to Islamic corporate governance and compliance with sharia principles is carried out because sharia compliance and Islamic corporate governance can be said to be very important elements in Islamic Banking, weak on corporate governance and low apply sharia compliance can affect performance and provide opportunities for fraud in Islamic banks.

1.2 Problem Formulation

1. Does Islamic corporate governance that is measured by the sharia board process, affect fraud in Islamic commercial banks registered with OJK for the period 2019 - 2023?
2. Does Islamic corporate governance that is measured by the sharia board competence, affect fraud in Islamic commercial banks registered with OJK for the period 2019 - 2023?
3. Does Islamic corporate governance that is measured by the sharia board independence, affect fraud in Islamic commercial banks registered with OJK for the period 2019 - 2023?
4. Does Islamic corporate governance that is measured by the sharia board crossmembership, affect fraud in Islamic commercial banks registered with OJK for the period 2019 - 2023?
5. Does Sharia compliance that is measured by the Islamic Income Ratio (IsIR) affect fraud at Islamic Commercial Banks registered with OJK for the period 2019 - 2023?
6. Does Sharia compliance that is measured by the Profit Sharing Ratio (PSR) affect fraud at Islamic Commercial Banks registered with OJK for the period 2019 - 2023?
7. Does Sharia compliance that is measured by the Zakat Performance Ratio (ZPR) affect fraud at Islamic Commercial Banks registered with OJK for the period 2019 - 2023?

1.3 Research Objectives

1. Analyzing the effect of Islamic corporate governance that is measured by sharia board process on fraud in Sharia Commercial Banks for the Period 2019 – 2023.
2. Analyzing the effect of Islamic corporate governance that is measured by sharia board competence on fraud in Sharia Commercial Banks for the Period 2019 – 2023.
3. Analyzing the effect of Islamic corporate governance that is measured by sharia board independece on fraud in Sharia Commercial Banks for the Period 2019 – 2023.
4. Analyzing the effect of Islamic corporate governance that is measured by sharia board crossmembership on fraud in Sharia Commercial Banks for the Period 2019 – 2023.
5. Analyzing the Effect of sharia compliance that is measured by Islamic Income Ratio (IsIR) on fraud at Islamic Commercial Banks registered with the OJK for the period 2019 - 2023.
6. Analyzing the Effect of sharia compliance that is measured by Profit Sharing Ratio (PSR) on fraud at Islamic Commercial Banks registered with the OJK for the period 2019 - 2023.
7. Analyzing the Effect of sharia compliance that is measured by Zakat Performance Ratio (ZPR) on fraud at Islamic Commercial Banks registered with the OJK for the period 2019 - 2023.

1.4 Research Benefits

By conducting this research, it is expected to provide benefits, as follows:

1. Theoretical Benefits

   This research will make a scientific contribution in the field of accounting and finance by identifying the effect of Islamic corporate governance and Sharia compliance on fraud using relevant datasets in providing detailed empirical analysis as a reference for further research on the same topic, and helping to understand how governance practices have an impact on the practice or case of fraud in the company.

2. Practical Benefits

   a) This research can be used as a means for researchers to increase knowledge, insight, and experience in applying the knowledge gained while in college, especially understanding the influence of Islamic corporate governance and Sharia Compliance on fraud in banking companies.

   b) For investors, the results of this study can be a reference for investors to assess the governance of a company. Understanding Islamic corporate governance and Sharia compliance can help investors identify company compliance in implementing sharia values.

   c) For company management, this research can be an encouragement to improve governance and sharia compliance. This can increase company transparency and stakeholder trust.

   d) For accounting and auditors, this research can be a guide to better understand potential areas where fraud can occur even in Islamic banking. This research can also be a guide in evaluating the company's Islamic corporate governance implementation.

   e) Capital market regulators and authorities can use the findings of this study as evaluation material to improve corporate governance standards and sharia compliance. The results of the study can be the basis for developing policies that reduce fraudulent practices through the implementation of better corporate governance.

1.5 Structure of The Thesis

This research is organized into five interconnected chapters. The first chapter reviews the background of the problem, formulates the problem to be studied, sets out the objectives and benefits of the research for various parties, and provides an overview of the systematic writing. The second chapter explores the fundamental theories and concepts that underpin the research, summarizes findings from previous research, develops a theoretical framework, and forms the basis for hypothesis development. The third chapter explains the methodology used, ranging from research design, population and sample, data collection methods, to variables and data analysis techniques applied. The fourth chapter presents the results of the analysis and hypothesis testing accompanied by an in-depth interpretation of the findings. The fifth chapter presents the conclusion, which includes the main conclusions, practical and theoretical implications, research limitations, and recommendations for future research.