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Governance and Performance of Indonesian Islamic Banks: Toward Sustainable Green Finance

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ABSTRACT
This study aims to examine the influence of Islamic Corporate Governance (ICG) mechanisms on the financial performance of Islamic banks in Indonesia within the perspective of sustainable green finance. The analysis focuses on seven governance components mandated by regulatory frameworks, namely the Board of Directors (BOD), Audit Committee (AC), Board of Commissioners (BOC), Nomination and Remuneration Committee (NRC), Risk Committee (RC), Sharia Supervisory Board (SSB), and External Audit (EA). This quantitative study uses secondary data from eight Islamic commercial banks in Indonesia for the 2016–2023 period and is analyzed using multiple linear regression in EViews 12. The results show that the BOC has a positive and significant effect on financial performance, indicating the importance of effective supervisory oversight. In contrast, the SSB has a negative and significant effect, suggesting that strict sharia compliance may restrict investment flexibility and reduce short-term profitability. Meanwhile, the BOD, AC, NRC, RC, and EA show no significant influence, indicating that their roles remain primarily administrative rather than strategic. Islamic banks should strengthen the strategic roles of internal governance committees and harmonize coordination between the BOC and SSB to balance sharia compliance with financial performance. Regulators (OJK and IFSB) are encouraged to enhance governance standards that support ethical integrity and financial sustainability. This study integrates all mandatory ICG components into a comprehensive governance-performance model and contextualizes the findings within sustainable and ethical financial practices.

***Keywords*:** Islamic Corporate Governance, Financial Performance, Green Finance, Sustainability, Islamic Banking

INTRODUCTION

Good Corporate Governance (GCG) plays a fundamental role in supporting the stability, accountability, and financial sustainability of Islamic banks. Unlike conventional banks, Islamic banks are required not only to ensure managerial efficiency but also to uphold compliance with Islamic ethical and legal principles. In Indonesia, the implementation of GCG in Islamic banking is regulated through OJK Regulation No. 8/POJK.03/2014 on the Implementation of Good Corporate Governance for Islamic Commercial Banks, which explicitly mandates the presence of key governance structures including the Board of Directors (BOD), Board of Commissioners (BOC), Sharia Supervisory Board (SSB), Audit Committee (AC), Risk Committee (RC), Nomination and Remuneration Committee (NRC), and External Audit (EA). The selection of these seven governance components is therefore based on the structural governance requirements outlined in POJK No. 8/POJK.03/2014, and is also in line with the governance frameworks recommended by IFSB-3 (Islamic Financial Services Board, 2006) and AAOIFI Governance Standards (2017), which emphasize supervisory oversight, sharia compliance, accountability, risk control, and audit integrity as core elements of governance in Islamic financial institutions. These governance mechanisms are designed to ensure strategic effectiveness, supervisory oversight, sharia compliance, risk mitigation, performance evaluation, and the integrity of financial reporting.

From an empirical perspective, the performance of Islamic banks in Indonesia has shown mixed developments over the past few years. While total Islamic banking assets have continued to grow, profitability indicators such as Return on Assets (ROA) and Return on Equity (ROE) have fluctuated, partly due to global economic uncertainty, shrinking margins, and rising operational risks. This condition highlights the importance of effective governance practices in maintaining sustainable financial performance. Studies have noted that governance quality remains uneven among Islamic banks, especially in the effectiveness and independence of supervisory roles, committee functionality, and the integration of sharia principles into strategic decision-making.

Several recent studies have examined the relationship between Islamic Corporate Governance components and financial performance. For instance, research has shown that an active **Board of Directors** improves strategic efficiency and profitability (Alam et al, 2021; The **Board of Commissioners** has been associated with better monitoring and stronger performance outcomes (Billah & Fianto, 2021; and Ramdani & Muflih (2023). Similarly, the **Sharia Supervisory Board** has been linked to enhanced ethical governance and increased stakeholder trust, which contributes to better financial and ESG performance (Boudawara et al., 2023; and Yusuf, H. (2024). Meanwhile, the roles of the **Audit Committee**, **Risk Committee**, and **Nomination and Remuneration Committee** have been recognized for improving reporting transparency, risk governance, and incentive alignment (Hameed et al., 2022; and Darma & Afandi, 2021). Furthermore, **External Audit** is considered essential in strengthening credibility and investor confidence (Nasution et al., 2022).

However, despite the growing literature, **research gaps** remain. First, most prior studies examine governance components individually, whereas limited studies analyze all required GCG elements **simultaneously as mandated by POJK No. 8/POJK.03/2014**. Second, in many cases, the **Risk Committee** and **Nomination and Remuneration Committee** have received less empirical attention compared to the BOD, BOC, and SSB, even though they play strategic roles in risk planning and managerial incentives. Third, differences in governance effectiveness across Islamic banks indicate a need to reassess how governance mechanisms interact in influencing performance within the Indonesian Islamic banking context.

Based on these gaps, the **novelty** of this study lies in developing a comprehensive empirical model that examines **all seven governance components required by the Indonesian regulatory framework** and testing their direct effects on financial performance. This study contributes to both literature and practice by demonstrating how the completeness and effectiveness of Islamic governance structures influence financial outcomes, offering insights for policymakers, regulators, and Islamic banking institutions in strengthening governance implementation aligned with sharia and sustainability objectives.

RESEARCH METHODS

This study employs a quantitative correlational design using secondary data. The research population includes all Islamic commercial banks registered under the Financial Services Authority (OJK) between 2016 and 2023. Purposive sampling was applied to select eight Islamic commercial banks that consistently published governance and financial data during the observation period. The sample consists of the following banks: PT Bank Muamalat Indonesia Tbk, PT Bank BCA Syariah, PT Bank Jawa Barat Banten Syariah, PT Bank Syariah Bukopin, PT Bank Mega Syariah, PT Bank Panin Syariah, PT Bank Victoria Syariah, and PT BTPN Syariah Tbk.

The dependent variable is financial performance, measured by Return on Assets (ROA). The independent variables represent seven ICG components:
(X1) Board of Directors (BOD), (X2) Board of Commissioners (BOC), (X3) Sharia Supervisory Board (SSB), (X4) Audit Committee (AC), (X5) Risk Committee (RC), (X6) Nomination and Remuneration Committee (NRC), and (X7) External Audit (EA).
Data were collected from OJK's Islamic Banking Statistics and each bank's annual report. Multiple linear regression analysis was performed using EViews 12 to assess the relationship between ICG variables and ROA.
Model Specification:

$$ROA = \alpha + \beta_1X1 + \beta_2X2 + \beta_3X3 + \beta_4X4 + \beta_5X5 + \beta_6X6 + \beta_7X7 + \varepsilon$$

Where:
α = the constant,
β = the regression coefficients
X_1 = Board of Directors (BOD),
X_2 = Audit Committee (AC)
X_3 = Board of Commissioners (BOC),
X_4 = Nomination and Remuneration Committee (NRC)
X_5 = Risk Committee (RC),
X_6 = Sharia Supervisory Board (SSB)
X_7 = External Audit (EA).

ε = error term

HYPOTHESIS DEVELOPMENT

The theoretical foundation of this research is primarily grounded in **Signaling Theory**, which posits that effective governance sends positive signals to stakeholders by demonstrating transparency, accountability, and reliability. In the context of Islamic finance, governance also conveys ethical and sharia values, reinforcing institutional credibility and social trust. Additionally, the study is supported by **Agency Theory**, which explains the role of governance in minimizing agency conflicts, and **Stakeholder Theory**, which emphasizes that Islamic banks are accountable not only to shareholders but also to broader societal interests. The **Sharia Governance Framework** further highlights the necessity of oversight to ensure compliance with Islamic ethical principles.

Building upon these theoretical foundations and prior empirical evidence, this study develops a set of hypotheses to examine the impact of Islamic Corporate Governance (ICG) mechanisms on the financial performance of Islamic banks in Indonesia. The hypotheses capture the influence of seven key governance components—Board of Directors, Audit Committee, Board of Commissioners, Nomination and Remuneration Committee, Risk Committee, Sharia Supervisory Board, and External Audit—on financial performance measured through profitability. In this framework, strong governance is expected to enhance monitoring effectiveness, promote sharia compliance, strengthen stakeholder trust, and improve sustainable financial outcomes.

H1: The Board of Directors (BOD) positively affects financial performance.

According to **Agency Theory**, the Board of Directors serves as the primary decision-making body responsible for formulating strategies, managing operations, and ensuring organizational efficiency. A competent and active board helps reduce agency conflicts by aligning managerial actions with organizational objectives, which in turn enhances profitability. Prior studies provide empirical support for this relationship. Alam, et al, (2021) found that an effective BOD improves strategic governance and positively influences financial outcomes in Islamic banks. Similarly, Sari (2022) demonstrated that proactive board involvement enhances operational performance and financial efficiency.

H2: The Audit Committee (AC) positively affects financial performance.

Grounded in **Resource Dependence Theory**, the Audit Committee plays a critical role in strengthening internal control, overseeing financial reporting quality, and reducing information asymmetry. A well-functioning AC improves transparency and enhances investor trust, contributing to improved financial results. Empirical findings by Hameed et al. (2022) showed that the presence of a skilled and independent Audit Committee increases credibility in reporting and supports financial performance. Sarker, M. (2022) also affirmed that effective audit oversight is positively associated with profitability in Islamic banking institutions.

H3: The Board of Commissioners (BOC) positively affects financial performance.

The **Stewardship Theory** suggests that the Board of Commissioners ensures management accountability and provides strategic supervision to protect stakeholder interests. Strong oversight reduces managerial opportunism and enhances governance quality. Billah and Fianto (2021) found that the Board of Commissioners improves transparency and positively influences profitability in Indonesian Islamic banks. Ramdani & Muflih (2023) also demonstrated that supervisory effectiveness contributes to stronger financial standing.

H4: The Nomination and Remuneration Committee (NRC) positively affects financial performance.

Based on **Agency Theory**, incentive alignment is essential to ensure managers act in the best interests of stakeholders. The NRC establishes performance-based remuneration systems and evaluates leadership suitability, thereby encouraging effective managerial behavior. Alam, et al, (2021) highlighted that well-designed remuneration policies enhance managerial motivation and financial results. Al Rafi (2025) also reported that NRC effectiveness is linked to improved governance performance in Islamic banks.

H5: The Risk Committee (RC) positively affects financial performance.

According to **Signaling Theory**, effective risk governance sends a positive signal to stakeholders regarding organizational stability and prudence. The Risk Committee monitors, identifies, and mitigates potential risks, which supports financial resilience. Darma & Afandi (2021) found that strong risk oversight enhances risk-adjusted performance in banks. Ramdani & Muflih (2023) similarly showed that risk governance structures are positively associated with financial outcomes in Islamic banking.

H6: The Sharia Supervisory Board (SSB) positively affects financial performance.

Rooted in **Islamic Corporate Governance Theory**, the SSB ensures compliance with Sharia principles, which enhances ethical operations and stakeholder trust. This governance role builds reputational value and legitimacy in the Islamic financial market. Boudawara et al. (2023) found that SSB effectiveness improves both ethical governance and financial performance. Umar (2022) further demonstrated that stronger sharia compliance correlates with better profitability and stakeholder confidence.

H7: The External Audit (EA) positively affects financial performance.

The **Signaling Theory** also explains the role of External Audit in enhancing the credibility of financial statements through independent verification. A credible audit improves transparency, reduces risk perception, and strengthens market trust. Syukri, A. (2023) confirmed that high audit quality positively influences financial performance in Islamic banks. Boudawara et al. (2023) supported this by showing that reliable auditing promotes accountability and improves profitability.

RESULT AND DISCUSSION

Result

The multiple linear regression analysis was conducted to examine the influence of seven Islamic Corporate Governance (ICG) components—Board of Directors, Board of Directors and Commissioners Meetings, Board of Commissioners, Remuneration Committee Meetings, Risk Committee Size, Sharia Supervisory Board, and External Audit—on the financial performance of Islamic banks in Indonesia measured by Return on Assets (ROA). To evaluate the extent to which the Islamic Corporate Governance mechanisms contribute to the financial outcomes of Islamic banks, a multiple linear regression analysis was employed. This analysis aims to determine whether each governance component provides a statistically significant effect on the financial performance measured by Return on Assets (ROA). The estimated regression equation is as follows:

Table 1. Regression Results

Variable	Coefficient(β)	Std. Error	t-statistic	Probability	Significant
C	0.060366	0.024382	2.475823	0.0163	-
X1	-0.005478	0.004044	-1.354586	0.1810	Tidak Signifikan
X2	-0.000225	0.000433	-0.520678	0.6046	Tidak Signifikan
X3	0.013777	0.006472	2.128659	0.0377	Signifikan
X4	0.004807	0.004473	1.074661	0.2871	Tidak Signifikan
X5	-0.001373	0.001026	-1.338217	0.1862	Tidak Signifikan
X6	-0.036821	0.009964	-3.695484	0.0005	Signifikan
X7	0.000497	0.005021	0.098984	0.9215	Tidak Signifikan

R-squred = 0.245472
Adjusted R-squared = 0.151156
F-statistic (Prop.) = 2.602657
Source: Eviews 12 processing results

The regression results presented in Table 1 indicate that among the seven Islamic Corporate Governance (ICG) variables analyzed, only the **Board of Commissioners (BOC)** and the **Sharia Supervisory Board (SSB)** significantly influence the financial performance of Islamic banks. The model has an **R-squared of 0.245**, suggesting that approximately **24.5% of the variance in financial performance (ROA)** can be explained by the ICG components included. Meanwhile, the **Adjusted R-squared of 0.151** indicates a modest explanatory power after adjusting for the number of predictors. The **F-statistic is significant ($p < 0.05$)**, implying that the model is collectively meaningful:

Effect of Board of Directors (BOD) on Financial Performance

The coefficient for the Board of Directors (BOD) is negative (-0.005478) and statistically insignificant ($p = 0.1810$). This suggests that the size or structure of the BOD does not necessarily translate into higher profitability for Islamic banks. One possible explanation is that BOD roles may be more administrative and compliance-oriented rather than directly strategic in many Islamic banks, especially those with state-linked ownership structures. Previous research such as Putra (2025) also found no significant link between BOD effectiveness and Islamic bank ROA in developing markets, emphasizing that board governance quality may be more influential than board size alone. Therefore, the hypothesis proposing a positive and significant influence of the BOD on financial performance **(H1) is rejected.**

Effect of Audit Committee (AC)

The Audit Committee (AC) variable also shows no significant effect ($\beta = -0.000225$; $p = 0.6046$). This result may indicate that the AC's monitoring function is more compliance-driven than performance-oriented. Islamic banking operates under dual-layer governance (regulatory + shariah oversight), which may reduce the audit committee's relative influence. Similar results were reported by Hasani (2022), who noted that AC effectiveness in Islamic banks is often constrained by limited financial expertise and overlapping committee roles. Accordingly, the hypothesis proposing a significant influence of the AC on financial performance **(H2) is rejected.**

Effect of Board of Commissioners (BOC)

The BOC demonstrates a positive and significant relationship with financial performance ($\beta = 0.013777$; $p = 0.0377$). This confirms that the BOC's supervisory function plays a crucial role in ensuring effective strategic oversight, risk control, and managerial discipline consistent with POJK No. 8/POJK.03/2014. A strong and active BOC aligns managerial decisions with stakeholder interests, improving bank stability and profitability. These findings are aligned with Sari (2022) and Al-Sharif et al (2023), who highlight BOC independence and experience as key drivers of Islamic bank performance. Thus, the hypothesis proposing a positive and significant influence of the BOC on financial performance **(H3) is accepted.**

Effect of Nomination and Remuneration Committee (NRC)

The NRC variable is positive but insignificant ($\beta = 0.004807$; $p = 0.2871$). This suggests that the committee's role in determining leadership and compensation policies may not directly impact short-term financial outcomes. In many Islamic banks, reward systems prioritize compliance and stability rather than aggressive revenue growth, which could explain the lack of measurable impact on ROA. Accordingly, the hypothesis proposing a significant influence of the NRC on financial performance **(H4) is rejected.**

Effect of Risk Committee (RC)

The RC has a negative but insignificant influence ($\beta = -0.001373$; $p = 0.1862$). This likely reflects the risk-averse nature of Islamic finance, where stringent risk controls may limit profitability in the short term. Prior studies such as Khan & Samad (2021) found that strong risk committees may improve long-term resilience rather than immediate financial performance. Therefore, the hypothesis proposing a significant effect of the RC on financial performance **(H5) is rejected**.

Effect of Sharia Supervisory Board (SSB)

The SSB shows a significant negative effect on financial performance ($\beta = -0.036821$; $p = 0.0005$). This is a critical and noteworthy finding. The SSB ensures full compliance with Sharia principles, often resulting in conservative financing practices and restrictions on profit-maximizing activities. While this strengthens ethical integrity and stakeholder trust, it may limit revenue diversification and raise operational costs, thereby reducing short-term profitability. The negative relationship indicates that stronger sharia oversight tends to reduce financial performance because banks may avoid high-risk/high-return products, implement more rigorous screening procedures, and incur higher compliance costs, which collectively suppress short-term profitability. Studies by Rahman & Fikri (2023) and Fadillah (2023) similarly found that strong sharia compliance can reduce ROA due to increased compliance overhead and restricted product flexibility. Therefore, the hypothesis proposing a positive and significant effect of the SSB on financial performance **(H6) is rejected.**

Effect of External Audit (EA)

External Audit does not significantly affect financial performance (β = 0.000497; p = 0.9215). Since external audit primarily ensures transparency and credibility rather than influencing business strategy, its impact on profitability tends to be indirect and long-term. This aligns with findings by Abdullah et al. (2022), suggesting that external audit improves reporting quality but does not directly enhance ROA. Accordingly, the hypothesis proposing a significant influence of External Audit on financial performance **(H7) is rejected.**

Discussion

The findings indicate that governance mechanisms associated with external monitoring, particularly the Board of Commissioners (BOC) and the Sharia Supervisory Board (SSB), exert a more substantial influence on financial performance compared to internal management committees such as the Audit Committee (AC), Nomination and Remuneration Committee (NRC), Risk Committee (RC), and the Board of Directors (BOD). The positive and significant effect of the BOC reinforces **Stakeholder Theory**, which emphasizes the importance of supervisory oversight in ensuring accountability, managerial discipline, and balanced decision-making. This suggests that strong supervisory governance contributes to enhanced financial stability and operational efficiency in Islamic banks.

In contrast, the Sharia Supervisory Board (SSB) exhibits a negative yet significant influence on financial performance. This indicates a structural trade-off between sharia compliance and short-term profitability, where adherence to religious ethical standards limits investment flexibility and increases compliance-related costs. Theoretically, this finding contributes to the understanding of the **dual-layer governance model in Islamic finance**, which differentiates Islamic Corporate Governance (ICG) from conventional systems. While conventional governance prioritizes profit maximization, ICG integrates moral values and religious compliance, demonstrating that financial outcomes are shaped not only by managerial capability but also by normative institutional frameworks.

Meanwhile, the internal governance committees (AC, NRC, RC, and BOD) demonstrate statistically insignificant impacts, suggesting that their current roles may be more **procedural than strategic**. This supports emerging perspectives stating that the **effectiveness of governance is determined not merely by its structural presence, but by its functional authority, competence, and integration into strategic decision-making processes**. Thus, improvement in internal governance quality—not just structural compliance—is essential to enhancing financial outcomes.

From a **sustainability and green finance perspective**, the findings illustrate that Islamic governance frameworks inherently promote **long-term ethical value creation** over short-term profitability. The role of the SSB aligns with sustainable finance principles emphasizing social responsibility and ethical investment behavior, while the oversight of the BOC supports **green governance** practices through transparency and responsible risk management. Although this orientation may reduce immediate returns, it strengthens institutional resilience, stakeholder trust, and long-term sustainability, which are core priorities in sustainable financial systems.

These results imply that Islamic banks need to strengthen the functional authority and strategic involvement of internal governance bodies to ensure their contributions extend beyond administrative compliance. Enhancing the independence, expertise, and decision-making capacity of AC, NRC, RC, and BOD can help transform their roles from procedural oversight to strategic value creation. At the same time, banks should seek ways to **balance sharia integrity with financial innovation**, enabling product diversification that remains compliant yet competitive. Regulators such as OJK and DSN-MUI may consider developing targeted capacity-building programs, competency certifications, and governance performance evaluation frameworks to reinforce governance quality and support the advancement of sustainable and sharia-compliant financial practices

CONCLUSION AND RECOMMENDATION

Conclusion

This study shows that the Board of Commissioners (BOC) positively influences the financial performance of Islamic banks, underscoring the importance of supervisory oversight in ensuring accountability, strategic alignment, and operational efficiency. In contrast, the Sharia Supervisory Board (SSB) demonstrates a significant negative effect, indicating that strict sharia compliance may restrict investment choices and increase compliance costs, thereby reducing short-term profitability. Meanwhile, the Board of Directors (BOD), Audit Committee (AC), Nomination and Remuneration Committee (NRC), Risk Committee (RC), and External Audit (EA) show no significant influence, suggesting that their roles remain more administrative and procedural rather than strategically impactful. Overall, the findings illustrate a governance trade-off in which Islamic banks must balance sharia integrity with financial performance. At the same time, the results align with sustainability and green finance principles that prioritize long-term resilience and ethical accountability over short-term profit maximization.

Recommendation

Islamic banks are encouraged to enhance the strategic capacity of the BOD and empower internal committees through clearer authority and continuous governance training. The SSB's role should be optimized by integrating expertise in financial innovation and risk management to maintain compliance without overly restricting profitability. Coordination between the BOC and SSB should be strengthened to ensure aligned oversight and strategic direction. Regulators such as OJK and IFSB are advised to refine governance guidelines that support both sharia adherence and financial efficiency, ensuring sustainable performance within the Islamic banking sector. For future research, expanding performance indicators beyond ROA and conducting cross-country or comparative governance analyses are recommended to enhance generalizability.

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