



Background of The Board of Directors and Financial Intermediaries: Does It Contribute to The Performance of Islamic Banks?

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Abstract:

This study aims to examine the effect of women's leadership, education level, financing, and investment on the profitability of Islamic banks. The type of data used is secondary data in the form of annual reports of Islamic banks for the 2016-2020 period. Data collection was carried out using purposive sampling so that the research sample was 12 Islamic banks. The analytical tool used in this panel data regression with dummy variables. The results showed that partial financing and investment have a positive and significant effect on the profitability of Islamic banks. However, women's leadership and education level do not affect profitability. Simultaneously, women's leadership, education level, financing, and investment influence profitability, and the results of the determination test show that the independent variables in the form of women's leadership, education level, financing, and investment can explain the dependent variable profitability by 99%. In comparison, the other 1% is explained by other variables not mentioned in this study.

Keywords: Women Leadership, Education Level, Financing, Investment, Profitability

JEL Classification Code: C33, G21, G41

1. Introduction

The advent of the Islamic financial system cannot be dismissed as a mere trend or phenomenon of Islamic revival. Recently, Islamic finance has played an essential role in global economic growth. Through a growth rate of 5% in 5 years (2019-2024), Islamic finance assets could reach US\$3.69 trillion by 2024 (Dinar Standards, 2020). Even amid the COVID-19 pandemic that has caused economic uncertainty and low investment interest in the Islamic finance industry S&P Global Ratings (2020) reported that the Islamic finance industry is heading towards a recovery period with low to mid-single-digit growth in 2020/2021.

Islamic banking is the sector that contributes the most to global Islamic finance assets. In 2020, Indonesia is reported to occupy the 7th position as the most significant contributor of assets to global Islamic finance, followed by the 10th position as the country with the most significant ownership of Islamic banking assets (Islamic Finance Development Report, 2020). However, this position is still far behind compared to Iran and Saudi Arabia, which can occupy the first and second positions. Even though according to the Central Intelligence Agency (2021), Indonesia has the fourth-largest population and the world's largest Muslim population (Mulazid et al., 2020). Where Cham (2018) and



Suhardi (2011) mention that most Muslim countries can support the development of Islamic banks.

In maintaining business growth, Islamic banking needs to pay attention to profitability. Adams R et al. (2009), Milliken FJ & Martins LL (1996) and Nielsen S & Huse M (2010) revealed that profitability could be influenced by the diversity of the board of director backgrounds and the role of banks as financial intermediaries. This background diversity is considered to improve the quality of board structure policy making so that banking performance is getting better. Ascarya (2007) explains that the role of banks as financial intermediary institutions that collect customer funds and channel them back in the form of business capital can also increase profitability.

The background of board structure is often discussed by academics and policymakers (Gallego-A´lvarez & Pucheta-Martínez, 2020). Furthermore, contemporary organizational theory highlights the importance of background differences in improving corporate board performance. Among the background differences in a board structure, demographic backgrounds such as age, gender, nationality, and education are observed (Ali et al., 2014; Erhardt et al., 2003).

Many gender inequalities arise in the biological aspects of leadership of an organization or institution. Among other things, women are seen as weak and do not have the rational nature of men, so they are considered inappropriate to have careers equal to men and are instead charged with doing all the housework that looks trivial (Fitriani, 2015; Hasibuan, 2017). However, after the Good Corporate Governance scandals in giant companies such as Enron and WorldCom in the United States, which were thought to be due to the lack of heterogeneity in the board structure, many companies began to increase gender diversity in their board structure (Brahma et al., 2021; Erhardt et al., 2003). Lee-Kuen et al. (2017) researched 76 non-financial companies listed on the FTSE Bursa Malaysia Top 100 Index and showed positive results of women's involvement as a board structure on company performance. He mentioned that women can provide different perspectives and more comprehensive thinking in the decision-making process to ensure the company's long-term performance. In addition to gender diversity, the diversity of board education levels is also considered to provide innovations and better abilities in information management to impact company performance positively (Hsu & Chen, H.L Cheng, 2013; Kolev & McNamara, 2019).

The role of banks as financial intermediary institutions between parties with surplus funds and parties with deficit funds is considered to improve the financial performance of banks (Menkhoff, 2000; Stiglitz & Greenwald, 2003). In this case, banks collect funds from customers and channel them back into the business world through their investments (non-yield sharing) and investments with other parties (profit sharing). Furthermore, the profits from these investment activities will be shared back between customers and banks (Ascarya, 2007). Karim (2014) states that financing is a form of distribution of funds carried



out with the principles of *murabahah* (mark-up sale), *sharikah* (profit sharing), *ujroh* (fee) principles, and other complementary contracts. Among the four financing patterns of Islamic banks, financing with *murabahah* (mark-up sale) and *sharikah* (profit sharing) arrangements are two commonly used principles. Investment is another activity related to improving bank performance (Rahman, 2015). Pertiwi et al. (2016) reveal that investment is a significant factor in a company's finances, where the higher investment decision will increase the company's opportunity to get a more significant return. High investment can increase demand for company shares, which in turn can increase profitability.

Some literature that examines the background of the board of directors and financial intermediaries on profitability showed mixed results. Research by Carter et al. (2003), Kılıç & Kuzey (2016) and Lee-Kuen et al. (2017) in Turkey and Malaysia revealed a positive effect of women's involvement on financial performance. Some literature in line with the results of this study reveals the positive impact of women's involvement on the board of directors, such as improving corporate governance structures, maintaining good relationships and communication with female customers and increasing the effectiveness of policymaking by relying on different perspectives and non-traditional approaches (Carter et al., 2003; Shrader et al., 1997). Meanwhile, the results of research in Indonesia and Sri Lanka by Astuti (2017), Saputra (2019), and Wellalage & Locke (2013) show a negative effect of women's involvement on the board of directors on profitability. This influence can be caused by several things, such as the nature of women who are less risk averse than men, or because women have a dual role as housewives that can affect performance so that some positions in the company are more dominated by men (Charness & Gneezy, 2004).

Research by Khidmat et al. (2020) and Waliuddin (2018) on board of director diversity in China and Malaysia shows a positive influence between the board of directors' education diversity and profitability. In contrast, Dedunu & Anuradha (2020) and Wellalage & Locke (2013), who conducted research in India and Sri Lanka, revealed that education hurts company profitability, which may occur because the educational diversity of board members can expand business knowledge and increase individual interests between groups and triggering conflicts. Then, research on financial intermediaries by Afkar (2017), Almanaseer & Alslehat (2016) and Haq (2015) shows a positive influence between *murabahah*, *musyarakah*, *mudharabah*, *qardh* financing on profitability. Meanwhile, research by Putra & Hasanah (2018), Rahman & Rochmanika (2012) and Riyadi & Yulianto (2014) revealed a negative effect of financing of *musyarakah*, *mudharabah*, *murabahah*, *salam* and *istishna* contracts on profitability. Muhammad (2005) mentioned several causes of the negative effect of financing on bank profitability, namely: first, the bank's involvement in intensive monitoring of financing schemes makes banking operations run inefficiently. Second, bank involvement also minimizes the instinct of entrepreneurs who prefer freedom over



interference from other parties in using loaned funds. Third, banks need to increase their costs to maintain efficient performance.

Previous research on investment revealed by Ginting (2019), Haryadi (2016), Purnama shows a positive effect of investment on profitability. It is explained that the investment issued by a company is a critical decision to increase market share and sales, ultimately increasing company profits. Meanwhile, Suryandani's research (2018) shows that investment does not affect profitability. It can be caused by the high investment risk in the future, which can affect investor confidence in investing their capital. Based on the different research results shown by previous researchers, the authors are interested in conducting further research related to women's involvement, education level, financing, and investment in the profitability of Islamic banks in Indonesia. So, this study will examine the effect of the Board of Directors Background and Financial Intermediary on the profitability of Islamic Bank in Indonesia.

2. Literature Review

Agency theory explains the relationship between shareholders (principals) and managers (agents) who are responsible for using and controlling a company's resources (Jensen & Meckling, 1976). In an agency relationship, the principal will authorize the agent to make good decisions for the principal. This separation of ownership and management can trigger agency conflicts between principals and agents. Board members are essential in reducing agency conflicts between owners and managers. In a company, shareholders can only sometimes monitor management due to limited costs or abilities. Therefore, shareholders usually appoint directors to monitor management and ensure their interests (Herdhayinta, 2014). Becker (1964) invented the human capital theory, explaining the importance of individual skills, knowledge, and expertise in a corporation. This theory suggests that diversity is essential in ensuring better performance of board members. Therefore, directors who have a high level of education, knowledge and expertise can influence board decisions so that they can solve problems creatively and innovatively (Bear et al., 2010; Chang et al., 2017; Fernańdez, -Gago et al., 2018; Hsu & Chen, H.L Cheng, 2013; Milliken & Martins, 1996; Srinidhi et al., 2011). Upper echelons theory explains that the financial performance of an organization can be predicted by the background characteristics of top-level managers. Several studies based on this theory show that several factors such as experience, education level, age, tenure and duality are cognitive orientations that can have an impact on corporate behaviour (Daily et al., 2000; Herrmann & Datta, 2005; Roth, 1995). It is also mentioned that an organization can attract, retain and take competitive advantage by increasing diversity among the top management team (Raver & Schneider, 2004).

Intermediary financial theory discusses the primary function of banking as a financial intermediary between parties with excess funds and those with



deficit funds (Gurley & Shaw, 1956). Furthermore, Suhendra & Ronaldo (2017) revealed that funds collected from the public in deposits would be channelled to the real sector and society through investment, working capital and other financing. Bank activities as financial intermediaries include channelling financing and investment to the real sector (Hakim & Anwar, 2017; Ilyas, 2015; Muhammad & Suprayogi, 2019; Munthalib et al., 2016). Based on the Law of the Republic of Indonesia Number 21 of 2008 about Islamic Banking, financing is the provision of funds or bills in profit-sharing transactions, leasing, mark-up sale, borrowing and lending, and leasing services. According to Karim (2008), financing channelled by Islamic banks consists of 4 principles, namely the mark-up sale principle (*murabahah*, *salam* and *istishna*), the profit sharing principle (*mudharabah* and *musyarakah*), lease principle (*ijarah* and *ijarah mutahhiyah bittamlik*), as well as complementary contracts (*hiwalah*, *rahn*, *qardh*, *wakalah* and *kafalah*).

Profitability is the company's ability to generate profits. Kasmir (2008) reveals that profitability has the aim of knowing the bank's ability to analyze profits during a certain period. In addition, profitability also aims to measure the level of management effectiveness in its business operations. The profitability of a bank can be known by analyzing the company's financial statements, the analysis will show the bank's ability to earn profits. Several previous studies related to the relationship between the background of the board of directors and financial intermediary to the level of profitability have been conducted and have different results. Research by Lee-Kuen et al. (2017), Dedunu & Anuradha (2020), Brahma et al. (2021) and Khidmat et al. (2020) revealed that the involvement of women as board of directors has a positive influence on financial performance. In this case, it is stated that women can bring new perspectives and different skills in determining effective policies for company performance. In contrast, several other studies have shown different results (Astuti, 2017; Issa et al., 2021; Rafindaa et al., 2017; Wellalage & Locke, 2013). It is stated that the risk-averse character of women and their role as housewives may adversely affect profitability.

Regarding education level, research by Brahma et al. (2021) and Khidmat et al. (2020) revealed that the level of education of the board of directors has a positive effect on profitability. These two studies reveal that good intellectual abilities can create superior decisions for a company. In contrast, Issa et al. (2021) and Boadi & Osarfo (2019) revealed that the level of education sometimes needs to represent the practical knowledge possessed so that the decisions made become less effective and then have an adverse impact on performance. Furthermore, financing products in Islamic financial institutions show a positive influence (Lisa, 2016). It mentioned that the profit earned from financing products can increase the profitability of the institution. However, research by Fernanda et al. (2016) shows that financing does not affect profitability. For investment, Febriana (2012) and Fernanda et al. (2016) found that investment will increase the profitability of Islamic banks. Through the return of invested funds,

banks can improve their financial performance. Conversely, other studies reveal that the resale of securities can take a long time, so it adversely affects profitability (Munthalib et al., 2016).

3. Research Methods

This study examined the effect of the board of directors' background and the bank's role as a financial intermediary on the profitability of Islamic banks in Indonesia. It uses a non-probability sampling method and selected 12 Islamic banks in Indonesia as samples. The sample determination was based on purposive sampling with the following judgment sampling criteria. First, Islamic commercial banks registered with the Financial Services Authority (OJK). Second, Islamic commercial banks publish annual reports for the 2016-2020 period on the official website of Islamic banks. Finally, it has an annual report that contains information on all research variables. Then, panel data of independent and dependent variables were collected from 2016-2020. In this case, female leadership, education level, financing and investment are categorized as independent variables. Meanwhile, the dependent variable used is the total profitability of Islamic banks. Furthermore, the following is the operational definition of each variable in this study:

Table 1: Operational Definition of Variables

Variable	Measurement	Source
Dummy Woman Leadership (DWL) (X1)	Measured by a dummy variable, which is equal to 1 if there is at least one female director in the board structure and 0 otherwise.	Kılıç & Kuzey (2016) and Lee-Kuen (2017)
Dummy Education Level (DEL) (X2)	Measured by a dummy variable that is equal to 1 if there are at least two directors with educational backgrounds in business and economics and 0 otherwise.	Saputra (2019)
Total Financing (TF) (X3)	Measured by the total financing distributed by Islamic Commercial Banks.	Fernanda et al. (2016) and Rahman & Rochmanika, (2012)
Investment (IV) (X4)	Measured by the value of investments in securities.	Muhammad & Suprayogi (2019) and Fernanda et al., (2016)
Profitability / Income as <i>Mudharib</i> (IM) (Y)	Measured by the bank's income as <i>mudharib</i> .	Wijayanti (2016)

Source: Data processed, 2022

The panel data regression test with dummy variables will be conducted with e-views software. The relationship between the board of directors and

financial intermediaries on the profitability of Islamic banks can be expressed in a theoretical framework as below:

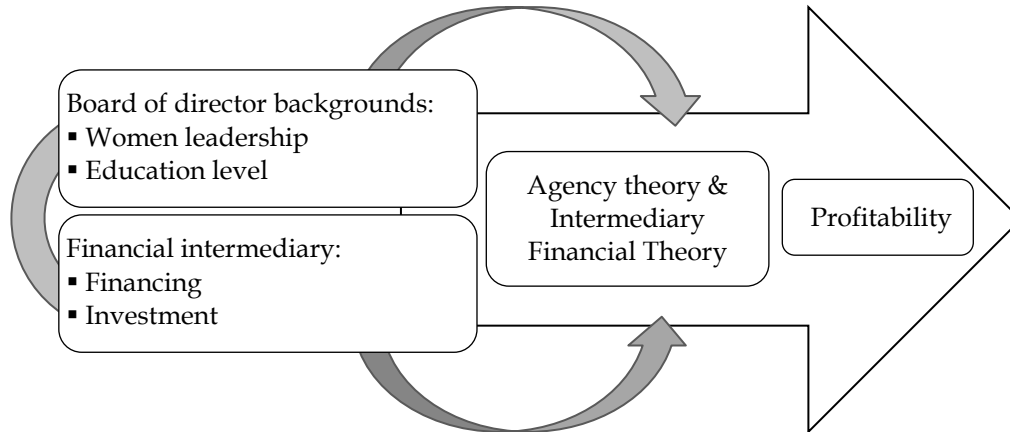


Figure 1: Scheme of Board of Director Background and Financial Intermediary in Determining Profitability

Before looking at the form of regression on the variables tested, estimating the panel data model is necessary. Generally, three techniques can be used: Ordinary Least Square (OLS) or Common Effect, Fixed Effect and Random Effect models. Then, to determine the best model between the three models, it is necessary to conduct a Chow test, Hausman test and Lagrange multiplier test. In the chow test, a comparison will be made between the common model and the fixed model. Meanwhile, the Hausman test will compare the random and fixed effect models. As for the Lagrange multiplier test, a comparison will be made between the common effect model and the random effect model.

This research regression test uses several qualitative variables, which are then transformed into dummy variables. This variable transformation also requires the transformation of the variables used into natural logarithms (Ln) except for the dummy variable itself (Ghozali, 2011). Therefore, the regression equation used in this study is as follows:

$$\text{Ln}Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 \text{Ln}X_{3it} + \beta_4 \text{Ln}X_{4it} + \mu_{it}$$

$$\text{Ln}Y_{IM} = \beta_0 + \beta_1 X_{DWLit} + \beta_2 X_{DELit} + \beta_3 \text{Ln}X_{TFit} + \beta_4 \text{Ln}X_{IVit} + \mu_{it}$$

Based on the equation above, it can be seen that $\text{Ln}Y_{IM}$ is the dependent variable to be predicted in this study. Ln is indicating that the natural logarithm is used in this variable. Then, X_{DWLit} , X_{DELit} , $\text{Ln}X_{TFit}$ and $\text{Ln}X_{IVit}$ are independent variables. Where each coefficient β describes the effect of the independent variable on the dependent variable. Finally, the μ_{it} is the error term in the model.



4. Finding and Discussion

Table 2: Statistics Descriptive

Indicator	Ln_IM	DWL	DEL	Ln_TF	Ln_IV
Mean	13.864	0.167	0.883	15.631	14.312
Median	13.638	0.000	1.000	15.747	13.952
Maximum	15.971	1.000	1.000	18.237	16.933
Minimum	10.351	0.000	0.000	3.989	10.568
Std. Dev.	1.398	0.376	0.324	2.241	1.593

Source: Data processed, 2022

Table 2 shows that the average Ln_IM (Income as *Mudharib*) during the observation period was 13.8, with a standard deviation 1.3. The standard deviation value, which is smaller than the average, indicates no gap in the income value as a *mudharib* of Islamic banks during the observation period. This good result also occurs in three other variables, namely DEL (Dummy Education Level), Ln_TF (Total Financing) and Ln_IV (Investment). However, the Ln_DWL (Dummy Women Leadership) variable obtained an average value of 0.1 with a more significant standard deviation of 0.3. This more excellent standard deviation value than the average indicates a gap between the number of women leaders and men leaders on the board of directors of Islamic banks.

Table 3: Regression Model Selection

Chow Test			
Effect Test	Statistic	d.f	Prob.
Cross-section F	88.315930	(11.44)	0.0000
Hausman Test			
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f	Prob.
Cross-section random	22.857839	4	0.0001

Source: Data processed, 2022

Table 3 shows that the Cross-Section F probability value of the Chow test is <0.05 . It indicates that the fixed effect model is better than the common effect model. Then, in the Hausman test, the probability value is <0.05 . It indicates that the fixed effect model is better than the random effect model. Therefore, the regression model chosen in this study is the fixed-effect model

In order to fulfil the BLUE (best linear unbiased estimation) requirement in this research, a classic assumption test is carried out so that the interpretation of the results is free from bias. This classical assumption test consists of normality, multicollinearity, heteroscedasticity and autocorrelation tests (Ghozali, 2005). In the normality test, the Jarque-Bera value of $0.39 > 0.05$ was obtained, indicating that the data in this study were normally distributed. In addition, a multicollinearity test was also conducted to see the correlation between the study's independent variables with a tolerance limit of <0.8 (Abdul-Rahman et al., 2017). Based on the test results, the correlation value of all

independent variables is <0.8 , so the regression model of this study is free from multicollinearity.

Then, an autocorrelation test is carried out to see the residual correlation between one observation and another. The basis for decision-making is that if the Durbin-Watson value lies between dU and $4-dU$, there is no autocorrelation. The dU value with 4 independent variables is 1.7274, and the $4-dU$ value is 2.2726. So, the DW value of 1.735855 is between the dU value of 1.7274 and $4-dU$ 2.2726 and indicates that the regression model of this study is free from autocorrelation. As for avoiding heteroscedasticity problems, the interpretation of the panel data regression test with dummy variables in this study will be carried out using the Cross Section Weight method in the three regression models used (Gujarati & Porter, 2009; Mufraini et al., 2021).

The results of the regression test on the variables of women leadership, education level, financing and investment on the profitability of Islamic banks will be presented in simultaneous tests, partial tests and the coefficient of determination (R-squared). Simultaneous test (F-test) is used to test the effect of independent variables on the dependent variable simultaneously or together. The significant level used in this test is 0.05 ($\alpha = 5\%$). The basis for determining the decision is that if the probability value is less than the significant level ($\alpha = 5\%$) then the independent variables jointly affect the dependent variable (Widarjono, 2009). The simultaneous test results in this study are as follows:

Table 4: Simultaneous Test Results

Test	Value
R-squared	0,997417
Adjusted R-squared	0,996537
S.E. of regression	0,204711
F-statistic	1132,860
Prob(F-statistic)	0,000000

Source: Data processed, 2022

Based on the results of the simultaneous test in Table 4, the Prob (F-statistic) value = 0.00 <0.05 is obtained, indicating that the variables of women's leadership, education level, financing, and investment simultaneously affect profitability and the adjusted R2 value is 0.99 or 99%. It shows that profitability can be explained by women's leadership, education level, financing, and investment by 99%, while the remaining 1% is explained by other variables not mentioned in this study.

The next stage, the partial test is conducted to see how significant the effect of independent variables is on the dependent variable (Eksandy, 2018). The decision on the partial test results can be seen by comparing the probability values. If the probability value $<$ level of significance ($\alpha = 5\%$) then the independent variable significantly influences the dependent variable.

Table 5: Partial Test Results

Variables	Coefficient	Std. Error	t-Statistic	Prob.
C	9,668949	0,388982	24,85707	0,0000
DWL	0,041975	0,034118	1,230276	0,2251
DEL	0,043078	0,060080	0,717010	0,4772
Ln_TF	0,145914	0,013509	10,80093	0,0000
Ln_IV	0,130622	0,021285	6,136922	0,0000

Source: Data processed, 2022

Table 5 shows that the women leadership variable has a coefficient value of 0.04 with a probability of 0.225. This value shows profitability > 0.05 . It means there is no significant effect of women's leadership on the profitability of Islamic banks. Therefore, if there is a decrease or increase in women's leadership, it cannot determine the profitability obtained by Islamic banks. It can be caused by the characteristics of women who generally do not like risk compared to men. This is evidenced by the low percentage of women on the board of directors compared to men. In addition, women active in the public sphere have a dual role as housewives and career women who are thought to affect performance at work. These results are in line with the research of Issa et al. (2021), Rafindaa et al. (2017) and Astuti (2017), which state that there is no significant effect of women's leadership on financial performance. However, this study contradicts the research results by Lee-Kuen et al. (2017) and Brahma et al. (2021), which show a significant positive effect of women's leadership on financial performance.

The coefficient value of the education level variable is 0.043, with a probability of 0.477. This value shows a probability > 0.05 . It means education level does not affect profitability. The reason for this absence of influence is that although directors with a high level of education can provide relevant knowledge and information, more is needed to improve the ability of directors to make decisions. It is thought to be because someone with a high level of education needs practical knowledge, so decisions related to bank performance become ineffective (Klarnar et al., 2019). This research is in line with the research of Astuti (2017), Boadi & Osarfo (2019) and Wellalage & Locke (2013) which state that the level of education has no influence on financial performance. However, this research contradicts the results of research by Khidmat et al. (2020) and Brahma et al. (2021) which state the effect of education level on profitability.

The financing variable has a coefficient value of 0.145 with a probability of 0.000. This value shows a probability of < 0.05 . It means there is a positive and significant effect of financing on profitability, where if financing increases by 1 unit, it will increase profitability by 0.145. It shows that the greater the financing channel, the greater the profitability. Financing channelled by Islamic banks with the principles of mark-up sale, profit sharing, lease or other complements will



generate profits for Islamic banks. So, the more channelled financing, the more profitability the Islamic bank will obtain. This research is in line with the results of Lisa (2016), which states that financing has a significant effect on profitability. However, this research contradicts the results of Fernanda et al. (2016), who state that financing does not affect profitability.

In the partial test of the investment variable, the coefficient value is 0.130 with a probability of 0.000. This value shows a probability of <0.05 . It means that there is a positive and significant effect of investment on profitability, where if investment increases by 1 unit, it will increase profitability by 0.130. As with its purpose, investment involves using funds outside of operational activities to obtain future profits (Suryandani, 2018). It shows that the company can increase its long-term profits by maximising investment (Mardiyati et al., 2015). In addition, investment instruments can also be an alternative when banks need funds quickly by selling these investments. This research is in line with the research of Fernanda et al. (2016) and Febriana (2012), which state that investment securities significantly affect profitability. However, this study contradicts the results of research by Munthalib et al. (2016), which revealed a negative effect of investment securities on profitability.

5. Conclusions

The findings in this study indicate that women's leadership, education level, financing, and investment significantly influence Islamic banks' profitability. However, the variables that partially affect profitability are only financing and investment. Meanwhile, the other two variables, namely women's leadership and education level, do not affect profitability. Meanwhile, the other variables, female leadership and education level, do not affect profitability. It can be caused by the women's character, who tend to avoid risk; their role as housewives also affects their performance at work. This study suggests that more than the level of education of the board of directors is needed to guarantee that they have practical knowledge. Hence, the decisions made become less effective

The study provides practical implications for banking sector regulators. First, to maximize the profitability of Islamic banks in Indonesia, stakeholders can maintain and increase the amount of bank financing and investment. Second, as women tend to be risk-averse and have dual roles as homemakers, regulators need to consider the proportion of women in the board of director structure. It is necessary because the courage to take risks is important to grow a business. Finally, stakeholders should make the level of education a manageable criterion in selecting the board of directors. However, they also need to balance it with practical experience to make decisions more effective. There are several limitations in this study. First, gender and education are only some aspects of directors' background. Thus, future studies must consider other aspects such as



age, experience, and culture. Second, future research can be conducted on the same topic in other developing countries to compare the findings.

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