

## DISCLOSURE OF ISLAMIC VALUES AND THEIR IMPACT ON THIRD-PARTY FUNDS AND ISLAMIC BANK FINANCING

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**ABSTRACT:** This study investigates how the disclosure of Islamic values may contribute to third-party funds and financing in Islamic-compliant banks. This study employs a sample of 12 Islamic commercial banks in Indonesia with panel data from 2015 to 2020. Weights, based on expert assessments to determine the level of Islamic values, present as the academic contribution of this research. The finding reports that exposure to Islamic values negatively and significantly impacts financing. Third-party funds provide an indirect positive relationship between the disclosure of Islamic values and financing. These findings further consider the importance of implementing and disclosing Islamic values for investors.

**Keyword:** Islamic Value; Third Party Fund; Financing; Indonesia

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## **INTRODUCTION**

The growth of Islamic Banks in Indonesia is at the crossroad. The positive sides reveal the favourable industry with the highest number of institutions globally, with 197 by the end of December 2020 (Otoritas Jasa Keuangan, 2020). Unfortunately, the growth of Islamic banks is not proportional to the number of Indonesian Muslims who mostly prefer conventional bank products. According to data from The Indonesian Financial Service Authority (2020), third-party traditional bank funds amount to Rp. 6,665 trillion, while Islamic banks accounted for Rp. 322.85 trillion or 5% only. Furthermore, conventional banks report their financing as Rp. 5.547 trillion, while Islamic banks Rp. 246.53 trillion or 4 %, respectively.

The growth of Islamic banks in Indonesia from their first establishment in 1992 can be considered slow compared to the total number of banks in Indonesia. If the market share of Muslims in Indonesia can be controlled, the performance of Islamic banks should improve. The Financial Services Authority attributes Muslims' low market share to a lack of optimal Islamic financial literacy, human resources, and Islamic bank resources (Liputan6.com, 2021). Besides that, trust in Islamic banks remains low; many people believe that Islamic banks are no better than conventional banks (Kardoyo et al., 2020). Islamic banks are criticized to have not fully implemented Islamic values (Azmat et al., 2015; Khan, 2010; Ul-Haq, 2012). Islamic banks are also accused of over emphasizing the commercial side over the social side, similar to that of conventional banks (Dusuki, 2008).

The fact that Islamic banks' market share in Indonesia remains lower than the majority of the Muslim population should motivate Islamic banks to show that changes in Islamic banks are sending signals to public to understand the activities of Islamic banks. The public's concerns about the bank's failure to fully implement Islamic values should be addressed by disclosing Islamic values in every activity. Thus, the public interest in depositing funds and using Islamic bank financing products are subject to this disclosure.

There has been much research on the disclosure of Islamic values in Islamic banks (Abdullah et al., 2013; Hameed et al., 2004; Sofyan, 2003). The revelation of Islamic values informs the public about how Islamic banks implement Islamic values. Customers use Islamic banks because they believe in Islam and want to practice it in all aspects of their lives. As a result, it is appropriate for Islamic banks to provide certainty that banks have implemented Islamic values in providing services and products by disclosing Islamic values.

Disclosure of Islamic sharia banks has been done routinely, but the activity should be evaluated, and its effects need to be known. Does the disclosure activity, which includes the disclosure of Islamic values, increase the trust of related stakeholders? Indications of the impact of the exposure include an increase in third-party funds (Dzahabiyah & Umiyati, 2020; Hassan & Syafri

Harahap, 2010; Widialoka & Hidayat, 2016), as well as the demand for financing products (Abduh et al., 2018; Bhat et al., 2006; Islam & Deegan, 2008).

This study begins by identifying the disclosure of Islamic values using a disclosure item derived from previous research. The checklist looks at Indonesian Islamic banks' disclosure of Islamic values between 2015 and 2020. Each exposure has a different weight. The weights are obtained from experts who understand and are interested in Islamic banks. The score weighting method refers to the research of Mohammed and Taib (2015), who developed a *Maqasid-al-Shari'ah* Islamic bank performance by assessing disclosure items. The weighting distinguishes this study as previous studies only examine the disclosure by their report only, leading to potential biases. Following the identification of the disclosure, the next step is to test the impact of the revelation on third-party funds and financing.

## **THEORETICAL REVIEW**

### *Stakeholder Theory*

The Stanford Research Institute (SRI) pioneered stakeholder theory in 1963 (Freeman, 1984). This theory is related to how to create as much value as possible. It was developed on the basis that when a company wants to survive and grow, all parties must be given the benefits of the company's presence. The company must show more accountability or responsibility and reach out to many parties, not just owners of capital. Stakeholder theory aims to raise awareness of banks' obligations to internal and external stakeholders. As a result, the bank's responsibility extends beyond increasing annual income to the well-being of all stakeholders. On a global scale, stakeholders positively perceive Islamic banks, and their reputation has grown (Choudhury & Hussain, 2005). Islamic bank stakeholders are essentially the same as conventional bank stakeholders, but their information requirements differ. Muslim banks must demonstrate their Islamic identity for stakeholders to believe that they have upheld justice, honesty, and other Islamic values.

### *Signalling Theory*

The theory of signalling is a seminal work of Arkelof (1970), which Spence (1973) introduced in his study of Job Market Signaling. According to Spence, when the information is delivered, the recipients adapt their understanding accordingly. Thus, following this study's conceptualizations, Islamic banks must send signals to related parties. The movement is in the form of information to increase the knowledge of associated parties about the Islamic activities that have taken place. Bank signals may take the form of financial or non-financial performance reports. The information released will serve as a signal to those who need to make decisions. If the information signal meets the expectations of interested parties, it is expected to impact the company.

### *Disclosure of Islamic Values*

As financial intermediaries that embed religious identity, Islamic banks should adhere to Islamic values in carrying out and being accountable for their operational activities. Disclosure is an essential component of accountability to all stakeholders (El-Halaby et al., 2018). Non-financial information, mainly information related to Islamic identity, is disclosed by Islamic banks in addition to financial information. The disclosure of Islamic values distinguishes Islamic banks from conventional banks (Ismail & Jabeen, 2019). An annual report containing information on the existence of a Sharia supervisory board that routinely identifies activities carried out by Islamic banks can show disclosure of Islamic values.

According to several studies, Islamic bank compliance with Islamic values is essential criterion customers consider when selecting Islamic banking services (Abduh & Omar, 2014). Sharia bank customers are selective and tend to leave when they doubt the consistency with which Islamic values are applied. Sceptical customers will question the suitability of bank activities with Islamic values. This implies that Islamic banks must consider Islamic values when carrying out and disclosing their operations.

#### *Disclosure of Islamic values on Third-party Funds*

Banks disclose Islamic values by sending signals to customers that their activities are consistent with Islamic values. Disclosure is expected to provide customers with peace of mind, as evidenced by their loyalty to deposit funds, which are then collected in third-party funds. Widialoka and Hidayat (2016) discovered that sharia compliance significantly impacts third-party funds' growth. The study's findings are supported by the research of Febriani et al. (2016) and (and Mehtab et al., 2015), who discovered that disclosing Islamic values affects the growth of third-party funds. Another study by Mehtab et al. (2015) used a knowledge-attitude-practice (KAP) survey on Islamic banking to identify the knowledge, attitudes, and practices of Islamic banks and account holders in Pakistan. They found a relationship between the knowledge and practice of Islamic banks and account holders. Islamic bank practices related to Sharia, such as *riba*, *takaful*, *ijarah*, *qard hasan* (interest-free loans), and trade finance, will be responded to positively by account holders. As a result, the first hypothesis is provided.

*H1: Disclosure of Islamic values significantly positively affects Islamic bank third-party funds.*

#### *Disclosure of Islamic Values on Financing*

The disclosure of Islamic values is consistent with stakeholder theory and signalling theory. According to stakeholder theory, it is the company's responsibility to meet the interests of its stakeholders. At the bank, one of the stakeholders is referred to as the customer. Banks must demonstrate accountability to gain trust (Islam & Deegan, 2008). While signalling theory states that companies must give signals in the form of disclosure of their responsibility

to stakeholders to improve the company's image. In the context of Islamic banks, banks must make public the accountability of their Islamic values.

Implementing Islamic values in activities creates a positive impression and message for Islamic banks. The incompatibility of operational implementation with Islamic values affects customer trust in using Islamic bank financing services via partnership contracts, buying and selling, or leasing. When Islamic banks can persuade all parties of the Islamic values they operate, the desire to continue using Islamic bank financing services or products is maintained or even increased. Anwar and Edward (2016) found that Islamic banks' adherence to Islamic values influences customer decisions to use financing products and serves as the following hypothesis's foundation.

*H2: Islamic values disclosure has a significant positive impact on Islamic bank financing.*

#### *The Impact Third Party Funds on Financing*

Both Islamic and conventional banks require funds to carry out their daily operations. Third-party funds from customers are the most critical source of funds for banking businesses. If the amount of third-party funds collected is significant, they must be immediately disbursed in the form of financing so the funds can be used. As stated in the stakeholder theory, the company's purpose is to manage interests while still paying attention to the company's interests. Because collecting a large number of third-party funds while disbursing a small number of financing funds will result in losses. For this study proposal, Qur'an and Setiawan (2020) discovered that customer funds for financing are positively and significantly related to mudharabah financing.

*H3: Third Party Funds have a significant positive impact on financing.*

#### *Disclosure Of Islamic Value on Financing Through Third-Party Funds*

One of the functions of Islamic banks is to channel financing. Islamic bank financing is unmistakably distinct from traditional bank financing. The fundamental feature that distinguishes it is the prohibition of using usury (interest) by Islamic values. According to Indonesian Law No. 10, 1998, financing is a bank's effort to provide money to customers through a contract. It requires the party being financed to provide a refund or bill after a certain period with compensation or profit sharing. This financing aims to provide job opportunities and economic welfare for customers and parties being financed.

The disclosure of Islamic values by Islamic banking will undoubtedly increase public trust in incorporating them into the products and services offered by Islamic banks. The increase may lead to confidence in customer perception. This is consistent with signalling theory, that information sent to the company about its activities is expected to provide added value to the company. Channelled financing, for example, can increase the value of Islamic banking companies. The more financing channelled, the more income the bank will receive. However, the financing available depends on bank funds (Tabish, 2019)

for the following proposition. Furthermore, figure 1 conceptualizes the research ideas for quantitative investigation.

*H4: disclosure of Islamic values indirectly has a significant positive effect on financing through third-party funds*

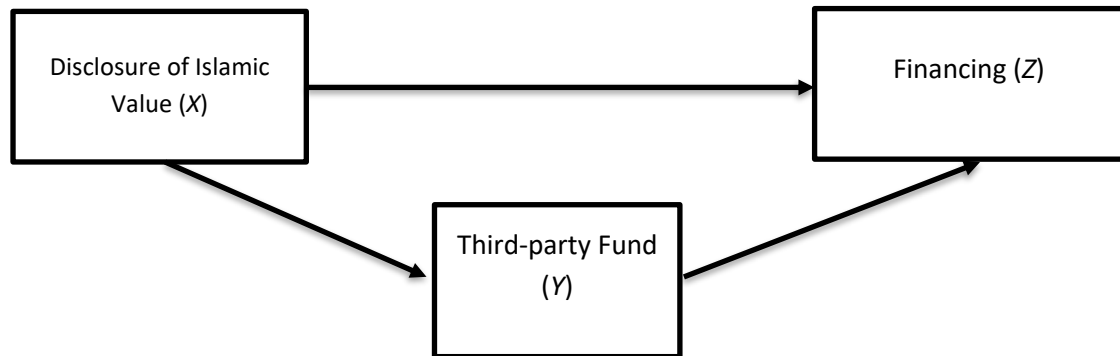


Figure 1. Conceptual Model

## METHODOLOGY

The research sample consisted of 12 Indonesian Islamic banks from 2015 to 2020, with the following sample criteria:

Table 1. Sample Selection Criteria

Information	Amount
Islamic banks in Indonesia operating in 2015 – 2020	12
Observation for six periods	72
Outliers	(5)
The number of samples obtained	67

The research data is based on annual reports of Islamic banks obtained from each bank's website. The data analysis period spans six years, from 2015 to 2020. Because the disclosure of Islamic values in 2015 was widely disclosed compared to the previous year, it is appropriate to conclude the effect of exposure on the increase in third-party funds and financing for six periods.

### Measures

The disclosure of Islamic values refers to the exposure of Islamic banks regarding activities of Islamic values in bank operations. Basic information, financial statements, and other information disclosed by Islamic banks can all be used to demonstrate Islamic values. The disclosure of Islamic values is measured using an index derived from previous research.

This study employs content analysis to investigate items concerning the disclosure of Islamic values. Each item of disclosure has a different value weight. Islamic finance practitioners, academics, and observers are given importance.

The weighting is done because each disclosure item is thought to contain unique information. The following formula is used to calculate the weight of each article:

$$\% \text{ Weight per disclosure item} = \frac{\text{Total score on a specific item}}{\text{Total score overall}} \times 100\% \dots\dots\dots(1)$$

The total disclosure on Islamic values totals 16 disclosures. The formula used is as follows:

$$\sum_{i=1}^{mj} \left( \frac{dj}{N} \right) \dots\dots\dots(2)$$

Where:

- N = maximum disclosure
- Dj = zero when there is no disclosure and the disclosure will be given a weight according to the value obtained from the survey conducted if there is disclosed.

Third-party funds are collections of funds derived from Islamic bank customers' savings, current accounts, and deposits. The formula below calculates the third-party fund ratio.

$$\text{Third Party Funds Ratio} = \frac{\text{Total Third Party Funds}}{\text{Total Assets}} \dots\dots\dots (3)$$

Where:

$$\text{Total Third Party Funds} = \text{savings} + \text{deposits} + \text{checking account} \dots\dots\dots (4)$$

Sharia bank financing is the distribution of sharia bank funds to parties who apply for financing based on sharia principles. Islamic bank financing consists of financing through the purchase and sale of contracts, partnerships, and leasing. The financing ratio is calculated using the formula below:

$$\text{Financing Ratio} = \frac{\text{Total Financing}}{\text{Total Assets}} \dots\dots\dots (4)$$

Where:

$$\begin{aligned} \text{Total Financing} = & \text{Aqad Murabahah} + \text{Aqad Musyarakah} + \text{Aqad} \\ & \text{Mudharabah} + \text{Aqad Qardh} + \text{Aqad Ijara} \\ & + \text{Aqad Istisnha} \dots\dots\dots (5) \end{aligned}$$

### Data Analysis Technique

Multiple regression analyses with SPSS software are employed to test the hypothesis in this study. The classical assumption tests are performed and meet the requirements. The following equations summarize the used model.

$$Y = a + pX + e1 \dots\dots\dots (6)$$

$$Z = \beta + pX.Y + pX + e2 \dots\dots\dots (7)$$

Where:

- X = Disclosure of Islamic value
- Y = Third-party Fund

- Z = Financing
- $\alpha\beta$  = Constant
- p = Coefficient
- $e_1 e_2$  = Error term

## RESULT

The scores were weighted by distributing questionnaires to practitioners, academics, and sharia accounting observers to determine the value of each disclosure of Islamic values. The following are the outcomes:

Table 2. Results of Islamic Value Disclosure Score Weighting

	Basic Information	Score	Sum of Scores	
1	Basic information about Islamic banks (vision, mission, and objectives of establishing Islamic banks)	6.22 %	12.31 %	
2	Report of the Sharia Supervisory Board regarding compliance with Islamic principles	6.09 %		
<b>Financial statements</b>				
3	Halal investment disclosure	6.87 %	62.82 %	
4	Non-Halal investment disclosure	6.99 %		
5	Halal income disclosure	6.35 %		
6	Disclosure of non-halal income sources	6.35 %		
7	Disclosure of the source and use of funds in Zakat and charity	6.74 %		
8	Disclosure of non-halal fund distribution	5.70 %		
9	Policy for giving <i>qard al-Hassan</i>	5.57 %		
10	The policy of not paying <i>qard al-Hassan</i>	5.44 %		
11	Method of calculating Zakat by Islamic Sharia	6.09 %		
12	Disclosure of profit distribution process according to Islamic principles	6.74 %		
<b>Others</b>				
13	Information on the bank's responsibility for activities that are not by Sharia and how the bank deals with it	5.57 %		24.87 %
14	Collection and distribution of funds are only by Islamic values.	6.35 %		
15	Development of products and services by Islamic values	6.35 %		



16	Improved understanding of Islamic banking practices by Sharia Principles	6.61 %	
	TOTAL	100 %	100 %

Before testing the effect of variables, the classical assumption test is performed. Table 3 summarizes the statistical result with the evidences support the data quality for hypothesis testing.

Table 3. Results of the Classic Assumption Test

Testing	Result	Decision
Kolmogorov-Smirnov	0.200	Accepted
Tolerance	0.768	Accepted
VIF	1.302	Accepted
The Spearman	0.615 & 0.793	Accepted

Regression equations 4 and 5 were used to test the hypothesis in this study. Table 4 and Table 5 present the results of multiple regression tests.

Table 4. Results of Direct Effect Testing

Direct Effect	R <sup>2</sup>	Sig.	Stand. Coefficient	Decision
X → Y	0.232	0.000*	0.482	Positive significant
X → Z	0.118	0.004*	-0.344	Negative Significant
Y → Z	0.005	0.555	0.073	Positive, not significant

\*sig. 5%

Table 5. Results of Indirect Effect Testing

Indirect Effect	Stand. Coefficient	Decision
X → Y → Z	0.482 * 0.073 = 0.035	a positive indirect effect

According to the regression results, Islamic values have a significant positive effect on third-party funds but a significant adverse impact on financing. This study also discovers that Third Party Funds mediate the development of Islamic value disclosure on financing.

## DISCUSSION

According to the data analysis findings, the disclosure of Islamic values in the annual reports of Islamic banks has a positive and significant impact on third-party funds. These findings support the previously proposed hypothesis, so the idea is accepted. Disclosure of Islamic values in Islamic banks is critical because it signals that the bank is carrying out activities by Islamic values, which can be seen in the disclosed annual report.

This study employs three indicators from three dimensions: basic information about Islamic banks. A sharia supervisory board report in the essential information dimension contains a statement from the sharia supervisory board regarding their supervision of implementing the basic principles of running the business they have run. Furthermore, Islamic values can be seen in financial reports that present information such as halal investments made, halal and non-halal income, *zakah* sources and uses, *qard* elimination policies, and other Islamic values-related information. This data can provide an overview of the Islamic values practiced and is expected to impact stakeholders or Islamic bank fund collectors.

The study's findings support the research of Al-Tamimi et al. (2009) on the factors that influence customer deposit funds in the United Arab Emirates bank. They discovered that religion is one of the reasons customers choose a place to save. Meanwhile, Widialoka and Hidayat (2016) conducted research in Indonesia on the effect of Islamic values compliance on third-party funds from 2010 to 2015. They discovered that Islamic values compliance significantly affected the increase in third-party funds. Similar findings were found in the research of Dzabiyah and Umiyati (2020), who discovered compliance with Islamic values for third-party funds of all Islamic commercial banks in Indonesia.

The study's findings are consistent with stakeholder theory and signaling theory. According to stakeholder theory, for a company to run continuously, all parties must benefit from the company's presence. A company must be accountable and reach out to various parties (Freeman, 1984). As religiously labeled banks, Islamic banks naturally display Islamic values to stakeholders. Meanwhile, signaling theory explains that businesses are required to send signals about the state of their businesses (Morris, 1987).

Based on the results, it was found that the disclosure of Islamic values had an insignificant negative effect on financing. The findings of this study contradict the hypothesis. This result suggests that the disclosure of Islamic values between 2015 and 2020 is not a sufficient basis for customers to use financing products. The financing customer is the party that requires financing. Hence, the consideration of Islamic value obedience in assessing the bank is not the primary consideration, even though the disclosure of Islamic value obedience of Islamic banks is high.

The study's results, which found the opposite direction, were because some Islamic banks had financing values quite far apart from Islamic banks. This condition causes the disclosure of Islamic values, which, while increasing, has an opposite and insignificant effect on financing. From 2015 to 2020, there was no distance between Islamic banks regarding the disclosure of Islamic values. In contrast, in the funding, the values differ significantly between Islamic banks, especially those with large and small assets.

The study's findings, while contradictory, are absolute disclosures of Islamic values by banks as a form of accountability and provide a sense of security to various parties. Customers who use Islamic banks make religion a primary consideration in using Islamic banks. The research findings can be contrasted with signaling theory, which states that companies must send signals

to various parties as a form of accountability and bank efforts to increase company value (Al-Sartawi & Reyad, 2018). Disclosures that do not affect inappropriate decisions will impact the bank's assessment (Al-Sartawi & Reyad, 2018).

Islamic banks' primary activity is collecting funds from the general public, known as third-party funds. All Islamic bank activities are dependent on the availability of third-party funds. A differentiation between Islamic and conventional banks is required to increase public interest in saving their funds in Islamic banks. Applying Islamic values to Islamic banks is one of the fundamental differences between Islamic and conventional banks.

Third-party funds from Islamic banks differ from those of conventional banks. According to the Indonesian Financial Services Authority, third-party funds are classified into three types: *Wadiah* Current Accounts, *Mudharabah* Deposits, and *Mudharabah* Savings. Each deposit has a unique contract, allowing people to save money for various reasons. The customer can select only non-return storage or expect returns. Customers who save only will be under the *wadiah riyadh addhamamah* contract. In contrast, customers keen on investment will select *mudharabah* deposits, in which the customer expects a return on the deposited funds.

According to the findings of this study, third-party funds have a positive but non-significant effect on financing. Indeed, third-party funds are the primary source of bank financing. However, many other factors have a more significant impact on financing. Amin et al. (2011) researched the factors that influence the selection of Islamic Financing in Malaysian banks. This study discovered three critical determinants of the intention to use Islamic personal financing, i.e., attitudes, social influence, and the price offering of private Islamic funding. The problems and challenges in implementing *mudharabah* and *musharakah* contracts are the high risk, asymmetrical problems, moral hazard, and poor financing evaluation processes.

According to this study's findings, Islam's value on financing is negatively related. However, the effect is positive if third-party funds are used as an intervening variable. This means that Islamic values are indirectly associated with financing via third-party funds. The public responded positively to the banking sector's signal by saving at Islamic banks, which use Islamic values in their products and services. Although many studies have concluded that Islamic values are not the primary reason people use sharia products (Awan & Bukhari, 2011; Dusuki, 2007; Selvanathan, 2018) but Usman et al. (2017) discovered otherwise. The study found that religion significantly impacts customer bank selection, particularly in understanding their deep faith and traditional groups.

## FURTHER STUDY

This study data is only from secondary data in annual reports. However, Activities and disclosures of Islamic values can be carried out but are not disclosed in annual reports or other publication media. Thus, more investigations are recommended from various sources to explain the nature Islamic values.

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