



Analysing Banking Compliance from Maqasid Shariah Perspective: Evidence from Islamic and Conventional Bank in Indonesia

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ABSTRACT: Using the Shariah (Islamic legal rulings) and its higher ethical objectives namely the maqasid shariah, the purpose of this paper is to analyze the success of Banking in Indonesia. The maqasid shariah index (MSI) and limited maqasid shariah index (LMSI) are emphasizes disclosures regarding education, social justice, and redistribution of wealth. Researchers assess the ethical and social performance of selected banks in Indonesia from its annual reports. Simple Additive Weighting (SAW) technique used to calculate the sample's MSI score. Empirical evidence suggests that conventional performance measurements do not truly reflect IBs' higher ethical objectives and create a deficiency of attaining maqasid shariah performance in these banks. This study extends the previous literature on evaluating the performance of banks beyond the financial return to include their ethical and social identity based on the maqasid shariah scale, particularly over the past five years. The result reveal that there is a financial cost to achieving the maqasid shariah, as in the model generated from the panel data regression which shows a significant negative relationship between MSI and ROA for Islamic banks. Different results were obtained in analyzing conventional banks and mixed banks (Islamic banks and conventional banks) using the Limited MSI (LMSI). LMSI has a significant positive relationship to ROA in both conventional banks and Islamic banks. This happens because the elements used in MSI and LMSI calculations are different.

KEYWORDS: Limited MSI; Maqasid Shariah Index (MSI); Panel Data Regression; Simple Additive Weighting; Bank; Indonesia

INTRODUCTION

Increasing consumer interest in halal goods and services has been a driving force in the expansion of the global Islamic financial market. With Islamic banking's contribution now at 71% of total industry assets, the Islamic financial sector saw an 8.3% increase in its overall value¹. Considering that Islamic banking (IB) is anticipated to experience gradual growth, particularly in Moslem majority countries, as the Moslem population is projected to reach 2.4 billion by 2031².

There are a variety of reasons why some people prefer to use Islamic banks instead of conventional ones. To begin, when compared to their conventional counterparts, IBs are thought to be more stable in times of economic uncertainty^{2,3}. When a crisis hits, Islamic banks can step in for conventional ones⁴. Second, IBs use a PLS structure and forbids maysir (gambling), gharar (uncertainty), and riba (interest) that designed to foster fairness among the parties. Maysir, gharar, and riba were also blamed as contributing factors to the economic meltdown⁵. Third, Islamic banks have helped increase economic development and broaden access to banking services⁶. IB practices growth may also be aided by the adoption of banking regulations in either Islamic or non-Islamic countries.⁶

Commercial Islamic banks are encouraged by Sharia values and mashlaha (public interest) through favorable outcomes and advantages, to be as effective as possible, with the hopes of fostering economic growth and ensuring social justice⁷. Thus, the effectiveness and sharia value perspective of Islamic banking must be evaluated. Maqasid shariah reflects the core values upheld by the sharia. This is made up of two words: maqasid, which means "desires and intentions," and shariah, meaning "the well-worn path to water"⁸. Incorporating maqasid shariah principles into everyday life has the potential to raise living standards, promote economic equity, and hasten economic growth⁷. There has been a lot of research done on IB's performance with the maqasid shariah index (MSI) serving as a common metric⁹⁻¹². With the largest assets as a benchmark, this study compares seven commercial IBs and seven commercial conventional banks in Indonesia.

BUSINESS ISSUE

This study is motivated by the concern that the current practices of IBs have deviated from their intended ethical and social outcomes. Specifically, the objective of this study is to evaluate the progress made by IBs toward maqasid shariah targets over the past five



years. The majority of IB performance studies consider only conventional aspects of performance, such as financial results, and ignore the Maqasid. In addition, these conventional measures do not adequately evaluate the Maqasid-based performance required to positively identify IBs. The original version of the maqasid shariah index (MSI) was created by Mohammed, Razak, and Taib (2008) to assess the effectiveness of IBs in adhering to maqasid Shariah. According to some of Islamic economists, the relative stability of Islamic banks in the face of economic turmoil is a major factor in the growing interest in IBs as an alternative to conventional banking¹³, making it intriguing to conduct the MSI analysis of IB over the past five years. This study was also motivated by IBs' disproportionate reliance sale at a markup (Murabahah) agreement, as opposed to PLS agreements (e.g., Musharakah, Mudharabah) in which profits and losses are shared. The widespread use of Murabaha contracts undermines the principles of Maqasid Shariah and Islamic ethics. Along the same lines as the imposition of a nonpayment penalty, the utilization of an interest rate benchmark (such as LIBOR), and the rebate on early payment of Murabaha, this is one of probably the most contentious deals ever made with Islamic finance^{14,15}.

Considering these research motivations, this research aims to assess the performance of IBs according to the maqasid shariah. This study is to delve deeper into the literature-based MSI analysis to assess the degree to which IBs have progressed toward Maqasid over the past five years (2017- 2021).

LITERATURE REVIEW

As a business model, IB philosophy is based on Shariah objectives, which differs from the conventional model due to its emphasis on interest-free transactions¹². However, several studies indicate that Islamic banks still imitate conventional banks in the form of products whose main objective is profit maximization¹⁶, for instance, criticised IBs for not meeting Maqasid Shariah goals because they attempt to mimic the substance of Conventional Banks financial system. Islamic banks were heavily criticized for not achieving Shariah or 'human and social well-being', despite their success in mobilising financial resources¹⁷.

The optimal method by which IBs' performance can be evaluated is still a topic of heated debate¹⁸. The effectiveness of IBs has been the subject of numerous studies, many of which have relied on traditional ratios in their analyses^{19,20}. A common financial ratio is used to evaluate the success of any business, including IIFS, by showing how various components of the financial statements are related to one another. The Return on Assets (ROA), Capital Adequacy Ratio (CAR), Management, Asset Quality, Earnings, Liquidity, and Sensitivity (CAMELS), and Economic Value Added (EVA) are metrics used in finance to approximate a firm's economic profit, or the value it generates for its shareholders beyond the minimum acceptable return on their investment²¹. On the other hand, Islamic banking has its own moral identity²² that differs from conventional banking and finance in practice; therefore, Maqasid Shariah, the actual objective of Shariah, must be used as a metric in addition to financial ratios when assessing the success of Islamic banks. In their relatively recent work, Mohammed, Razak, and Taib (2008) operationalized the three classified objectives of education, justice, and welfare according to Abu Zahrah's theory of the maqasid sharia into a single measurable concept that called the MSI.

Previous studies were conducted to calculate the Maqasid index. This study, however, expands upon its predecessors by analyzing data from the preceding five years (2017 2021) and relies on the MSI to determine which IBs are most successful at meeting Shariah requirements. Therefore, in order to prevent a misleading performance ratio comparison, this study narrows its scope to a single country. The unique contribution of this study is to evaluate IBs' progress in implementing Maqasid Shariah over the last five years and develop a model using panel data regression to define the correlation between MSI with financial performance.

METHODOLOGY

This research employs a mixed methodology, combining qualitative and quantitative approaches to examine the content analysis of annual reports to evaluate IBs' progress toward Maqasid al- Shari'ah objectives. Qualitative methodology utilizes content analysis of annual reports to generate disclosure-related data for MSI and evaluate the ethical performance of the sampled IBs. The objective of the quantitative methodology is to quantify ethical and social indicators and assess the achievement of maqasid shariah by IBs. Simple Additive Weighting (SAW) is used to assign numerical values to the relative importance of the maqasid shariah indicators. The MSI value of multiple conventional banks is calculated using the same method. It's just that the MSI calculation excludes several elements that do not exist or are not presented in conventional bank annual reports.



Table 1. Maqasid Shariah Index Variable

Concept (Objective)	Average weight (100%)	Dimension	Element	Performance Ratio	Average Weight (%)
O1. Education	W1. 30%	D1. Advancement of Knowledge	E1. Education Grant	V1.1 Education grant or scholarship/ Total expenses	24
			E2. Research	V1.2 Research expense/ Total expense	27
		D2. Installing new skills and improvement	E3. Training	V1.3 Training expense/ Total Expense	26
			E4. Publicity	V1.4 Publicity expense/ Total expense	23
O2. Justice	W2. 41%	D4. Fair returns	E5. Fair Returns	V2.1 Profit Equalisation reserve (PER)/Net or Investment Modes	30
		D5. Cheap product and services	E6. Functional Distribution	V2.2 Mudharabah and Musharakah modes/Total investment modes	32
		D6. Eliminations of negative elements that breed injustice	E7. Interest Free Product	V2.3 Interest free income/ Total income	38
O3. Welfare	W3. 29%	D7. Profitability	E8. Profit Ratio	V3.1 Net income/Total assets	33
		D8. Redistribution of income and wealth	E9. Personal Income	V3.2 Zakat/Net Income	30
		D9. Investment in real vital sector	E10. Investment ratios in real sector	V3.3 Investment in real economic sector/ Total investment	37

Note: The table present the components of the Maqasid Shariah Index. Table MSI based on research by Mohammed, Razak, and Taib (2008). The limited MSI (LMSI) that used for conventional bank are used the same index except element E4, E5, E6, and E9

The research conducted to establish a relationship between the dependent and independent variables; the data collected will be analyzed using multiple linear regression to back up the study's findings. Panel data will be used in this investigation, which is a combination of time series and cross-sectional data. Time series and cross section data can be combined to produce higher quality and more extensive data than could be obtained using either type of data alone ²³.

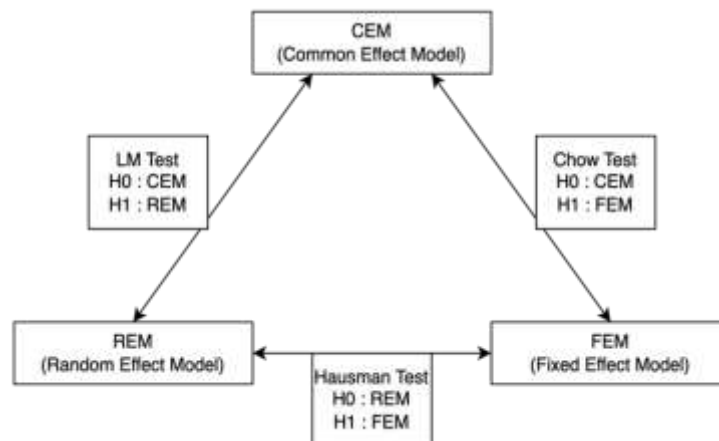


Figure 1. Choice of regression estimation of panel data



Classic hypothesis testing is required prior to testing with multiple linear regression methods. The classic assumption test ensures the absence of multicoinerity, autocorrelation, and heteroscedasticity in the model. This test is only performed on scaled or serialized data using the Multiple Linear Regression technique.

FINDING AND ARGUMENTS

This paper is using MSI methodology to annually assess the ethical and social performance of IBs in Indonesia over the last five years (2017-2021).

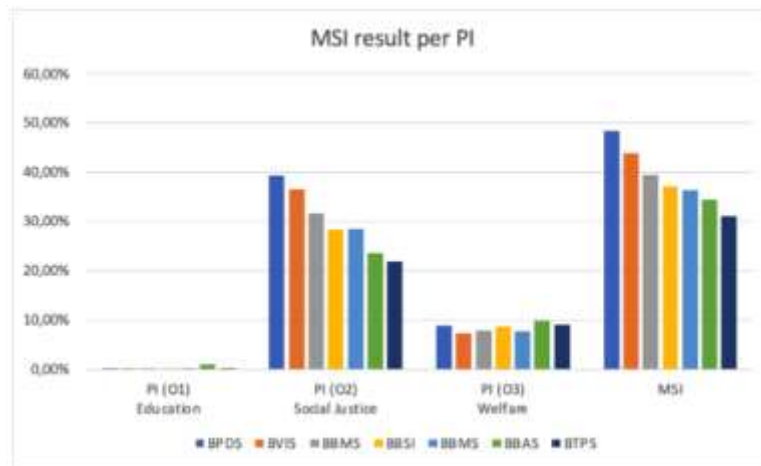


Figure 2. Maqasid Shariah Index per Performance Indicators (PI)

Note: This graph illustrates the Maqasid Shariah Index (MSI) and performance indicators (PI) for each bank. Note that PI (O1) is below 1 percent due to a lack of expenditures on the education objective.

As indicated in figure 2 PI (O1) which is education, suggests that BBAS (0.96 %) has the highest performance relative to the rest. Thus, BBAS is more concerned with educating its employees and society than other IBs. The second performance indicator, namely justice, demonstrates that BPDS 39.37% has the highest performance followed by BVIS 36.55%, BBMS 31.57%, and the others below that score. Thus, we might conclude that BPDS is more concentrated than other banks on financing PLS deals. The third indicator, welfare, illustrates that BBAS 9.78% has the highest rank followed by BTPS 9.11%, BPDS 8.93%, BBSI 8.60%. To compare the ethical and social performance of conventional banks and Islamic banks, researchers try to calculate the limited MSI value of conventional banks. Some elements that need to be omitted from the MSI created by Mohammed, Razak, and Taib (2008), namely: Publicity, fair returns, functional distribution, and personal income transfer.

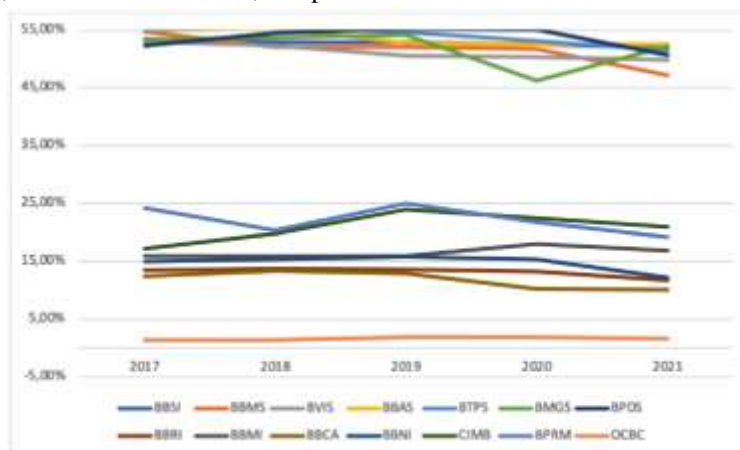


Figure 3. LMSI score for selected Islamic and conventional banks in Indonesia



It can be seen from figure 3 that the ethical and social performance based on the limited MSI (LMSI) of Islamic banks is much higher than that of conventional banks. This is because the objectives of the two types of banks are different.

The original contribution of this paper, relative to prior relevant research, is to examine the impact of MSI on the financial performance of banks in Indonesia. Return on Assets (ROA) was chosen as an indicator for measuring banking financial performance. Return on Assets is used to measure a company's profitability relative to the usage of its assets. The control variables used are CAR, NPF, and BOPO. Table 2,3, and 4 are the regression models result developed in this research.

The first model developed is for IBs. Based on the selection of the estimation model, Random effect model with robust is the best model for this data. The result shown on table 2. In this regression model, MSI is the only independent variable with a negative significant association ($P < 0.01$) on ROA.

Table 2. Regression result for Islamic Banks in Indonesia

ROA	Coef.	Robust St.Err	t-value	p-value	[95% Conf Interval]	Sig
MSI	-.042	.022	-1.90	.058	-.086 .001	*
CAR	-.026	.069	-0.37	.708	-.161 .109	
NPF	.774	.691	1.12	.263	-.582 2.129	
BOPO	-.002	.01	-0.20	.839	-.022 .018	
Constant	.026	.022	1.20	.231	-.017 .069	
Mean dependent var	0.035		SD dependent var		0.058	
Overall r-squared	0.299		Number of obs		35	
Chi-square	17.603		Prob > chi2		0.001	
R-squared within	0.150		R-squared between		0.406	

*** p<.01, ** p<.05, * p<.1

Second model developed for CBs. Based on the selection of the estimation model above, Random effect with robust is the best model for this data. The result shown on table 3. In this regression model, MSI is the only independent variable with a statistically significant association (10%) on ROA.

Table 3. Regression result for Conventional Banks in Indonesia

ROA	Coef.	Robust St. Err.	t-value	p-value	[95% Conf Interval]	Sig
LMSI	.029	.015	2.01	.045	.001 .058	**
CAR	-.012	.015	-0.79	.43	-.041 .017	
NPF	.114	.261	0.44	.663	-.398 .626	
oBOPO	-.01	.001	-12.54	0	-.012 -.009	***
Constant	.02	.005	4.26	0	.011 .029	***
Mean dependent var	0.023		SD dependent var		0.010	
Overall r-squared	0.898		Number of obs		35	
Chi-square	247.517		Prob > chi2		0.000	
R-squared within	0.847		R-squared between		0.915	

*** p<.01, ** p<.05, * p<.1

Third model developed for both of IBs and CBs. Based on the selection of the estimation model above, Fix effect is the best model for this data. The result shown on table 4. MSI and BOPO have a 10% and 5% significance in this regression model's effect on ROA, respectively.



Table 4. Regression result for Mix Banks in Indonesia

ROA	Coef.	St Err.	t-value	p-value	[95 Conf %	Interval]	Sig
LMSI	.443	.252	1.76	.084	-.062	.949	*
CAR	.044	.092	0.48	.634	-.141	.23	
NPF	.307	.501	0.61	.543	-.699	1.312	
BOPO	-.058	.025	-2.29	.026	-.108	-.007	**
Constant	-.088	.104	-0.85	.401	-.296	.12	
Mean dependent var	0.027		SD dependent var		0.046		
R-squared	0.209		Number of obs		70		
F-test	3.445		Prob > F		0.000		
Akaike crit. (AIC)	-304.041		Bayesian crit. (BIC)		-292.799		

*** p<.01, ** p<.05, * p<.1

CONCLUSIONS

Islamic banking relies on the maqsid shariah framework to promote socioeconomic justice. However, IBs have been criticized for deviating from Maqasid Shariah requirements. Building on the ongoing debate on what are the appropriate and more efficient Maqasid Shariah measurements, this study investigates the level of Maqasid Shariah compliance by a sample of IBs in Indonesia over the past 5 years (2017-2021), focusing on disclosures related to education, social justice, and redistribution of wealth (Hudaefi & Noordin, 2019). This research uses the MSI to evaluate how well IBs adhere to Maqasid Shariah on issues like education, social justice, and redistribution of wealth. In this research, the performance of Indonesian IBs in the realms of education, justice, and welfare varies. A greater MSI percentage indicates that the bank contributes more to socioeconomic fairness in the community and is consistent with its ethical identity. For example, utilizing more PLS investments illustrates the significance of IBs in implementing socioeconomic justice, whilst avoiding interest-derived income minimizes economic inequality. Other example, a high net income ratio would be more beneficial to shareholder interests. In contrast, a larger Zakat ratio adds to the welfare of stakeholders and society by distributing wealth to the poor and needy, so supporting the community by reducing poverty and inequality.

Table 5. Regression result recap (significany and coefficient) for all type of banks in Indonesia

ROA	Sharia h Bank	Conventional Bank	Mix Bank		Significancy	Coefficient
	Significancy	Coefficient	Significancy	Coefficient		
MSI / LMSI	0.058*	-0.042	0.045**	0.029	0.084*	0.443
CAR	0.708	-0.026	0.43	-0.12	0.634	0.044
NPF	0.263	0.774	0.663	0.114	0.543	0.307
BOPO	0.839	-0.002	0.000***	-0.01	0.026**	-0.058
R-squared	0.406		0.915		0.209	

Note: MSI are used only to Shariah bank, while conventional/ mix bank use limited MSI (LMSI). (***), (**), (*) indicate significance at the 1% level, 5% level, and 10% level respectively.

There is a negative association between Maqasid Shariah compliance and IBs' financial success, indicating that achieving maqasid shariah objectives incurs a financial cost. This demonstrates that IBs may forego some potential profits in pursuit of a high MSI score just like the previous research from ¹². Some ethical and social strategies, for example, have been shown to have a negative impact on performance, as ²⁵ point out. Some IBs' failure to meet Maqasid Shariah standards may be attributable to this.



However, a different pattern emerges when examining the association of the limited MSI (LMSI) on return on asset (ROA). Both conventional and mix banks are analyzed for some of their social and ethical performance using LMSI. The data demonstrates a positive correlation between LMSI and ROA with significance level of 5% and 10% for conventional and mix bank respectively. This exemplifies how a bank's return on assets improves as its LMSI score rises. This occurs because the performance index is based on a variety of factors. For instance, conventional banks do not offer PLS financing, so that component must be eliminated. Since conventional banks don't spend money raising people's consciousness about sharia banks, there is no need for a public relations campaign promoting them (not related). Another reason, conventional banks do not contribute to zakat. As a result, conventional banks and LMSI values will be significantly lower than Islamic banks', leading to a dissimilar relationship between the two types of institutions' return on assets

Another Dependent that are significance to ROA is BOPO in conventional and mix bank with 1% and 5% significance level and negative correlation. This is in line with ²⁶ that BOPO has a negative effect on ROA because the high operational costs incurred in generating profits achieved by the company will result in reduced rentability (ROA).

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