CORPORATE LAW AND SHARIA GOVERNANCE: EMPIRICAL INSIGHTS, RISK-BASED BANK RATING, AND ESG ISLAMIC APPROACH

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Abstract

This study examines the impact of bank soundness ratio (based on the Risk-Based Bank Rating (RBBR) method) on financial performance via the environmental, social, and governance (ESG) framework within Islamic governance and social responsibility in Indonesian Islamic commercial banks (Sharia banks). The sustainability of Islamic banks is attained not solely through corporate performance, dictated by financial ratios, but also by a focus on global concerns, specifically environmental, social, and banking governance (Adu et al., 2024; Pasko et al., 2022). This study utilizes data from all Islamic commercial banks in Indonesia, with a sample for 2018–2022, and employs moderating regression analysis. The findings indicate that liquidity risk, financing, operating, and capital adequacy (RBBR), Islamic social reporting (ISR), and Islamic corporate governance (ICG) significantly impact Sharia banking performance. ICG effectively moderates the relationship between RBBR and ISR on Sharia banking financial performance. ICG can enhance the health of Sharia banks and their awareness of social responsibility, thereby positively influencing their performance. The Financial Authority can use these insights to enhance risk management and ISR regulations in Sharia banks. This study reveals discrepancies with prior studies, where return on equity (ROE) yielded superior outcomes to return on assets (ROA). This study identifies ICG's significance in enhancing RBBR and ISR impact on banking performance within Sharia banking, a topic unexplored by scholars.

Keywords: Islamic Corporate Governance (ICG), Islamic Social Reporting (ISR), Environmental, Social and Governance (ESG), Bank Performance, Corporate Social Responsibility (CSR), Indonesia

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1. INTRODUCTION

The banking industry is intricately linked to a nation's financial system and economic issues. Banking is the core and catalyst of the economy, facilitating cash mobilization and allocation to mitigate risk and maintain macroeconomic stability. An unstable financial system can precipitate an economic crisis, requiring substantial costs and extended recovery periods to recover. Historical accounts show that the banking crisis of 1997–1998 and the global crisis of 2008 significantly affected Indonesia's economy, particularly the monetary crisis of 1998 and COVID-19. However, Sharia banking has demonstrated resilience during crises, with Sharia banks showing greater performance than conventional banks before and after the 2008 global financial crisis (Ulina & Majid, 2020). Indonesia's banking penetration is lower than that of other Islamic nations, such as Saudi Arabia and Malaysia. The state of the Global Islamic Economy 2024 Report (Liaqat, 2023) ranks Indonesia third (80.1), with Saudi Arabia second (93.6) and Malaysia first (193.2). The endurance of Sharia banking after crises has strengthened public faith in Indonesia's banking system. Islamic banks have shown positive annual growth. The Sharia Financial Development Report (Financial Services Authority, 2025) indicates that by 2024, the market share of Sharia banking will increase by 7.72%, up from 7.44% in 2023. While Shariah banking assets are lower than conventional banking, their growth rate often exceeds that of conventional banking. The low market share remains a challenge for Sharia banks, given that Indonesia has one of the largest Muslim populations globally.

The sustainability of Islamic banks is not solely contingent on financial performance indicators such as liquidity, financing risk, operational risk, capital adequacy, market risk, and bank size (Alnajjar & Abdullah Othman, 2021; Hosen et al., 2019; Nurwulandari et al., 2022; Rahman et al., 2020). It also encompasses a commitment to global issues, specifically the Sustainable Development Goals (SDGs) related to environmental, social, and banking governance concerns (Adu et al., 2024; Pasko et al., 2022; Pekovic & Vogt, 2021; Puspitasari et al., 2023; Zhao et al., 2016). Financial institutions can significantly contribute to sustainable economic development and environmental protection. Banks face significant pressure from stakeholders to address climate change by disclosing their environmental consequences and actively working to reduce greenhouse gas emissions (Adu et al., 2024).

This study addresses three fundamental research questions to attain these objectives.

RQ1: Does Risk-Based Bank Rating (RBBR) method enhance the financial performance of Islamic banks?

RQ2: Do Islamic social reporting (ISR) and Islamic corporate governance (ICG) enhance the Islamic banks' financial performance?

RQ3: Can ICG strengthen the influence of RBBR and ISR on the financial performance of Islamic banks?

Environmentally and socially focused banking activities can be conducted through corporate social responsibility, CSR (Faturohman et al., 2021; Hosen et al., 2019; Rehman et al., 2020). In the Islamic context, CSR is referred to as Islamic social reporting (ISR), which guides firms in meeting their commitments to Allah and society. ISR was introduced by Haniffa (2002) and elaborated on by Othman and Thani (2010). Sharia bank governance is conducted through good corporate governance (GCG); Sharia banks must implement GCG at all organizational levels, adhering to the principles of transparency, accountability, responsibility, professionalism, and fairness (Ben Abdallah & Bahloul, 2021; Darma & Afandi, 2021; Khan & Zahid, 2020). ICG encompasses integrity, trustworthiness, transparency, performance orientation, accountability, mutual respect, and adherence to Islamic laws. Yusuf et al. (2025) identified the accountability components as human rights infringements, ethical breaches, and oversight mechanisms. Research by Grassa (2016) shows that Islamic banks with robust governance obtain better credit ratings than those with deficient governance, with Southeast Asian Islamic banks showing higher ratings than GCC Islamic banks. Zhao et al. (2016) found that governance mechanisms moderate CSR's impact on corporate social performance in Chinese listed companies. This aligns with Pekovic and Vogt (2021), who highlight how corporate governance attributes moderate the CSR-financial success relationship. Pasko et al. (2022) asserted that corporate governance enhances CSR's impact on business performance in China. The Corporate Governance Disclosure Index influences bank sustainability reporting regarding financial performance in Africa, showing that reporting efficacy depends on governance structures (Adu et al., 2024).

This study addresses the deficiencies in prior research by incorporating diverse concepts and analyses, specifically those by Alnajjar and Abdullah Othman (2021), Nawrah and Khuluqi (2024), Nurwulandari et al. (2022), Rahman et al. (2020), and Wahyudi et al. (2021), which investigate the impact of bank health levels on bank performance. Additionally, it references studies by Ben Abdallah and Bahloul (2021), Darma and Afandi (2021), and Faturohman et al. (2021), which explore the effects of governance and CSR disclosure on bank performance, as well as research by Adu et al. (2024) and Puspitasari et al. (2023), which assess the influence of governance and social responsibility disclosure on the performance of Islamic banks. This study examines the role of ICG in enhancing the impact RBBR and ISR on Islamic commercial banks, which has not been previously studied in Indonesia. The study's approach is based on agency theory (Jensen & Meckling, 1979), which suggests that managers may prioritize their interests over those of shareholders and depositors, leading to conflicts and agency costs. Enhanced ICG requires procedures to regulate agency conflicts and optimize transparency in Islamic banking. ISR disclosure can reduce agency costs by encouraging stakeholder participation (Albarrak & El-Halaby, 2019). Stakeholder, legitimacy, and signaling theories support our research hypotheses.

This study investigates ICG's function in moderating the impact of Islamic bank stability, measured through the financing to deposit ratio (FDR), non-performing financing (NPF), operating expense ratio (OER), capital adequacy ratio (CAR), and ISR, on the performance of Islamic commercial banks in Indonesia. This study provides an understanding of how Sharia-based governance principles can enhance bank performance while promoting transparency aligned with Maqāṣid Sharia. This helps regulators and management improve governance methods to ensure sector stability. The study employs quantitative methodology using moderated regression analysis (MRA), based on data from annual financial and sustainability reports of Islamic commercial banks in Indonesia.

The rest of the study is structured as follows. Section 2 examines the pertinent literature. Section 3 delineates the study technique employed for evaluating RBBR, ISR, and ICG on Islamic bank financial performance. Section 4 delineates the findings. Section 5 discusses the results. Section 6 concludes the study by presenting the conclusions, implications, limitations, and recommendations for further research.

2. LITERATURE REVIEW

2.1. Risk-based bank rating

A Sharia bank conducts business activities based on Sharia principles, providing services for payment transactions (Act of the Republic of Indonesia Number 21 concerning Sharia (Islamic) banking, 2008). Evaluating bank health using a risk-based approach (RBBR) entails assessing the risks and performance of banks in Indonesia. This method requires banks to evaluate their health using a risk framework covering risk profiles (credit risk, liquidity risk, and operational risk), GCG, profitability (earnings), and capital (Financial Services Authority, 2016a). This study evaluates Sharia banking soundness by analyzing its risk profile using liquidity risk measured by the finance to deposit ratio (FDR), credit risk through non-performing finance (NPF), and operational risk through operating expense ratio (OER). It employs the capital adequacy ratio (CAR) for capital measurement, the Islamic Corporate Governance (ICG) Index for Good Corporate Governance, and return on assets (ROA) and return on equity (ROE) for profitability evaluation.

Liquidity risk is assessed using the FDR as a proxy. The FDR summarizes the volume of third-party funds allocated for financing purposes. Increasing third-party funds for financing can enhance bank performance through higher profitability. Increased funding to third parties correlates with enhanced bank financial performance, as indicated by ROA (Adelopo et al., 2018; Darma & Afandi, 2021). Conversely, Nawrah and Khuluqi (2024) document that FDR adversely impacts Islamic banks' financial performance. However, Wahyudi et al. (2021) indicate that the FDR has no substantial influence on Islamic banks' performance. An elevated FDR increases the risk due to higher capital requirements for credit financing. An increase in the financing-to-deposit ratio reduces the bank's profit percentage, indicating heightened vulnerability to liquidity risk. A high ratio indicates that the bank cannot extend financing beyond deposits. Banks then use costlier options, such as debt, deposits, and equity, to finance their liabilities, diminishing profitability. The Indonesian Financial Services Authority (*Otoritas Jasa Keuangan*, OJK) indicates an optimal loan-to-deposit ratio of 80% to 110%. If a bank allocates substantial funds as credit, it accrues significant earnings from the loan interest. An elevated FDR within defined boundaries, supported by robust credit distribution quality, results in a larger spread, enhancing profitability. Based on this theoretical framework and previous research, the following hypothesis is proposed:

H1: The finance to deposit ratio (FDR) has a positive effect on financial performance.

The risk of problematic financing in Islamic banks is related to financing with repayments that exceed the agreed-upon time limits. Banks with significant credit issues incur higher expenses, including reserves for productive assets and additional costs, which affect future losses. Financing challenges arise from insufficient customer goodwill, poor economic conditions, and governmental policies. If unresolved, this leads to a deterioration in financing portfolio quality, increased non-performing loans, reduced profitability, and capital depletion. If improper financing is not addressed, a financial crisis ensues (Darma & Afandi, 2021). According to signal theory, investors retain cash as bank capital if the financial performance is robust. The NPF ratio serves as a performance indicator for management and investment decisions. Islamic banks must maintain an NPF ratio at or below 5% (Financial Services Authority, 2014). A higher NPF ratio indicates declining bank profitability due to clients' inability to repay loans. This elevated ratio shows that banks struggle to ensure and manage their lending portfolios, which impacts Islamic banks' profitability from profit-sharing financing. The research conducted by Puteri et al. (2024) indicates that governance, as assessed by the size of the sharia supervisory board and the inclusion of women on the board of directors, exhibits a negative and substantial correlation with the credit risk of Islamic banks in Indonesia. Studies indicate that NPF adversely impacts Islamic banks' financial performance (Cantia Lambada et al., 2022; Darma & Afandi, 2021; Nawrah & Khuluqi, 2024; Puspitasari et al., 2023). An elevated non-performing finance (NPF) ratio indicates deteriorating credit quality, leading to an increase in problematic loans and potentially jeopardizing bank stability. Based on this, the following hypothesis is proposed:

H2: NPF has a negative influence on financial performance.

Operational risk refers to potential losses from human activities, processes, infrastructure, or technology that negatively affect banking operations. This risk encompasses fraud, managerial incompetence, insufficient controls, and ineffective procedures. OER quantifies a bank's efficiency by comparing its operational costs to its income. Operational costs assess a bank's efficiency and capacity to execute tasks. Research findings of Hosen et al. (2019), Nawrah and Khuluqi (2024), and Nurwulandari et al. (2022) indicate that OER adversely impacts banks' financial performance. A lower OER indicates greater operational efficiency, reflecting a stronger institution. An elevated OER corresponds to increased operational cost inefficiency. Consequently, banks' capacity to generate profits diminishes (Nurwulandari et al., 2022). The inverse relationship between operational risk and financial performance suggests that reduced risk may signify enhanced asset quality and efficiency, potentially improving financial performance. In light of this description, the following hypothesis is proposed:

H3: Operating expense ratio (OER) has a negative effect on financial performance.

The CAR serves as a metric of banking stability, affecting public trust in depositing funds. The CAR evaluates a bank's capital to yield profits. These funds are reallocated as finance, enabling the bank to obtain profit shares and promote profitability. If the CAR meets the Financial Services Authority standard of a minimum of 8%, Islamic banks may allocate funds more liberally to lucrative investments. A decline in CAR may result from risky assets stemming from capital growth disparity and diminishing investment choices. According to signal theory, this reduces public trust, leading to decreased profitability. A higher CAR enhances a bank's potential to generate revenue. With substantial funds, management can allocate resources to make lucrative investments. A high CAR enables banks to fund their operations and enhance profitability. Research findings from Puspitasari et al. (2023) and Wahyudi et al. (2021) indicate that CAR positively influences financial performance. Research by Cantina Lambada et al. (2022) and Hosen et al. (2019) indicates that CAR does not significantly affect Islamic banks' performance. Alnajjar and Abdullah Othman (2021) reveal that CAR has a considerable negative impact on performance. Commercial Islamic Banks in Middle East and North Africa (MENA) countries (Qatar, Oman, Bahrain, Kuwait, the United Arab Emirates, Saudi Arabia, and Jordan) exhibit robust performance, as evidenced by ROA and ROE indicators. The fourth research hypothesis is derived from signal theory and previous studies:

H4: The capital adequacy ratio (CAR) has a positive effect on financial performance.

2.2. Islamic social reporting

Companies must oversee operations to align with societal ideals, thereby reducing the legitimacy gap and maintaining human-environment equilibrium (Islam et al., 2021). Legitimacy theory explains the connection between corporate incentives in revealing CSR or ISR within Sharia commercial banks. ISR goes beyond reporting and influences bank reputation through economic functions and stakeholder expectations. CSR under Islamic principles is based on morality, ethics, and social accountability. The focus on allegiance to Allah, the Caliph, and public welfare requires avoiding devastation of any kind. Islam recognizes proprietors' right to generate profits while protecting stakeholders' rights. The ISR Index assesses Sharia social performance through CSR criteria set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), enhanced by researchers regarding CSR elements for Islamic entities (Haniffa, 2002; Othman & Thani, 2010). Research shows that CSR disclosure negatively affects bank financial performance in Pakistan (Rehman et al., 2020), while ISR can enhance Islamic banks' financial performance (Faturohman et al., 2021). However, some scholars have reported that ISR does not significantly influence banks' financial performance (Hosen et al., 2019; Oktaviana et al., 2021; Puspitasari et al., 2023). Studies also indicate the adverse effects of ISR on Islamic banks' ROA and ROE in the MENASA region (Ben Abdallah & Bahloul, 2021). According to legitimacy theory and prior studies, the fifth research hypothesis is as follows:

H5: ISR has a positive effect on financial performance.

2.3. Islamic corporate governance

Islamic Corporate Governance (ICG) derives from Good Corporate Governance (GCG) with identical objectives. Law No. 21 of 2008 on Sharia Banking mandates Sharia commercial banks and business units to follow the corporate governance principles of transparency, accountability, responsibility, professionalism, and fairness (Act of the Republic of Indonesia Number 21 concerning Sharia (Islamic) banking, 2008). In Sharia banking, stakeholder interests include Sharia compliance. ICG principles safeguard stakeholder rights and relationships while preventing agency conflict. ICG motivates managers to enhance profitability by minimizing organizational discrepancies. Research on ICG's impact on financial performance has shown varied results. ICG enhances banks' financial performance (Puspitasari et al., 2023), while Oktaviana et al. (2021) found that ICG does not significantly affect financial performance. However, board size, independence, and chief executive officer (CEO) power negatively affect firm performance. Ben Abdallah and Bahloul (2021) examined Sharia governance's influence through the Board of Directors, Audit Committee, and Sharia Supervisory Board on ROA and ROE in Middle East, North Africa, and South Asia (MENASA) region Islamic banks. Their findings show that governance positively impacts financial performance, supporting previous studies (Khan & Zahid, 2020). ICG positively influences Islamic banks' financial performance, with larger institutions exhibiting superior governance. According to agency theory and prior studies, the fifth research hypothesis is as follows:

H6: ICG has a positive effect on financial performance.

2.4. ICG moderation with RBBR and ISR on financial performance

Stakeholder theory posits that firms bear responsibilities to shareholders and all stakeholders, including regulators, customers, and society. ICG upholds stakeholder interests and adherence to Sharia standards. Legitimacy theory states that organizations must acquire and maintain societal legitimacy to endure and avoid being labelled as deviant. ISR establishes legitimacy by demonstrating that Sharia banks prioritize profitability and social responsibility aligned with Islamic ideals. ICG enhances ISR's function in bolstering Sharia banks' legitimacy, particularly in showing adherence to Islamic ideals and maintaining public trust. Pekovic and Vogt (2021) examine the moderating role of corporate governance characteristics, including board size, ownership concentration, board gender diversity, and board independence, on the relationship between CSR and business performance, measured by Tobin's Q. Results show that governance, evaluated using board size and gender diversity, influences the relationship between financial performance, CSR, and corporate performance. Conversely, governance, assessed by ownership concentration, negatively influences the relationship between CSR and financial performance. Pasko et al. (2022) examined the moderating influence of corporate governance and the impact of CSR on firms' financial performance. To mitigate financing issues in Islamic banking, it is crucial to enhance the implementation of Sharia principles by establishing laws that delineate the role of the Sharia Supervisory Board (SSB) in overseeing customer financing issues. The ICG, as a risk controller, can enhance the impact of the health ratio on performance while alleviating the adverse impacts of risk on bank profitability (Minaryanti et al., 2024). The findings indicate that corporate governance, evaluated through board size, stock concentration, and CEO duality, amplifies the effect of corporate social responsibility on financial performance. In contrast, governance, evaluated via board gender diversity and independence, does not weaken the relationship between corporate social responsibility and corporate financial performance. This study employs the ICG Index to assess the corporate governance of Indonesian Islamic banks. No study has investigated the relationship between ICG, bank risk profiles, and ISR on Islamic banks' performance. Based on prior theories and studies, the governance interaction hypothesis is articulated as follows:

H7: ICG Index moderates the influence of FDR on financial performance

H8: ICG Index moderates the influence of NPF on financial performance

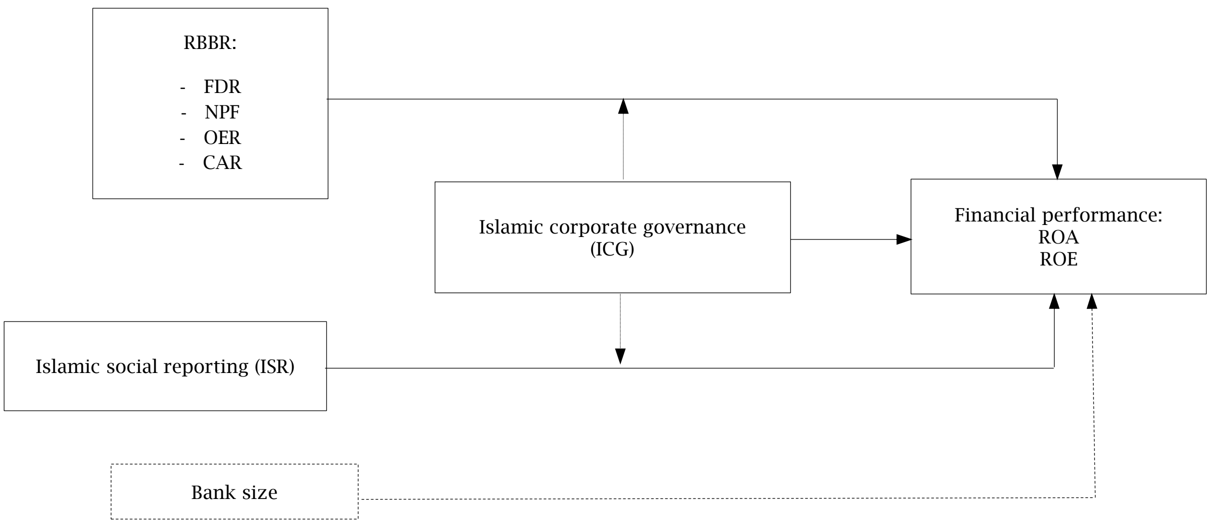
H9: ICG Index moderates the effect of OER on financial performance

H10: ICG Index moderates the effect of CAR on financial performance

H11: ICG Index moderates the effect of ISR on financial performance.

Figure 1 illustrates the study framework based on theoretical and hypothesis development.

Figure 1. Conceptual framework



Source: Authors' elaboration.

Firm size serves as a control variable in this study to examine the disparities in ICG and ISR between large and small firms. A greater bank size, as indicated by total assets, is correlated with improved performance (Adelopo et al., 2018; Darma & Afandi, 2021). The relationship between ICG and bank size adversely impacts financial performance (Oktaviana et al., 2021).

3. RESEARCH METHODOLOGY

3.1. Sample and data collection

This study employed quantitative methodologies with a causal approach. The study population comprised 13 Islamic commercial banks in Indonesia from 2018 to 2022. The sample employed a purposive method with criteria for data completeness, particularly for ISR disclosure. According to these criteria, only 10 Sharia banks fulfill the sample requirements and possess ISR disclosures: PT Bank Aceh Syariah, PT BCA Syariah, PT BPD Nusa Tenggara Barat Syariah, PT Bank Muamalat Indonesia, PT Bank Mega Syariah, PT Bank Jabar Banten Syariah, PT Bank Panin Dubai Syariah, PT Bank Syariah Bukopin, and PT Bank Tabungan Pensiunan Nasional Syariah, PT Bank Victoria Syariah.

3.2. Measurement

This study used financial performance as the dependent variable, while the independent variables included Sharia bank RBBR (liquidity risk, credit risk, operational risk, capital sufficiency) and ISR disclosure. The moderating variable was ICG. The ISR Index comprises 43 categories, which are categorized into six disclosure themes: investment and finance, products and services, labor, social, environment, and corporate governance. The ISR Index is derived from an analysis of a company's annual reports. ISR items reported in the company's annual report are assigned a value of 1, while those not reported in the financial report are assigned a value of 0. The ISR Index computation, as per the AAOIFI, is derived from the total items acquired divided by the total items.

The effectiveness of ICG implementation can be assessed via self-evaluation performed by banks in accordance with the established regulations. The Financial Services Authority Regulation No. 55/POJK.03/2016 stipulates that the governance of Sharia commercial banks must include eleven factors, such as the execution of duties and responsibilities by the Board of Commissioners, Board of Directors, completeness and execution of the committee's duties, and the responsibilities of the Sharia Supervisory Board. Implementation of Sharia principles in fundraising and distribution processes. Management of financial resources and offerings, conflict of interest management, compliance activity execution, internal audit function establishment, external audit function establishment, maximum fund distribution limits, transparency in financial and non-financial conditions of Sharia banks, reports on GCG implementation, and internal reporting. ICG evaluation is performed through self-assessment by the Islamic banks. The ICG composite score ranking was categorized from 1 to 5, with a rank of 1 indicating excellent performance, 2 indicating decent, 3 indicating fair, 4 indicating poor, and 5 indicating very poor. A lower composite ranking signifies enhanced governance (Financial Services Authority, 2014). Table 1 delineates the indicators used to assess the research variables.

Table 1. Variable description

Variables	***Indicator***	***Reference***
Dependent variables		
Financial performance (%)	Return on assets (*ROA*) = Profit (loss) before tax / Total assets Return on equity (*ROE*) = Profit (loss) before tax / Total equity	Alnajjar and Abdullah Othman (2021), Peprah-Yeboah et al. (2025), Yip et al. (2025)
Independent variables		
Liquidity risk (%)	Financing to deposit ratio (*FDR*) = Financing / Third-party funds	Darma and Afandi (2021), Nawrah and Khuluqi (2024), Wahyudi et al. (2021)
Financing risk (%)	Non-performing financing (*NPF*) = Troubled financing / Total financing	Darma and Afandi (2021), Nawrah and Khuluqi (2024), Puspitasari et al. (2023), Wahyudi et al. (2021)
Operational risk	Operating expense ratio (*OER*) = Operating expenses / Operating income	Nawrah and Khuluqi (2024), Wahyudi et al. (2021)
Capital adequacy (%)	Capital adequacy ratio (*CAR*) = Capital / Risk-balanced assets	Nawrah and Khuluqi (2024), Puspitasari et al. (2023), Wahyudi et al. (2021)
Islamic social reporting (*ISR*)	Islamic social reporting (*ISR*) = Total scores disclosure / Maximum total score	Hosen et al. (2019), Othman and Thani (2010), Puspitasari et al. (2023)
Moderating variable		
Islamic corporate governance (*ICG*)	Assessment: Self-assessment by every Sharia commercial bank in Indonesia, which consists of 11 indicators Rank 1 is very good, 2 is good, 3 is quite good, 4 is not good, and 5 is not good.	Financial Services Authority (2014), Oktaviana et al. (2021), Puspitasari et al. (2023)
Control variable		
Bank size	Natural logarithm of total assets	Darma and Afandi (2021), Faturohman et al. (2021), Puspitasari et al. (2023), Wati et al. (2023)

Source: Authors' elaboration.

3.3. Data analysis

This study employed a panel data regression analysis utilizing EViews software for data analysis. This study investigates the function of ICG in moderating the impact of Islamic bank soundness (*FDR*, *NPF*, *OER*, and *CAR*) and ISR on the performance of Islamic commercial banks in Indonesia. The analytical phase commenced with data processing and descriptive statistical tests to ascertain the attributes of the variables. The optimal panel model was identified using three primary methodologies: the common effect model (CEM), fixed effect model (FEM), and random effect model (REM). A set of tests was employed to identify the most suitable model: the Chow test (to differentiate between CEM and FEM), the Hausman test (to distinguish between FEM and REM), and the Lagrange Multiplier (LM) test (to compare CEM and REM).

The subsequent panel data regression model was employed to evaluate the research hypotheses.

$$ROA = \alpha_{it} + \beta_1 FDR_{it} + \beta_2 NPF_{it} + \beta_3 OER_{it} + \beta_4 CAR_{it} + \beta_5 ISR_{it} + \beta_6 SIZE_{it} + \varepsilon_1 \quad (1)$$

$$ROA = \alpha_{it} + \beta_7 ICG_{it} + b_8 ICG * FDR_{it} + \beta_9 ICG * NPF_{it} + \beta_{10} ICG * OER_{it} + \beta_{11} ICG * CAR_{it} + \beta_{12} ICG * ISR_{it} + \beta_{13} IICG * SIZE_{it} + \varepsilon_2 \quad (2)$$

$$ROE = \alpha_{it} + \beta_1 FDR_{it} + \beta_2 NPF_{it} + \beta_3 OER_{it} + \beta_4 CAR_{it} + \beta_5 ISR_{it} + \beta_6 SIZE_{it} + \varepsilon_3 \quad (3)$$

$$ROE = \alpha_{it} + \beta_7 ICG_{it} + b_8 ICG * FDR_{it} + \beta_9 ICG * NPF_{it} + \beta_{10} ICG * OER_{it} + \beta_{11} ICG * CAR_{it} + \beta_{12} ICG * ISR_{it} + \beta_{13} IICG * SIZE_{it} + \varepsilon_4 \quad (4)$$

The hypothesis testing findings were analyzed according to the regression coefficient values, with p-values at the 1%, 5%, and 10% significance thresholds.

4. RESULTS

4.1. Descriptive analysis

The results of the descriptive statistical data analysis are shown in Table 2. The efficacy of Sharia commercial banks is assessed using two metrics: ROA and ROE. The mean ROA and ROE values from 2018 to 2022 were 1.79% and 6.57%, respectively. The ROA and ROE of Islamic commercial banks in Indonesia are classified as healthy (above 1.5%). This demonstrates that Islamic banks can generate profits by effectively employing all assets and capital under their management. The average FDR ratio for Islamic banks in Indonesia from 2018 to 2022 is 84.97%, indicating that the FDR at Sharia commercial banks in Indonesia is classified as good, exceeding 80%. The FDR of Islamic banks should be maintained between 80% and 110% to mitigate financing risks, as a ratio beyond 110% signifies heightened susceptibility to liquidity risk and potential financial distress. Ultimately, this affects the reduction in the bank's profit margin.

The average NPF ratio at Islamic banks in Indonesia from 2018 to 2022 is 2.64%, indicating that the NPF at Sharia commercial banks in Indonesia is within the favorable range of 2% to 5%. The NPF ratio of Islamic banks should be below 5% to mitigate the risk of substandard or non-recoverable funding. A bank is considered unhealthy if its ratio exceeds 5%. The OER for Islamic banks in Indonesia from 2018 to 2022 is 81.57%, indicating that the OER at Sharia commercial banks in Indonesia is classified as favorable, namely below 85%. A smaller OER indicates greater efficiency in an Islamic bank's commercial operations, reflecting a healthier institution than its peers. A high OER signifies that an organization exhibits lower operational efficiency. The average CAR from 2018 to 2022 is 26.5122%, indicating that the CAR ratio of Islamic banks in Indonesia falls within the very healthy category, exceeding 12%. The bank is prepared to confront future threats because of its significant capital reserve.

Table 2. Descriptive analysis

Variables	*Mean*	*Minimum*	*Maximum*	*Median*	*Std. dev.*
ROA	1.7896	0.0005	10.7900	0.8432	2.7538
ROE	6.5656	-31.7600	31.2000	3.6000	11.6019
FDR	84.9696	38.3300	196.7300	86.5850	21.9354
NPF	2.6412	0.0740	5.9935	2.2590	1.6375
OER	81.5698	1.3600	202.7400	85.2100	36.0028
CAR	26.5122	12.3430	53.6590	24.1460	9.5558
ISR	0.7507	0.5814	0.8372	0.7674	0.0681
ICG	2.0800	1.0000	3.0000	2.0000	0.6007
SIZE	16.2473	14.3228	17.9323	16.2292	0.8485

Source: Authors' calculation.

The mean ISR value from 2018 to 2022 was 0.7507, which is equivalent to 75.07%. Sharia Commercial Banks have engaged in Sharia social performance initiatives, encompassing six disclosure themes: investment and finance, products and services, labor, social, environmental, and corporate governance. This initiative seeks to enhance the company's reputation and position it as a viable option for investors in their investment decisions. It seeks the bank's long-term viability because of its favorable future profit potential. ICG derived from the self-assessment conducted by each bank, as documented in the Report on Good Corporate Governance. The mean or average for the period 2018–2022 is 2.0800. The average ICG ratio in Indonesian Islamic banks is categorized as fairly good to good, ranging from 2 to 3. This indicates that each Sharia bank's administration has implemented the governance practices. Nonetheless, its implementation has not been deemed significant, rendering it suboptimal in fulfilling the corporate objectives of companies.

4.2. Correlation matrix

Tables 3 and 4 display a correlation study among several independent variables (*FDR*, *NPF*, *OER*, *CAR*, *ISR*, *ICG*, *SIZE*), revealing that no independent variable exhibits a correlation coefficient greater than 0.8 in either the ROA or ROE models, indicating the absence of multicollinearity. FDR, NPF, OER, and ICG were negatively associated with ROA, although they only significantly influenced the NPF and OER. This demonstrates that Islamic liquidity and financing risk can diminish the performance of Sharia banking. Currently, CAR, ISR, and SIZE exhibit a positive connection with ROA; however, only CAR and SIZE demonstrate statistically significant results for the full sample. This indicates that CAR and SIZE can enhance the performance of Sharia banking, as measured by the return on total assets of Sharia banks.

Table 3. ROA correlation matrix

Variables	*ROA*	*FDR*	*NPF*	*OER*	*CAR*	*ISR*	*ICG*	*SIZE*
ROA	1							
FDR	0.066	1						
NPF	-0.283**	0.255**	1					
OER	-0.216*	0.215*	0.039	1				
CAR	0.692***	0.089	-0.38***	-0.226**	1			
ISR	0.164	0.031	-0.324**	0.443***	0.145	1		
ICG	-0.112	0.115	0.538***	0.190*	-0.46***	0.068	1	
SIZE	0.198*	-0.39***	-0.321**	0.420***	-0.063	0.543***	0.155	1

*Note: *** significance at the 1% level, ** significance at 5%, and * significance at 10%.*
Source: Authors' calculation.

Table 4. ROE correlation matrix

Variables	*ROE*	*FDR*	*NPF*	*OER*	*CAR*	*ISR*	*ICG*	*SIZE*
ROE	1							
FDR	-0.145	1						
NPF	-0.411***	0.255**	1					
OER	-0.487***	0.215**	0.039	1				
CAR	0.374***	0.089	-0.38***	-0.226**	1			
ISR	0.099	0.031	-0.324**	0.43***	0.145	1		
ICG	-0.15	0.115	0.54***	0.190*	-0.46***	0.068	1	
SIZE	0.259**	-0.34***	-0.321**	0.421***	-0.063	0.543***	0.155	1

*Note: *** significance at the 1% level, ** significance at 5%, and * significance at 10%.*
Source: Authors' calculation.

4.3. Hypothesis testing results

FDR, NPF, OER, and ICG have a negative relationship with ROA (Table 3). However, the impact was significant only for the NPF and OER. This demonstrates that liquidity and financing risks may diminish the performance of Islamic banks. Currently, CAR, ISR, and SIZE exhibit a positive connection with ROA; however, only CAR and SIZE demonstrate statistically significant results for the full sample. This indicates that CAR and SIZE can enhance the performance of Sharia banking, as seen by the return on total capital of Sharia banks in Indonesia.

Table 5 displays the regression results of the main and robust models from multiple regression testing.

Table 5. ROA and ROE model

Variables	*Main model (ROA)*				*Robust model (ROE)*		
	Predict	*Coefficient*	*t-Statistic*	*Result*	*Coefficient*	*t-Statistic*	*Result*
C		-18.13417	-3.454635		-117.6671	-4.040914	
FDR	+	0.010255	0.998229	Unsupported	0.121223	2.238540	Supported**
NPF	-	-0.079262	-0.683347	Unsupported	-1.385459	-2.223482	Supported**
OER	-	-0.010886	-1.771141	Supported*	-0.236182	-6.387429	Supported***
CAR	+	0.113534	4.625730	Supported**	0.068875	0.589724	Unsupported
ISR	+	-1.632107	-0.626070	Unsupported	-7.877764	-0.511238	Unsupported
SIZE	+	1.112875	3.562304		8.761075	4.663851	
R-squared		0.5594 (55.94%)			0.6532 (65.32%)		
Adjusted R^2		0.4979 (49.79%)			0.6048 (60.48%)		
F-statistic		9.0974***			13.4975***		

*Note: Significant level, *** $p < 0.01$, ** $p < 0.05$, and * $p < 0.1$.*
Source: Authors' calculation.

Table 6. Moderating ROA and ROE model

Variables	*Main model (ROA)*				*Robust model (ROE)*		
	Predict	*Coefficient*	*t-Statistic*	*Result*	*Coefficient*	*t-Statistic*	*Result*
C		-0.929051	-1.250399		-3.315876	-1.333949	
ICG	-	-6.514442	-2.667972	Supported**	-25.54685	-2.166013	Supported**
*ICG*FDR*	+/-	0.002368	0.712416	Unsupported	0.028363	1.582707	Unsupported
*ICG*NPF*	+/-	-0.088638	-1.400941	Unsupported	-1.021503	-3.916633	Supported**
*ICG*OER*	+/-	-0.001747	-0.629812	Unsupported	-0.075023	-4.728852	Supported**
*ICG*CAR*	+/-	0.084728	5.511434	Supported***	0.124233	2.412572	Supported**
*ICG*ISR*	+/-	-2.503115	-1.722604	Supported*	-5.286842	-0.888647	Unsupported
*ICG*SIZE*	+/-	0.469951	3.248257		2.342806	3.163656	
R-squared		0.5716 (57.16%)			0.7157 (71.57%)		
Adjusted R^2		0.5002 (50.02%)			0.4029 (66.83%)		
F-statistic		15.103***			15.103***		

*Note: Significant level, *** $p < 0.01$, ** $p < 0.05$, and * $p < 0.1$.*
Source: Authors' calculation.

Table 6 displays the moderated regression results for the main and robust models. Based on the results of the hypothesis testing in Tables 5 and 6, OER, CAR, ICG, and the interaction of ICG with CAR and ISR significantly influence financial performance, as assessed by ROA. In the ROE model, several factors exert a more substantial influence than ROA, specifically FDR, NPF, OER, and ICG, and the interactions between ICG and NPF, OER, and CAR. The hypothesis testing results indicate that ROE outperforms ROA, evidenced by a superior R-square value of 71.57% compared with ROA's 57.16%. These empirical findings address the deficiency in prior research by Ongore and Kusa (2013), who asserted that ROA is a principal ratio indicative of a company's profitability or performance. The comparison of returns generated relative to equity contributions is more suitable than that of asset contributions in Indonesian Islamic banks.

5. DISCUSSION

The research findings demonstrate that liquidity risk positively impacts the financial performance of Islamic banks in Indonesia. This is significant only for the ROE. Improving bank liquidity can enhance the financial performance of Sharia banking through the efficient utilization of all managed capital. The findings of this study support signal theory, demonstrating that a high FDR influences stakeholders' investment decisions in Sharia banks. These findings are consistent with previous research

(Adelopo et al., 2018; Darma & Afandi, 2021), suggesting that the FDR positively impacts the financial performance of Sharia banking. Islamic banks must improve their liquidity reserves and effectively manage third-party funds to support the growth of the sector.

Financing risk negatively affects the financial performance of Indonesian Islamic banks, demonstrating significance only in ROE. This indicates that increased financing risk may reduce Islamic banks' profitability, as measured by ROE. The findings of this study support signal theory, demonstrating that a low NPF value influences stakeholders' decisions regarding fund allocation to Sharia banks, which are viewed as effectively managing risks related to problematic financing. The findings of this study are consistent with previous research on Sharia studies (Cantia Lambada et al., 2022; Darma & Afandi, 2021; Nawrah & Khuluqi, 2024; Puspitasari et al., 2023), demonstrating that NPF negatively affects the financial performance of Sharia banks. A lower NPF ratio signifies enhanced financing quality due to a decreased number of problematic loans in the bank. Increased financing risk may hinder banks from achieving their performance objectives, which is a significant concern for stakeholders in the Islamic banking sector.

Operational risk negatively impacts the financial performance of Sharia banking in Indonesia, significantly influencing both ROA and ROE. Heightened operational risk can reduce Islamic banks' profitability. The findings of this study support signal theory, indicating that a low OER reflects a bank's efficiency and ability to perform its operational activities. This affects stakeholders' investment decisions in Sharia banks, as these banks are perceived to effectively manage the risks associated with problematic operations. The findings of this study are consistent with those of prior research (Hosen et al., 2019; Nawrah & Khuluqi, 2024; Nurwulandari et al., 2022), demonstrating that NPF negatively affects the financial performance of Islamic banks. A reduced OER signifies enhanced efficiency in a bank's operational activities, contributing to a more resilient Islamic banking system.

The adequacy of capital has a positive impact on the financial performance of Indonesian Islamic banks. However, this is only relevant for ROA. The data demonstrate a correlation between capital adequacy and return on assets, indicating that an increase in CAR may improve the financial performance of Islamic banks (ROA). The findings of this study support signal theory, demonstrating that a high CAR value influences decision-makers to invest in Sharia banks, which are viewed as having minimal capital requirements. The findings of this study are consistent with those of prior research (Puspitasari et al., 2023; Wahyudi et al., 2021), demonstrating that CAR positively affects Islamic banks' financial performance. A higher CAR signifies an improved ability of the bank to endure operational risks in the future (Wahyudi et al., 2021). Substantial capital signifies that a bank's operations are strengthening, which, in turn, boosts public confidence and incentivizes individuals to keep their funds within the institution. The bank redistributes the funds accumulated through financing. The profit-sharing mechanism in this financing enhances Islamic banks' profitability growth. Consequently, stakeholders perceive the signals disseminated by Islamic banks through their financial reports.

The significant influence of RBBR on the performance of Sharia banking in Indonesia underscores the importance of risk management in achieving optimal performance; thus, management should emphasize the critical role of risk management within the Sharia banking framework. Islamic banks must develop and implement effective risk mitigation strategies to reduce the negative impacts of liquidity, financing, operational, and capital adequacy risks. Diversification of the financial portfolio and improvement of risk assessment are essential steps before extending the funds. Islamic banks should provide training to employees on risk management and its importance to improve their understanding and skills in addressing potential risks in the future.

The ISR does not significantly affect the financial performance of Sharia banking in Indonesia, as assessed by ROA or ROE metrics. The average ISR during the study period was 76.74%. In Indonesia, Sharia banks typically do not attain a 100% index in reporting ISR due to the lack of legislation establishing standards for Sharia social responsibility reporting. ISR represents a firm's initiative to achieve long-term profitability while fulfilling its social obligations. A bank with a high return on assets increases its disclosures. The findings of this study are inconsistent with legitimacy theory. Islamic bank management exhibits social responsibility aimed at fostering stakeholder loyalty; nonetheless, this did not impact financial performance during the study period. The findings of this study are consistent with previous research on banking (Hosen et al., 2019; Oktaviana et al., 2021; Puspitasari et al., 2023), suggesting that ISR has no significant effect on the performance of Islamic banks. Increased ROA and ROE metrics may provide Islamic banks with opportunities to improve transparency. ISR represents corporate activities aimed at leveraging assets to achieve long-term profitability. Additionally, stakeholders demonstrate a limited focus on ISR in annual reports for decision-making (Puspitasari et al., 2023).

ICG negatively influences the financial performance of Sharia banking in Indonesia, adversely affecting both ROA and ROE. Enhancing the ICG Index criterion improves the profitability of Islamic banks, as measured by ROE. The regression coefficient was negative because of the ICG measurement index, which ranged from 1 to 5, with 1 indicating excellent and 5 indicating poor ICG. The regression coefficient is adversely affected, as an elevated ICG Index is associated with inferior ICG quality, thereby reducing the financial performance of Islamic commercial banks in Indonesia. The findings of this study support agency and stakeholder theories, demonstrating that ICG addresses agency problems and reduces inequalities within the organization by promoting compliance with Sharia principles, which, in turn, strengthens stakeholder trust and protects the rights and relationships of all stakeholders. The findings support the principles of justice, transparency, and accountability within the framework of Islamic corporate governance theory related to Sharia banking. Improved governance of Sharia banks based on ICG principles can reduce disparities in Sharia banking in Indonesia and enhance corporate performance by optimizing the use of managed assets and capital. The findings of this study are consistent with those of earlier research (Ben Abdallah & Bahloul, 2021; Khan & Zahid, 2020; Puspitasari et al., 2023), demonstrating that ICG has a positive impact on the financial performance of Sharia banks. Given these findings, financial authorities should strengthen regulations regarding the implementation of ICG in Islamic banks.

The interaction between ICG and FDR on financial performance is insignificant for both ROA and ROE. This suggests that governance does not enhance the influence of liquidity risk on the performance of Sharia banking in Indonesia. The interaction between ICG and NPF on financial performance has a significant effect on ROE. This indicates that banks with strong governance can reduce financing risk and improve profitability for equity contributions to Islamic banks in Indonesia.

The interaction between ICG and OER significantly affects financial performance, particularly ROE. This indicates that governance enhances the impact of operational risk on the performance of Sharia banking. Banks with superior governance can mitigate Sharia banks' operational risks, thereby enhancing the profitability of Sharia bank equity contributions. The interplay between ICG and CAR substantially influences financial performance, specifically ROA and ROE. This demonstrates that governance enhances the impact of capital sufficiency on the financial performance of Sharia banks through the contributions of assets and equity held by Sharia banking institutions. Governance interactions in Islamic banking support the RBBR agency and stakeholder theory. ICG serves as a method for upholding stakeholder interests, including adherence to Sharia standards. ICG can enhance the health status of Sharia banks, reflecting the equitable benefits of all stakeholders.

The interaction between ICG and ISR on financial performance significantly affects ROA. This suggests that governance contributes to the effectiveness of ISR in improving the profitability of Sharia banking assets in Indonesia. Organizations that implement governance in accordance with Islamic principles improve their awareness of social responsibility, which subsequently impacts the performance of Sharia banks. The findings of this study support legitimacy theory, indicating that ICG can improve the role of ISR in reinforcing the legitimacy of Sharia banks, especially in demonstrating compliance with Islamic principles and maintaining public trust. This study supports the conclusions of Pasko et al. (2022) and Pekovic and Vogt (2021).

The size of a bank, as a control variable, significantly and positively influences financial performance, as measured by both ROA and ROE. This indicates that an increase in a company's assets is correlated with higher profits for Islamic banks. The relationship between GCG and bank size significantly affects the financial performance of Sharia banking.

This study identifies inconsistencies with previous research that primarily employed ROA as an indicator of financial performance (Adelopo et al., 2018; Cantia Lambada et al., 2022; Nawrah & Khuluqi, 2024; Puspitasari et al., 2023). This study demonstrates that ROE produces better outcomes than ROA, as indicated by its higher R-squared value. This study presents a new finding regarding the role of ICG in augmenting the effects of RBBR and ISR on banking performance in the context of Sharia banking, an area that has not been previously examined.

6. CONCLUSION

The findings indicate that liquidity risk, financing, operating, and capital adequacy (RBBR), ISR, and ICG significantly impact Sharia banking performance. The ICG can mitigate the impact of RBBR and ISR on the financial performance of Sharia banking. The interaction of governance in RBBR and ISR in Islamic banking reinforces agency, stakeholder, and signalling theories. These findings pertain to the status of Sharia banking, which is continually evolving in Indonesia. In light of intensifying competition, effective risk management is crucial for Islamic banks to sustain their competitiveness and enhance their profitability.

Islamic banks must enhance their liquidity reserves and effectively manage third-party funds (TPF) to facilitate commercial expansion. Islamic banks should provide employee training on risk management and its significance to enhance their knowledge and capability in mitigating potential hazards. The Financial Services Authority may enhance laws pertaining to the implementation of ICG within Islamic banks. Islamic bank management must prioritize the establishment of an effective ICG to fortify ISR disclosures and augment institutional legitimacy in the public's perception. Through effective Sharia-compliant governance, encompassing the supervisory role of the Sharia Supervisory Board (SSB), together with openness, responsibility, and commitment to fairness and integrity, banks can guarantee that all commercial activities and social reports accurately embody Islamic ideals. The Indonesian Financial Services Authority may utilize these findings to enhance the regulations governing risk management in Islamic banking. The absence of Sharia social responsibility reporting criteria necessitates ongoing attention to Islamic social responsibility. The objective is to enhance the company's contribution, thereby fostering stakeholder faith in Sharia banking and augmenting its financial performance in Indonesia. The government, specifically the Financial Services Authority, can establish regulations mandating ISR disclosure by Islamic banks in Indonesia, as this aligns with the business model based on Islamic principles of social responsibility. This involves identifying specific items that Islamic banks must disclose, given the absence of dedicated CSR disclosure regulations for Islamic banks in Indonesia.

This study has some limitations, including its sample size, which concentrated on Indonesian Islamic commercial banks and did not compare them with Islamic banks in other nations. Consequently, further research is anticipated to broaden the sample size of Islamic commercial banks to include other countries for comparative analysis. This study offers diverse perspectives and outcomes that may yield recommendations for the global expansion of Islamic banking. Future research may examine the implementation of ICG, bank health, ISR, and bank performance across nations with varying Islamic legal systems and cultures or between Islamic commercial banks and Sharia business units (*unit usaha Syariah*, UUS). This could involve qualitative methodologies, such as in-depth interviews or case studies, to investigate stakeholders' perceptions, including those of the Sharia Supervisory Board, management, regulators, and customers, regarding the role of ICG and ISR in establishing legitimacy. Additionally, integrating maqāṣid sharia and SDGs into the model would facilitate an assessment of the extent to which ICG and ISR practices genuinely contribute to the social, economic, and spiritual sustainability of Islamic banks.

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