THE MEDIATING EFFECT OF SHARIAH SUPERVISORY BOARD ON MANAGEMENT CONTROL SYSTEM AND PERFORMANCE OF ISLAMIC BANKS IN INDONESIA: COMPETITIVE STRATEGY AS MODERATOR

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2024

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by

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Thesis submitted in fulfilment of the requirements
for the degree of
Doctor of Philoshopy

September 2024

ACKNOWLEDGEMENT

First of all, my thanks go to Allah Almighty, for showing me the straight path. He gives us strength, love, and encouragement and all things at all times. Writing this pieces of work has never been completed without the encouragement and support of a number of valuable people in fulfillment of the requirements of this thesis.

I am greatly indebted to my supervisor, Dr. Md Harashid Haron, for his kindness, wisdom, and keenness to guide and counsel me and review my work during this period. His constructive feedback has helped me remedy the shortcomings in the study.

My appreciation and gratitude also goes to the Dean of the School of Management, Professor Dr. Noor Hazlina Ahmad. Many thanks also go to the academic staff in the School of Management and International Postgraduate Studies. Then, an infinite thank you to the Chancellor of Universitas Muhammadiyah Sumatera Utara, Prof.Dr.Agussani, MAP for his moral and material support so that the thesis can be completed.

I would like extend my great appreciation to my parents, Sugeng Rahayu and Darliana, my wife, Yunawati Siregar, my brothers and sisters, and my friends for the prayers and their affection that encouraged me for completing this thesis. To all USM lecturers and staff, family, and friends who have been with me through thick and thin, I pray that Allah SWT will always bless your live. All the mercy from Allah the Al mighty bless you all.

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AAOIFI	Accounting and Auditing Organization for Islamic Financial Intitution
AVE	Average Variance Extracted
BUS	Bank Umum Syariah
CAR	Capital Adequaty Ratio
FDR	Financing to Deposit Ratio
GCG	Good Corporate Governance
IB	Islamic Bank
ICMI	Ikatan Cendekiawan Muslim se Indonesia
IFI	Islamic Financial Intitution
IFSB	Islamic Financial Service Board
MCS	Management Control System
MPEM	Maqasid-based Performance Evaluation Measurement
MUI	Majelis Ulama Indonesia
NOI	Net Operating Income
NPF	Non Performing Financing
OJK	Otoritas Jasa Keuangan
PLS	Partial Least Square
ROA	Return on Assets
SEM	Structural Equation Modelling
SSB	Shariah Supervisory Board
UUS	Unit Usaha Syariah
SAW	Sallallaahu Alaihi Wasallam

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KESAN PENGANTARAAN LEMBAGA PENGAWASAN SYARIAH TERHADAP SISTEM KAWALAN PENGURUSAN DAN PRESTASI PERBANKAN ISLAM DI INDONESIA: STRATEGI PERSAINGAN SEBAGAI PENYEDERHANA

ABSTRAK

Kajian ini bertujuan untuk menyelidik kesan Majlis Pengawasan Syariah sebagai pengantara dan strategi kompetitif sebagai penyederhana terhadap hubungan antara sistem kawalan pengurusan dan prestasi bank Islam di Indonesia. Sistem kawalan pengurusan bank Islam di Indonesia dikaji berdasarkan “Tuil Kawalan” Simon, dan prestasi dinilai menggunakan konsep Maqasid Syariah. Kajian ini melibatkan 128 responden dari 32 bank Islam yang berdaftar di bawah Otoritas Jasa Keuangan (OJK), dan ujian hipotesis dilakukan menggunakan PLS-SEM dengan perisian Warppls versi 8.0. Hasil kajian menunjukkan bahawa sistem sempadan mempunyai impak positif dan signifikan terhadap prestasi bank Islam di Indonesia. Selain itu, Majlis Pengawasan Syariah bertindak sebagai pengantara dalam hubungan antara sistem sempadan dan prestasi bank Islam, serta sistem kawalan interaktif. Semua bank Islam di Indonesia menggunakan strategi kos rendah yang memudahkan pelaksanaan sistem kepercayaan dan sempadan. Implikasi kajian ini mengesahkan bahawa sistem kawalan pengurusan akan meningkatkan prestasi bank Islam dengan sokongan fungsi dan peranan Majlis Pengawasan Syariah. Kajian ini juga menunjukkan bahawa interaksi teori agensi, teori pemegang amanah, dan teori pihak berkepentingan mempengaruhi pelaksanaan tadbir urus korporat dalam bank Islam.

THE MEDIATING EFFECT OF SHARIAH SUPERVISORY BOARD ON MANAGEMENT CONTROL SYSTEM AND PERFORMANCE OF ISLAMIC BANKS IN INDONESIA : COMPETITIVE STRATEGY AS MODERATOR

ABSTRACT

This study aimed to investigate the impact of the Shariah Supervisory Board as a mediator and competitive strategy as a moderator on the relationship between the management control system and the performance of Islamic banks in Indonesia. The management control system of Islamic banks in Indonesia was studied based on Simon's levers of control, and the performance was evaluated using the Maqasid Shariah concept. The study included 128 respondents from 32 Islamic banks registered under the Financial Services Authority (OJK), and the hypothesis testing was conducted using PLS-SEM with Warppls software version 8.0. The results indicated that the boundary system had a positive and significant impact on the performance of Islamic banks in Indonesia. Furthermore, the Shariah Supervisory Board acted as a mediator in the relationship between the boundary system and the performance of Islamic banks, and the interactive control system. All the Islamic banks in Indonesia utilized low-cost strategies that facilitated the implementation of belief and boundary systems. The implications of this research confirm that the management control system will improve the performance of Islamic banks with the support of the functions and roles of the Shariah supervisory board. The study also demonstrated that integrating of agency, stewardship, and stakeholder theories influenced corporate governance implementation in Islamic banks.

CHAPTER 1

INTRODUCTION

1.1 Background

Globally, the growth of Islamic banking is very rapid. It has even been demonstrated that it could thrive in moments of recession. However, challenges still need to be resolved so that this sector can play a part in realizing the vision and task of banking operations with Islamic principles (Hadi, 2016; Ngalim & Ismail, 2014). Many Islamic banks have been established to perform retail banking operations for customers who plan to borrow and invest according to their Islamic beliefs (Grais & Pellegrini, 2006; Radiah et al., 2014).

Islamic banking has grown significantly in Muslim countries and around the globe since the operation of Egypt's Mitt Gamr Local Savings Bank in 1964. The growth is influenced by various factors, including the application of broad macroeconomic and cultural modifications in economic systems, the liberalization of capital transfers, privatization, global financial market integration, and the development of innovative and new Islamic products (Abdul Aris et al., 2013; Ahmed, 2014; Razak, 2014).

In 1990, supporters of the Islamic economic movement in Indonesia succeeded in convincing Islamic scholars in the Indonesian Ulema Council (Majelis Ulama Indonesia or MUI) and the Indonesian Association of Muslim Intellectuals (Ikatan Cendikiawan Muslim se-Indonesia or ICMI) to support the establishment of the first Shariah bank in Indonesia, Bank Muamalat Indonesia. MUI's involvement in this growth has given itself and Islamic scholars unique rights in the governance of the Islamic economic sector. Together with the development of the Islamic economy after 1998, the commitment of Islamic scientists to Islamic economic initiatives has also increased (Al Banna Choiruzzad & Nugroho, 2013).

The characteristics of the Islamic (*Shariah*) banking system that operates based on the principle of profit-sharing provide an alternative banking system that is mutually beneficial to the public and banks, as well as highlighting aspects of fairness in transactions, ethical investment, promoting the values of togetherness and brotherhood in production, and avoiding speculative activities in financial transactions (Muneeza & Hassan, 2014; Selvaraja & Man, 2016; Dammak & Triki, 2017).

By providing a variety of products and diverse banking services with more varied financial schemes, Islamic banking becomes an alternative and credible banking system that can be enjoyed by the public without exception as the application of Islam as *Rahmatan Lil 'Alamin* (Ginena, 2014; Mohamad, 2015).

The multiple reasons for the growth of the Islamic banking in recent years ((Cham, 2018; Effendi, 2021; Elasrag, 2010)) are as follows:

1) The flow of funds into Muslim oil-producing states;
2) The growing political and social desire in the Muslim world for financial alternatives to banking and investment institutions that the West has historically dominated;
3) The widespread credit crisis in global financial markets and the need to access new sources of investment capital;
4) The growth of sovereign wealth funds and the desire to have Shariah-compliant instruments through which to invest them; and
5) The rapidly accelerating number of cross-border multi-jurisdictional financial transactions that is possible and required in a globalized world economy from Muslim investors worldwide.

The organizational objectives of Islamic banking differ from conventional banks' organizational objectives. The vision and mission of Islamic banks are supposed to reflect the adherence of their activities and aspirations to Islamic principles. However, there are contentions that Islamic banks have been converging towards the conventional banking system (Albaity et al., 2019; Ibrahim & Ismail, 2015; Salman & Nawaz, 2018).

The organizational objectives of Islamic banks based on Islamic principles that differentiate them from conventional banks are aimed at increasing the Muslim community's comfort level while transacting with Islamic banks (Kadom, 2010; Rafiki & Wahab, 2014; Shibani & De Fuentes, 2017). Naturally, performance measurement is used to determine whether an Islamic bank's objectives have been achieved per Islamic principles (Adib & Khalid, 2010; Ikhsan Ramdhoni, 2018; Rusydiana & Al Parisi, 2016).

The Shariah Supervisory Board's (SSB) role is very important to ensure the achievement of Islamic banks' objectives (Alam et al., 2021; Ali & Hussain, 2021). The SSB becomes essential during the process of obtaining an Islamic bank performance review to ensure that all procedures, products, and services comply with Islamic principles (Lukito et al., 2021; Ulfi et al., 2020).

SSB will affect how well an Islamic bank operates by Islamic laws (Marwan et al., 2016; Rababah & Rababah, 2017). It can affect decision-making to be influenced by Islamic principles (Masruki, Mohd Hanefah, et al., 2018; Musibah & Alfattani, 2014). In addition to reporting and expressing an opinion on the Shariah compliance of Islamic banks in their annual reports, the SSB is responsible for issuing fatwas, overseeing banks' activities, authorizing (or rejecting) financial products, reporting on the Shariah compliance of Islamic banks in their annual reports, and providing opinions (Gusrianti & Bahtera, 2018; Najwa et al., 2019; Rafay & Farid, 2018).

In addition, the performance of Islamic banks is influenced by the match between the management control system and the chosen competitive strategy (Ali et al., 2022; Bose, 2016; Hussain.Hamid et al., 2019). Given the restrictions imposed by Islamic principles, Islamic banks tend to choose more conservative competitive strategies. Meanwhile, more competition exists among Islamic and conventional banks (Albaity et al., 2019; Mateev et al., 2022; Wahid, 2017).

The subsequent development is how to keep Islamic banks' activities following Islamic principles under the supervision of the SSB. Therefore, it is essential to continuously examine the mediating effect of SSB on aspects of good governance in Islamic banks (Mim & Mbarki, 2021; Saeed & Saeed, 2018; Ulfi et al., 2020). In addition, it is very exciting to examine the moderating effect of competitive strategies in Islamic banks.

1.1.1 Shariah Supervisory Board and Performance of Islamic Banks in Indonesia

Islamic banks can be triggered not to behave by the contracts agreed between the principals (shareholders) and management of Islamic banks due to agency problems caused by asymmetric information between principals and management (Htay & Syed, 2013; Mohammed & Muhammed, 2017).

Consequently, operations will be governed by Islamic principles, given that the Shariah Supervisory Board emphasizes *Maqasid Shariah* as a performance measure for Islamic banks (Fakhruddin & Purwokerto, 2020; Shahwan & Mohammad, 2013).The effectiveness of how the SSB performs its tasks and functions determines how well *Maqasid Shariah* is applied to measure the performance of Islamic banks (Ahmed, 2011; Ali & Hussain, 2021b; Masruki et al., 2018; Rosnia Masruki et al., 2018).

Maqasid Shariah is an objective in Shariah law that enables an easy understanding of the philosophy of Islamic law that Allah has established for the benefit of the world and the hereafter. Imam Ghazali and Ibn Ashur formulated the elements of the *Maqasid Shariah*, namely freedom of faith, preservation of human dignity/human rights, propagation of scientific thinking, the well-being of society/diminishing the difference between economic levels, and care of family/stakeholders

Maqasid Shariah must also be supported by a management control system, which is a system to achieve Islamic bank performance (Ullah, n.d.; Zulkhibri et al., 2012). Implementing the management control system in Islamic banks must be supervised by the Shariah Supervisory Board (T. E. Ahmed, 1998, 1998; Ullah, n.d.). To achieve the performance of Islamic banks, a match between the management control system and the competitive strategy chosen by the company is needed (Hisham Alnajjar et al., 2021; Said et al., 2017). Selecting a competitive strategy that is, of course, in compliance with Islamic principles is also a necessity. This part will also be supervised by the SSB (Muhammad et al., 2021; Sulub et al., 2020).

The presence of Shariah Supervisory Board (SSB) can boost acheiving the *Maqasid Shariah* in Islamic banks (Fakhruddin & Jusoh, 2018; Mustafa & Syahidawati, 2013; Ulfi et al., 2020). Due to strong *Shariah* supervision and competent oversight by the SSB, Islamic banks can comply with Islamic laws and prevent the management of Islamic banks from abusing their positions to deceive customers and benefit themselves (Abdullah, 2013; Saeed & Saeed, 2018a; Ulfi et al., 2020).

Recent empirical evidence is required to demonstrate the impact of the Shariah Supervisory Board on the performance of Islamic banks. Masruki, Hanefah, et al., (2018) found in his research that the presence of Shariah supervisory board significantly affects the Return on Assets (ROA) and Debt-to-Equity Ratio of Islamic banks in Malaysia.

Pratama et al. (2021)studied 14 Indonesian Islamic banks and found that the presence of SSB had a significant positive impact on their social performance. Alam et al.'s (2022) findings on Islamic banks in Bangladesh indicate that the presence of SSB has a substantial impact on their performance, which proves the effective implementation of *Shariah* governance in the banking industry.

A study conducted by Yuliani and Pratama (2019) shows that SSB at Indonesian Islamic banks has a vital role in maintaining the suitability of bank business activities with *Shariah* principles. The study found that the SSB in Indonesian Islamic banks has successfully acted as supervisor of bank business activities that carry out *Shariah* principles properly.

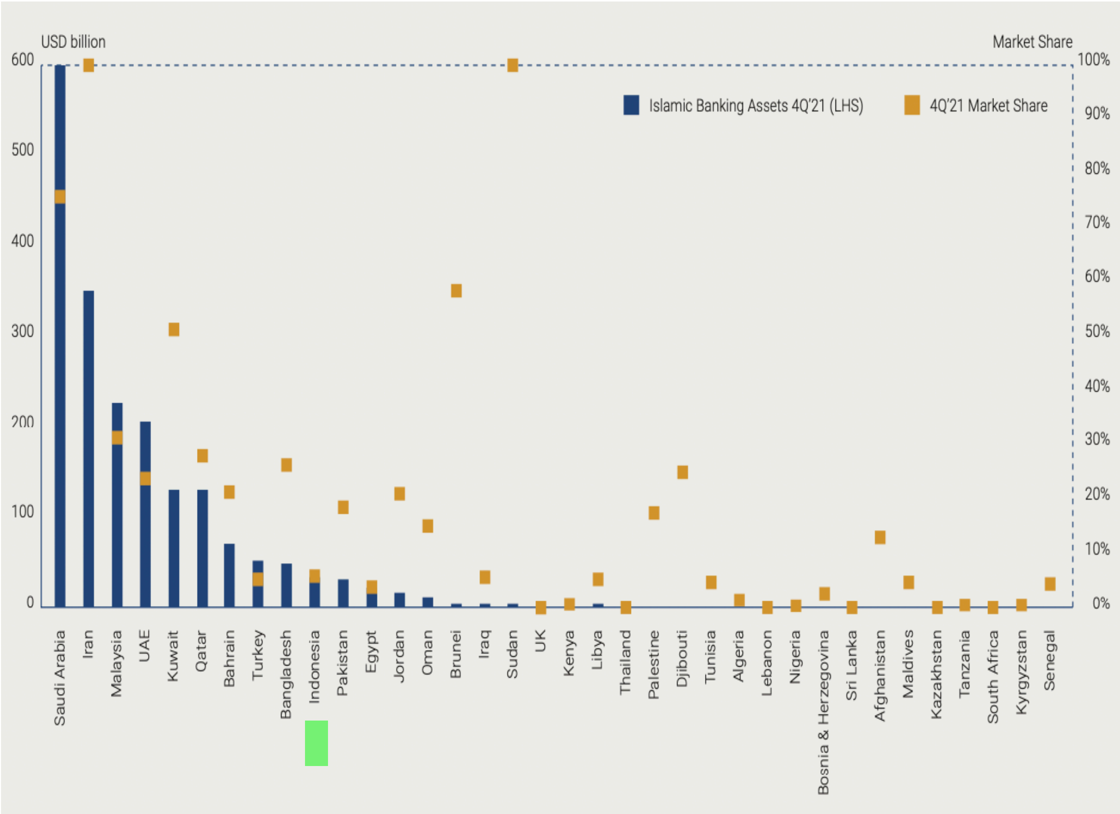
Contrary to the conclusions of the studies, there have been several occasions in which Islamic banks in Indonesia have been vulnerable to inadequate supervision by the SSB. One of the fraud cases at the PT Bank Muamalat Indonesia Tbk Mataram branch in 2017 involved employees allegedly involved in fraudulent practices related to the embezzlement of 21 customer accounts..

In addition, in 2020, there was a fraud case at PT Bank Rakyat Indonesia Syariah (BRI Syariah) carried out by unscrupulous employees. In this case, unscrupulous employees falsified documents and transferred customer funds to their own accounts. As a result, BRI Syariah suffered a loss of IDR 5 billion. In 2023, a leader of the Sumenep branch of Bank Syariah Indonesia was proven to have embezzled Rp. 60 billion in customer funds.

According to Mukhibad's (2019) study, which yielded contradictory findings, Indonesian Islamic commercial banks still need to implement *Maqasid Shariah* in measuring their performance, as the Shariah Supervisory Board is not yet concerned with it. Subsequent studies will be concerned about these contradictions so that a solution can be found.

The Islamic Financial Service Board (IFSB) explained in the 2022 Islamic

Financial Service Industry Stability Report on Islamic Banking Assets and Global Market Share in 2021 that Indonesia's banking assets are still below 50 billion dollars and its market share is still below 10%, as described in Figure 1.



Source: 2022 Islamic Financial Service Industry Stability Report (IFSB)

Figure 1. Assets and Market Share of Islamic Banks based on Country (2021)

The global data show that the performance of Islamic banking in Indonesia has not been optimal, considering that Indonesia is a country with the largest number of Muslims in the world. This indicates the low confidence of prospective customers in Indonesia who are making transactions in Islamic banks. One of the most important reasons why Muslim prospective customers choose to perform financial transactions through Islamic banks is the realization of Islamic principles in Islamic banking operations that differentiate them from conventional banks (Wan Ahmad et al., 2008; Osman et al., 2009; Radiah et al., 2014).

When an Islamic bank only uses the Islamic label and its operations do not fully fulfill Islamic principles, customers will move to other conventional banks which provide higher benefits and returns. Practically, the implementation of Islamic principles in the operations of Islamic banks is possible if Islamic banks implement Shariah-based corporate governance (Hayat & Kabir Hassan, 2017; Ullah and Rizwan, 2018).

Rama and Novela (2016) recommended that Islamic banks in Indonesia improve their Shariah governance practices to increase their governance performance and public confidence. Muslim customers establish relationships with Islamic banks because they trust that they are *Shariah*-compliant (Amin et al., 2013). The Shariah Supervisory Board's function and role in ensuring Shariah compliance in Islamic banks is therefore, important.

Nationally, the growth of assets, financing, and finance ratios in Indonesian Islamic banks were relatively strong, as indicated by data from the Financial Services Authority (OJK) for the 2017-2022 period, but Indonesian Islamic banks only account for a market share of below 7 %, as outlined in Table 1.

Table 1. Summary of Islamic Banking Growth in Indonesia

Indicator	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Assets	Rp 424,181 (billion)	Rp 477,327 (billion)	Rp 524,564 (billion)	Rp 517,250 (billion)	Rp 413,310 (billion)	Rp 447,725 (billion)
Financing	Rp 285,695 (billion)	Rp 320,193 (billion)	Rp 355,182 (billion)	Rp 363,446 (billion)	Rp 258,405 (billion)	Rp 271, 278 (billion)

Capital Adequacy Ratio (CAR)	17.91 %	20.39 %	20.59 %	20.62 %	24.97%	23.65%
Return on Assets (ROA)	1.55 %	1.76 %	1.88 %	1.72 %	1.97%	1.65%
Financing to Deposit Ratio (FDR)	89.50 %	90.92 %	89.92 %	93.85 %	81.52%	108.55%
Market Share	5.78 %	5.70 %	5.96 %	5.99%	6.52%	6.65%

Source: www.ojk.go.id

The growth of Islamic banks in Indonesia displays an increasing trend and is proven to weather global financial crises even though with less than 10% market share. Its market share is relatively small compared to the number of Muslims in Indonesia, who comprise 86% of the nation's population. Current market share indicates that prospective customers still do not believe in the benefits of Islamic banks which are associated with the application of Islamic principles in Shariah-based banking products and operations (Hidayat & Trisanty, 2020; Ltifi et al., 2016). Prospective customers have yet to see a fundamental difference between Islamic and conventional banks (Wan Ahmad et al., 2008; Ahmed, 2014; Radiah et al., 2014).

Prospective customers prefer Islamic banks because they see adherence to Islamic principles (*Maqasid Shariah*) in the products and services they receive. They then assess the quality and benefits of products and services compared to conventional banks, including comparing them with their competitors' Islamic banks (Haque et al., 2009; Isnurhadi et al., 2020; Naser et al., 1999). All of this can be realized easily if all policies and operations implemented in Islamic banks receive adequate supervision by the Shariah supervisory board.

In this regard, the role of the Shariah Supervisory Board is vital in overseeing the achievement of *Maqasid Shariah* in Islamic banks and the factors that influence their performance, namely the management control system and competitive strategy. SSB has the responsibility of Islamic banks to achieve the objectives of Shariah (Imaniyati et al., 2019; Mukhibad, 2019; Triasari & Zwart, 2021).

Another possible cause of the low market share of Islamic banks in Indonesia is the ineffectiveness of the management control system to ensure the achievement of the expected company performance and, possibly, the choice of an inappropriate competitive strategy (Aernoudts, 2012; Alaudin et al., 2010).

1.1.2 Management Control System, *Shariah* Supervisory Board, and Competitive Strategy in Islamic Banks

Performance measurement system plays an essential role in the internal and external elements of organizations. Internal parties can use performance measurement results as a basis for planning, organizing, directing, and monitoring strategies to improve performance. Likewise, a performance measurement system for external parties functions as an instrument or control mechanism to control management's operations under organizational objectives (Otley, 1999; Larcker et al., 2007).

To achieve desired performance, companies must have a management control system. A management control system is a complete system that encompasses all areas of company operations. It must be a complete system since one of the most essential management functions is ensuring that all operation components are in balance with one another, and in order to assess balance, management need information about each of the parts (Anthony, 1965). Anthony and Govindarajan (2004) defined a management control system as a management system used to control a company to achieve organizational objectives

Another similar definition states that a management control system (MCS) is a system that collects and uses information to evaluate the performance of different organizational resources, such as human, physical, financial resources, and the organization as a whole as well as taking into account the organization's strategies (Keighley & Higgins, 1970; Karsam, 2017). Simons (1995) defined management control systems as the formal, information-based – routines, and procedures used to maintain or alter the pattern in organizational activities.

Management control systems (MCS) has been categorized differently in the literature. Some of MCS categorizations include formal and informal controls, action and results controls, tight and loose controls, and financial and non-financial controls (Kald et al., 2000; Langfield- Smith, 1997; Simons, 1991). It has been argued that to make MCS more relevant in today's competitive environment, it is necessary to go beyond financial analysis and include non-financial analysis (Chenhall, 2003; Nyamori et al., 2001).

Simons (1987) developed an MCS model called the accounting control system. It is a formal control system consisting of a planning system, reporting system, and monitoring procedures based on the use of accounting information. The formal control system is a different management requirement; the organization has clear procedures, rules, and directives.

In 1995, Simons proposed a more comprehensive control system, which he referred to as levers of control, composed of four management control systems, namely belief system, boundary system, diagnostic control system, and interactive control system. The belief system emphasizes control by using company's vision, mission, goals, and core (belief) values. The boundary system emphasizes control with restrictions that have been determined to be avoided. The diagnostic control system emphasizes control by critical performance variables such as budget control, cost control, and performance measurement (such us balanced scorecard). Interactive control system emphasizes control that encourages organizational learning and communication in developing new ideas and strategies (Simons, 1995).

This study used Robert Simons's levers of control model for several reasons. First, it is more comprehensive, covering formal-informal control systems and financial-non-financial control systems (Martyn et al., 2016; Simons, 1995c, 2014). Second, levers of control are not in conflict with the Qur'an and Sunnah, and are appropriate for Islamic banks (Balwi et al., 2018) . Third, belief and boundary systems are MCS models that strongly support the application of Islamic principles.

A belief system encourages Islamic banks to develop their vision, mission and core values based on Islamic principles that must be adhered to and the boundary system asserts behavioral boundaries as prohibitions that have been established by Islamic principles, which will influence organizational culture and emphasize the banks' ethical identity, thereby increasing the trust of prospective customers (Hakim, 2012; Hassan & Rashid, 2010; Zaki et al., 2014).

Ahmadasri, et.al (2010) found that a budget system (diagnostic control system), belief system, and boundary system are used at the grass- roots level (operational level) of a Shariah bank in Malaysia. Their findings showed that Islamic banks used traditional budgetary controls that are commonly used at the branch level primarily for sales (financing product objectives) and profit-sharing rates.

Research on levers of control implementation in Islamic banks still need to be completed, including research on levers of control impact on the performance of Islamic banks. It is important to continue future research to develop Islamic banking best practices (Aljowder, 2018; Kousa & Ramzani, 2019; Narayan & Phan, 2019).

In implementing management control systems to achieve Islamic bank performance, the role of the Shariah Supervisory Board (SSB) also determines the achievement of Islamic bank performance. The SSB is one of Islamic financial institutions' (IFI) most significant governance process to guarantee *Shariah* adherence (Haji Besar et al., 2009). It is necessary to ensure that all transactions are executed according to Islamic principles (Garas, 2012).

Like other companies, Islamic banks also use MCS to implement competitive strategies. The management control system is a tool for implementing the strategies, which represent plans to achieve organizational performance (Govindarajan & Fisher, 1990; Govindarajan & Gupta, 1985; Strauss & Zecher, 2013). Under contingency theory, matching the management control system with contingency variables (this study uses competitive strategy) will ensure the achievement of the expected company performance (Fisher, 1998; Chenhall, 2003; Volberda et al., 2012).

Competitive conditions in Islamic banking are relevant for at least two reasons. First, the degree of market power has severe implications for financial stability. Second, competitive conditions are likely to affect banks' performance and efficiency (Ariss, 2010). Fungacova and Weill (2013) supported the view that tight competition among banks will increase the failure of banks.

Islamic banking has faced intense competition from conventional banking, which can use various competitive strategies to achieve performance. Islamic banking should be conservative in selecting and implementing performance achievement strategies (Ali et al., 2022; Hamid et al., 2019).

Al-Ajlouni (2008) stated that Islamic banking faces the challenges of global financial and liberalization, in which national and international financial openness harms the autonomy of Islamic banking, profit margins, and competitiveness. In conducting their business, Islamic banks will carefully choose a competitive strategy that can support the achievement of corporate performance.

Therefore, it is crucial to identify suitable competitive strategies for Islamic banks to achieve their expected performance. The management of an Islamic bank must measure competition risks before choosing a competition strategy (Rahmayati, 2021; Wahid, 2017). The SSB is responsible for ensuring that the selected competitive strategy complies with Islamic principles and supports the achievement of *Maqasid Shariah* (Hisham Alnajjar et al., 2021; Solichun et al., 2013).

Shariah Supervisory Board (SSB) is a very important part of the implementing corporate governance in Islamic banks (Suleiman, 2000). SSB is very important for two reasons. First, customers performing transactions with Islamic banks need a guarantee in transactions under Islamic laws (Ahmed, 2014; Bouheni & Ammi, 2015). If SSB reports that the management of an Islamic bank has violated any *Shariah* requirement, it will quickly lose the confidence of the majority of investors and clients.

Second, several Islamic scholars argued that strict adherence to the Islamic principles will address the problem of incentives from active transactions (Abdelhady, 2012; Adebayo & Hassan, 2013). This is because the Islamic moral code will discourage Muslims from behaving in an unsound manner, thereby minimizing transaction costs will result in incentive failures (Azmat et al., 2015; Ardiansyah, 2017; Zainuldinet al., 2018).

1.2 Problem Statement

The *Shariah* Supervisory Board, whose role is to supervise operations, performance measurement, and steps to achieve performance in compliance with Shariah (Islamic laws), is the entity that determines the effectiveness of *Shariah* implementation in Islamic banks (Fakhruddin & Purwokerto, 2020; Muhammad et al., 2021; Sulub et al., 2020).

Islamic banks, as organizations run by Islamic principles, are not only pursuing profit but must also be able to achieve *Maqasid Shariah*. By achieving *Maqasid Shariah,* Islamic banks can easily implement Islamic principles. The growth of Islamic banks will stagnate if they do not conduct operations in accordance with Shariah laws

(Haque et al., 2009; Yanīkkaya & Pabuçcu, 2017). The achievement of *Maqasid Shariah* determines the achievement of all the interests of stakeholders for which they are responsible (Marwa, 2019; Siddiqui et al., 2019).

In this case, the role and function of the Shariah Supervisory Board are crucial to ensuring the achievement of *Maqasid Shariah* in the process of improving the performance of Islamic banks (Abdullah, 2013; Masruki et al., 2018). Shariah implementation will be made simpler in the long run if the Shariah Supervisory Board decides to use *Maqasid Shariah*. This will motivate all operations to focus on achieving that performance.

Islamic banks must have a management control system to achieve performance like other companies. Islamic banks operate management control systems through the implementation of belief systems, boundary system, diagnostic control system, and interactive control system. The management control system is called the levers of control, and is to be used more comprehensively and balancedly (Simons, 1995, 2000). Although this level of control has been applied to Islamic banks, there is limited empirical evidence of its impact on their performance.

The management control system directly affects the performance of Islamic banks. The implementation must be supervised by the *Shariah* Supervisory Board (SSB) to ensure compliance with Islamic principles and reduce moral hazards and the asymmetry of information that might occur (Garas & Pierce, 2010; Alaudin et al., 2012; Sulaiman et al., 2015; Mohammed & Muhammed, 2017). Moral hazard and asymmetric information in Islamic banks include (1) transaction agreements that do not provide transparency for customers; (2) the absence of transparency in product financing information; (3) banks' stronger emphasis on customer installments; (4) the absence of monitoring and evaluation; and (5) requests for signing without proper explanation to customers (Husain, Ludigdo, & Adib, 2017).

Asymmetric information is the cause of agency problems as described in the agency theory, in which principals and agents are more concerned with gaining personal interests and benefits through various means. This moral hazard will eventually impact generating agency costs (Shamsuddin & Ismail, 2013). The presence of management control systems that are applied dishonestly and unfairly, as opposed to Islamic principles, showed that asymmetric information and moral hazards occur.

The role of the *Shariah S*upervisory Board (SSB) is very important to ensure that the management control system follows Islamic principles (Garas, 2012; Nerandzic & Zivkov, 2015). The SSB's roles and functions include monitoring and reviewing overall banking activities; reviewing products, services, and contracts; creating Shariah governance guidelines; ensuring Islamic principles compliance; offering opinions on current *Shariah* governance practices; and ultimately delivering Shariah resolutions on overall activities and operations (Alam et al., 2021; Ulfi et al., 2020).

Islamic banks that have succeeded in overcoming agency problems have opportunities to apply stewardship theory, in which agents become stewards to fulfill the interests of all stakeholders as part of their responsibility to implement Islamic principles.

The measurement of Islamic banks' performance based on *Maqasid Shariah* is justified in fulfilling all stakeholder interests as expected by stakeholder theory. Such action benefits stakeholders by protecting their interests, hence achieving the *Maqasid Shariah* (Abu et al., 2014). The presence of SSB is expected to address agency problems as described in agency theory (Al-Nasser Mohammed & Muhammed, 2017; Htay & Syed, 2013). This has the opportunity to change the agent's function to that of a steward who aligns his interests to provide services to principals, including stakeholders, as expected by stewardship theory (Pastoriza & Ariño, 2011).

However, several problems regarding the role and function of the SSB in Indonesia as stated by Triasari & Zwart, (2021) need attention, namely :

1. Not all Shariah Supervisory Boards in Islamic business units are supported by a solid legal basis on which their operations are inducted to
2. Members of the Shariah Supervisory Board are appointed chiefly based on their charisma and popularity in society, not of their knowledge and experience in related field
3. Ideally the Shariah Supervisory Board must have recognized the banking system before becoming Shariah Supervisory Board, but the basic knowledge is not easy to understand when entering on technical issues
4. Many Shariah Supervisory Boards are not focused on Shariah banks supervision duty because of their multi- profession
5. Lack of advice related to product innovation and social needs issues

These issues impact the effectiveness of good corporate governance implementation in Indonesian Islamic banks; hence, a continuous examination in order to identify a solution.

Furthermore, to achieve the expected performance of Islamic banks, the management control system must be designed to follow competitive strategies. Competitive strategy is aimed at creating a competitive advantage in the products or services of a company that competes in a specific industry. It is a contingency factor that must be adapted to the management control system as a contextual factor, including the application of contingency theory that also applies to Islamic banks (Simons, 1987; Bromwich & Scapens, 2016; Almutairi & Quttainah, 2017).

In conducting their business, Islamic banks must carefully select a competitive strategy that can support the achievement of company performance (Alnajjar et al., 2021; Solichun et al., 2013). The competitive strategies that companies choose to employ will result in varying performance depending on how well they match the characteristics of the established management control system (Fuadah, 2017; Junqueira et al., 2016; Waweru & Uliana, 2008).

The competitive strategy concept developed by Michael Porter is used in this study. Michael Porter's concept of competitive strategy has become popular among researchers because he provides a systematic framework for understanding how companies can gain and sustain competitive advantage in the long run (B. J. Ali & Anwar, 2021; Belton, 2017).

Porter suggests that there are five forces that influence the level of competition in an industry: the threat of new entrants, the threat of substitute products, the bargaining power of suppliers, the bargaining power of buyers, and the rivalry among existing competitors. Within this framework, Porter recommends that companies choose one of three generic strategies to achieve competitive advantage: cost leadership, differentiation, or focus (Porter.M.E, 2008; 1997).

Porter's concept is helpful researchers understand the factors that influence a company's success in competition and how companies can design strategies to address those factors. Furthermore, Porter's concept also helps researchers develop theory and empirical research in the fields of business strategy and strategic management (Porter.M., 2008; 1997).

In summary, the problem statement can be summarized as follows: the performance of Islamic banks is expected to be influenced by the management control system. Nonetheless, the relationship between the management control system and performance is posited to be mediated by the Shariah Supervisory Board and moderated by competitive strategy.

1.3 Research Objectives

This study aimed to examine the mediating effect of the *Shariah* Supervisory

Board and the moderating effect of competitive strategy in the relationship between management control systems and the performance of Islamic banks. The specific objectives of this study are as follows:

a. To examine the relationship between management control systems and the performance of Islamic banks.
b. To examine the mediated effect of the Shariah Supervisory Board in the relationship between management control systems and the performance of Islamic banks.
c. To examine the effect of competitive strategy as the moderator in the relationship between management control systems and the performance of Islamic banks.

1.4 Research Questions

Based on the research background and problem statement, the following research questions have been derived:

a. Does the management control system positively impact on the performance of Islamic banks?
b. Does the Shariah Supervisory Board mediate the relationship between the management control system and the performance of Islamic banks?
c. Does the competitive strategy moderate the relationship between the management control system and the performance of Islamic banks?

1.5 Research Scope

This study examines the effect of the management control system on the performance of Islamic banks through the *Shariah* Supervisory Board as the mediator. In addition, this study also examines the effect of competitive strategy as the moderator in the relationship between management control system and the performance of Islamic banks.

The performance of Islamic banks in this study is based on *Maqasid Shariah* (Mohammed et al, 2015) and is measured to adapt the measurement of company performance demonstrated by Govindarajan and Gupta (1985) as well as Hoque (2005), in which financial performance measurement was conducted through a qualitative questionnaire. The concept of a management control system developed by Simons, namely levers of control (Simons 1990; 1995,2000) is used in this study. This study uses the concept of a competitive strategy formulated by Porter (1980), in which companies are faced with a choice of competitive strategies: low cost, differentiation or focus. This study also uses the concept of the *Shariah* Supervisory Board role developed by Rini R (2014).

This study analyzes Islamic banks operating in Indonesia and listed in the Shariah banking statistics report issued by the Financial Service Authority (OJK) of the Republic of Indonesia, including Shariah commercial banks (BUS) and *Shariah* business units (UUS) (OJK, 2019).

1.6. Contribution of Research

1.6.1. Theoretical Contribution

The findings of this study demonstrate the integration of the main theories of corporate governance, including agency theory, stewardship theory and stakeholder theory. They also describe how to anticipate agency problems and apply the values of stewardship in Islamic banks to fulfill responsibilities to stakeholders.

This study also provides important results from examining the impact of management control systems on the performance of Islamic banks. Although Islamic banks have different objectives from conventional banks, this study also criticizes the performance measurement of Islamic banks with the *Maqasid Shariah* approach to focus on the operations of banks that have stated compliance with Shariah laws to fulfill responsibilities to stakeholders.

This study also proves that the *Shariah* Supervisory Board mediates the relationship between management control systems and the performance of Islamic banks as well as the extent of the *Shariah* Supervisory Board in demonstrating the implementation quality of the main theories of corporate governance in Islamic banks and in realizing the management's role as a steward for stakeholders.

In this study, the implementation of the contingency theory, which examines the significant impact of competitive strategy on the relationship between the management control system and the performance of Islamic banks, also proves a new fact.

1.6.2. Practical Contribution

For practical contribution, the results of this study are expected to motivate the use of the *Maqasid Shariah* approach in measuring the performance of Islamic banks. Islamic banks will not only strengthen the role of the *Shariah* Supervisory Board in the supervision of products and services, but they can also supervise management control systems and the competitive strategy so that there is a robust relevance between inputs, processes, and outputs that comply with Islamic principles. Finally, the results of this study are also expected to form the basis for the assessment of Islamic banks to redesign or replace management control systems to follow Islamic principles.

1.6 Definition of Variables

Five variables are discussed in this study, namely the performance of Islamic banks (PIB), management control system (MCS), competitive strategy (CS), and the *Shariah* Supervisory Board (SSB)

- Performance of Islamic banks (PIB) is all dimensions of Islamic bank performance based on *Maqasid Shariah*, which consists of 5 elements: preservation of faith, preservation of human dignity/right, propagation of scientific thinking, the wellbeing of society/diminishing the difference between economic level, and care of family/stakeholders. This research variable is measured by using the *Maqasid*-based performance evaluation model (MPEM) (Mohammed, et al., 2015).

- Management control systems (MCS) are formal and informal controls with information-based routines and procedures used to maintain or alter organizational activities pattern (Simons, 1987; Tekavčič et al., 2008). This study uses Simon's MCS model, namely the levers of control, consisting of four MCS, namely the belief system, boundary system, diagnostic control system and interactive control system. Belief system is a management control system to achieve company performance by using the company's vision, mission, goals and core beliefs as a means of controlling the activities and behavior of human resources in the organization. Boundary system is a management control system to achieve company performance by using limits and restrictions embodied in a code of ethics, activity restriction regulations and standard operational procedures. The diagnostic control system is a management control system to achieve company performance using key performance indexes and financial indicators as control tools. An interactive control system is a management control system to achieve company performance using interactive communication activities between top management and lower-level management about ideas to anticipate control problems and solutions to achieve expected company performance.
- Competitive strategy (CS) is a competitive advantage of the company that competes in a certain industry. Companies compete in an industry by using the advantages of the products or services. Porter's competitive strategy model is used in this study with a choice of low-cost strategy, differentiation strategy, and focus strategy (Islami et al., 2020)
- *Shariah* Supervisory Board (SSB) is a panel of *Shariah* scholars, appointed by the

shareholders similar to a board of director in charge of supervising the operations of Islamic banks according to Islamic principles (Garas 2012; Garas & Pierce 2010; Rini R,2014).

1.7 Thesis Structure

This thesis is organized into six sections: introduction, literature review, conceptual framework and hypotheses, research methods, findings and discussion, and conclusions. Chapter 1 explains the background of the study, problem statement, research questions, research objectives, research scope, significance of research, definition of variables, and the structure of the thesis.

Chapter 2 reviews the relevant literature on the performance of Islamic banks, and factors affecting performance, namely management control systems, Shariah Supervisory Board, and competitive strategy. It also reviews relevant theories that support the research variables. Chapter 3 clarifies the conceptual framework and research hypothesis developed from the literature review.

Chapter 4 describes the research methods, variables, operational definitions, unit of analysis, respondents, population, sample size, data collection methods, and data analysis methods. Chapter 5 consists of findings and a discussion of the results that have been analyzed statistically. The demographics of respondents, descriptive statistics, test results of data quality, classic assumption test results, hypothesis testing results, and discussion of the results of research associated with the implications of the theory and practice are also further elaborated.

Chapter 6 describes the conclusion of the study and research implications for the development of the theory and suggestions for improvement.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

This chapter reviews the theoretical literature on the performance of Islamic banks, management control systems, *Shariah* supervisory boards, and competitive strategies. It also discusses relevant theories, namely the main theories of corporate governance (agency theory, stewardship theory, and stakeholder theory) as well as contingency theory.

2.2 The Nature of Islamic Banks

A banking organization performs three major tasks: it accepts deposits, lends money, and offers remittance services. Initiation of the Islamic banking system has existed in the economic history of Muslim societies since the reign of the Prophet *Sallallaahu Alaihi Wasallam* (SAW), and financing through Shariah-compliant contracts has been a tradition of Muslims ever since Prophet Muhammad SAW period (Fauzi, 2019; Kusnan & Hakim, 2018).

Prophet Muhammad SAW was known by the nickname *Al-Amin*, which means trusted. The people of *Makkah* consistently deposited their wealth with him. As a result, just before the Apostle left for *Medina*, he asked *Sayidina* Ali R.A. to return all the deposits to their rightful owners (M. Iqbal & Molyneux, 2005).

Zubair bin Awwam *Rhadiallahu Anhu* (RA), a close companion of the Prophet Muhammad SAW, declined to take the deposit. Different consequences resulted from Zubair's actions, including the rights to use the money that he obtained by accepting it as a loan and the need to return it in full because it was a loan (Gulzar et al., 2021a; M. Iqbal & Molyneux, 2005).

In the Prophet's time, Baitul Mal was established in the Nabawi Mosque. This institution once served as an avenue to place deposits in the Prophet's mosque, which