

Integration of social function into Islamic bank soundness level assessment

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Abstract

In Islamic economics and finance, any commercial entity should implement social function. This includes Islamic banks which have been in operation in Indonesia for the past three decades. However, social function implementation was not fully integrated in the Islamic bank's soundness level assessment. This fact has caused unoptimized Islamic social fund potential. This paper attempts to identify determinants of Islamic bank social function, to develop an index of Islamic banking social function, and to integrate social function into Islamic bank soundness level assessment. Principal Component Analysis (PCA) and Analytic Network Process (ANP) were used to identify indicators of Islamic bank social function. Analytic Hierarchy Process (AHP) was employed to conduct weighting process for indicators of Islamic bank social function. AHP is also used to do the weighting for all variables in the new proposal of Islamic bank soundness level. The study found that there are 11 indicators of social function of Islamic bank. Integration of social function into the new soundness assessment was done through inclusion of social function as the fifth variable of Islamic bank soundness level, in addition to Islamic bank's risk profile, GCG, rentability and capital. A new formula to assess Islamic bank soundness level was introduced as the result.

Keywords: Islamic bank, social function, soundness level of Islamic bank

Introduction

Background

Banking is an important part of a country's economy as the transmission channels to achieve monetary policy objectives in creating macroeconomic stability under the form of price stability, economic growth stability and the availability of employment. Stability of financial system highly depends on banking stability after global financial crises in 2008 and uncertainty during pandemic-post pandemic era. It is important to maintaining the banking system resilience. Resilience of banking depends on its soundness. Therefore, banking soundness level assessment is highly importance.

Since the change of Law No.7 Year 1992 to Law No.10 Year 1998 concerning banking, Indonesia has officially implemented a dual banking system, namely the conventional and Islamic systems. Conventional banks and Islamic banks both have the same commercial function which is collecting funds in the form of deposits comprising current accounts, savings, or investments accounts and distributing financing loans to parties who need funds. In addition to these functions, both conventional banks and Islamic banks can also conduct debit card and/or credit card, financing business, buy, sell, or guarantee at their own risk securities, provide letter of credit or bank guarantee facilities, carry out foreign exchange activities, activities in the capital market, and so on in accordance with the provisions of applicable laws and regulations.

The fundamental difference between Islamic banks and conventional banks lies in the principle of managing a business in which conventional banks conduct their business lines conventionally, as has

been running so far. Meanwhile, Islamic banks perform business activities based on sharia principles, or Islamic law principles regulated in the fatwas of the Indonesian *Ulema* Council (in Bahasa is called Majelis Ulama Indonesia or MUI) such as the principles of justice and balance (*'adl wa tawazun*), benefit (*maslahah*), universalism (*alamiyah*), and the absence of *garar* (uncertainty), *maysir* (gambling or excessive speculation), *riba* (interest), *zalim* (oppressions) and haram objects.

Another fundamental difference lies in the core function of Islamic banks. As stated in Law No. 21 Year 2008 concerning Sharia Banking, the function of Islamic banks, both full-pledged (in Bahasa is called Bank Umum Syariah or BUS) and business unit (in Bahasa is called Unit Usaha Syariah or UUS) is not only obliged to accomplish the function of collecting and distributing public funds, but also carry out social functions whose activities include receiving funds derived from zakat, *infaq*, *sadaqa*, and waqf (abbreviated as ZISWAF), or other social funds and distributing them to zakat management organizations (in Bahasa is called Lembaga Amil Zakat or LAZ). BUS and UUS can also collect social funds of cash *waqf* and distribute them to *waqf* managers (*nazir*) in accordance with the will of the *waqf* giver (*wakif*). The implementation of social functions as referred to must be in accordance with the provisions of laws and regulations. Apart from being the mandate of the Law, the function of Islamic banking as a social institution is also stated in the Qur'an, one of which is QS. Al-Maidah verse 2.

"And please help you in doing good and devout and do not help to sin and enmity. And be devoted to God, verily Allah is very heavy in his torment".

According to Muslich (2010), "help" in this verse is in terms of lending and borrowing, which is one of the business domains of Islamic banks. Based on this understanding, the social function of Islamic banks is not limited to ZISWAF collection and distribution activities, but also includes help-oriented lending and borrowing activities. There is only one form of lending and borrowing in Islamic banks, that is the distribution of loans (*qard*) in the form of kindness loans (*qard hasan*).

As an Islamic financial institution, Islamic banks must be guided by and comply with sharia principles. Sharia principles emphasize that economic actors always uphold legal ethics and morals in economic activities. The realization of the sharia concept, basically the Islamic economic/banking system has three basic characteristics, including (a) the principle of justice, (b) avoiding prohibited activities, and (c) paying attention to aspects of expediency (Ali 2008). The principle of benefit (*maslahah*) makes Islamic banks not only as institutions that pursue corporate profits alone (commercial / profit-oriented), but also must meet the benefits for many parties (social-benefit oriented).

Several previous studies have used and built several indicators to measure the implementation of social functions and social performance of Islamic banks. Part from this research includes Fitrijanti & Alamanda (2013); Hameed et al. (2004) and Mukhibad, Nurkhin, & Khafid (2016) use the performance of zakat and *qard hasan* funds as indicators of the social performance of Islamic banks. In addition, Falikhathun, Assegaff & Hasim (2016); Sa'ad & Ibrahim (2015) shows that *qard hasan* financing is social financing that can be used as an indicator of social performance. According to Karim (2007), *qard* is a contract for lending money, while *qard hasan* is essentially almsgiving, because this contract does not require repayment of additional amount apart from principal amount.

Islamic banks in carrying out their social functions can contribute significantly in supporting the national economy and improving people's welfare. Through the distribution of *qard* and *qard hasan*, for example, Islamic banks can help MSMEs that have always experienced limitations in terms of capital and the ability to repay loans. The distribution of *qard hasan* funds in the form of productive policy funds can be one of the solutions offered from the Islamic banking sector. Through ZISWAF

distribution, Islamic banks can help the poor and poor to open up economic access and improve their welfare. Financial Services Board (in Bahasa Indonesia is called Otoritas Jasa Keuangan or OJK)'s research in 2021 concluded that Islamic banks can increase financial inclusion by optimizing social funds, while a study conducted by DPPS recommends integrating the commercial function and social function of Islamic banking through cooperation between Islamic financial institutions and zakat organisation. In addition, the social function is also expected to improve the image and loyalty of the public to Islamic banks (Antonio 2001). The fulfilment of social functions can also be beneficial for Islamic banks themselves as stated in the QS. Al-Baqarah verse 245 Allah also says as follows.

"Whoever wants to lend a loan to Allah, a good loan (to provide for his property on the way of Allah), then Allah multiplies the payment to him by multiples of a lot. And Allah narrowed and expanded (sustenance) and to him ye were returned."

Apart from the role of the social function of Islamic banks which has great potential in supporting the national economy and improving the welfare of the public in general, the implementation of its own social functions by Islamic banks is still not optimal. For example, the social function in receiving funds derived from ZISWAF or other social funds which are then distributed through LAZ or *nazir*. The potential for this social fund is very large, including zakat of IDR 327 trillion per year (BAZNAS, 2021) and cash *waqf* of IDR 180 trillion (Ministry of Religious Affairs, 2021). However, the realization is still small compared to its potential, namely zakat of IDR 71.4 trillion (BAZNAS, 2021) and the total cash *waqf* collected and placed in banks (sharia) is only IDR 328 billion, while project-based *waqf* reaches IDR 597 billion (BWI, 2021). The distribution of financing in *qard* contracts by Islamic banks is also still very low. As of November 2021, the portion of *qard* financing was only IDR 11.6 trillion (5.74%) compared to the total financing of Islamic banks' receivables of IDR 201.8 trillion.

Not only that, the social function of Islamic banks has also not become an official indicator in the assessment of Islamic bank performance by the competent financial system authority in Indonesia. This condition is one of the factors that contribute to the non-optimal implementation of social functions by Islamic banks. At present, the soundness assessment of Islamic banks still uses the Risk Based Bank Rating (RBRR) method. As for risk management, it categorizes into ten types of risk. Neither the soundness assessment method nor the types of bank risks have considered or included aspects of the performance of the social functions of Islamic banks.

The assessment of the performance of Islamic banks using the current measurements will lead to misleading conclusions because Islamic banks have a different set of values and products. Any efforts or processes made by Islamic banks to maximize output must also uphold Islamic values, so that *maqasid* sharia (the goal of *maslahah/sharia*) can be achieved. The absence of necessity in assessing bank performance is a disincentive for Islamic banks to fulfil their social functions. Therefore, this study is aimed at building an indicator that can capture the performance of Islamic banks' social functions and integrate them into the current performance assessment of Islamic banks.

Currently, according to POJK No. 8/ POJK.03/2014, the social function is a part of rentability assessment and qualitative assessment-wise. Does it be integrated into each variable of soundness level indicators one by one, or be created as new additional variable? This is the question that will be addressed by this paper.

Proposing new approach that attempts to integrate social function implementation into the existing Islamic bank's soundness level assessment may be a solution to promote unique value differentiating Islamic bank with its conventional counterpart. It is also inline with the sharia principles which place

social function implementation as embedded part of any commercial entities including Islamic bank. However, this may require new assessment method to evaluate Islamic bank's soundness level.

Objectives

Considering existing assessment for Islamic bank soundness level, it is found that social function has not been included fully as part of the assessment. The absence of social function implementation in this current regulatory scenario will not reduce the soundness level of Islamic banking operation, in which this condition actually is not in line with the sharia. Therefore, this study attempts to identify determinants of Islamic banking social function, to develop an index of Islamic banking social function, and to integrate social function into Islamic bank soundness level assessment.

Literature Review

Bank soundness level assessment: RGEC, CAMEL (Basel)

The RGEC method or stands for Risk Profile, Good Corporate Governance (GCG), Earnings and Capital is a substitute for the CAMELS after the issuance of BI Circular Letter No.13/24/DPNP and PBI No.13/1/PBI/2011 regarding the assessment of the soundness level of Commercial Banks based on the risk profile in force as of January 2012. There are various indicators used in the OJK Circular Letter No.10/SEOJK.03/2014 to assess the level of soundness of Islamic banks and sharia business units, among others:

Risk Profile Factor Assessment

Risk profile factors evaluate the effectiveness of the implementation of risk management as well as the risks that exist in bank operations. There are ten different forms of risk, including credit risk, market risk, liquidity risk, operational risk, legal risk, strategic risk, reputational risk, compliance risk, investment risk, and risk return, included in the list of risks that need to be evaluated.

Good Corporate Governance (GCG)

There are five principles of Good Corporate Governance factors which are referenced by Islamic Full-Pledged Commercial Banks or BUS in underlying the assessment of bank management quality including transparency, accountability, accountability, professionalism, and fairness. In applying these principles, BUS will continue to pay attention to the characteristics and complexity of each bank's business.

Rentability (*Earnings*)

Rentability factor assessment is an assessment of rentability performance, rentability management, various sources of rentability, sustainability of rentability, and the implementation of social functions. Based on "PBI No. 13/1/PBI/2011 concerning Soundness Level of Commercial Banks, profitability is calculated using the ratio of Return on Assets (ROA) and Net Operating Margin (NOM).

Capital

The assessment of capital adequacy and capital management both include the assessment of capital factors which are based on Bank Indonesia Regulation No.13/1/PBI/2011 Article 7 paragraph 2 concerning minimum capital obligations and capital management" for Islamic Commercial Banks. Assessment of capital adequacy that serves as a support for risky assets, can be measured by Capital Adequacy Ratio (CAR).

The assessment of aspects in CAMELS and RGEC has the following differences. Before implementing RGEC, according to Bank Indonesia Regulation Number: 6/10/PBI/2004 Rating System for Commercial Banks, the scope of Bank Rating encompasses rating of the following factors are based on CAMELS: a. capital; b. asset quality; c. management; d. earnings; e. liquidity; and f. sensitivity to market risk.

Table 1. Differences in aspects in the CAMELS and RGEC approaches

No.	CAMELS	RGEC
1.	Capital	Capital
2.	Asset	Credit Risk Profile
3.	Management <ul style="list-style-type: none"> In general, • Compliance • Management • Risk 	GCG Compliance Risk Profile Assessment of Risk Management
4.	Rentability (<i>Earning</i>)	Rentability (<i>Earning</i>)
5.	Liquidity	Liquidity Risk Profile
6.	Sensitivity to Market Risk	Market Risk Profile

Sarker (2005) have proposed 'S' in the CAMELS is deemed for Sharia framework in the context of Islamic banking soundness rating system. Muljawan (2007) emphasized that CAMELS has been improved to fit more effective banking supervision by implementing Risk Based Supervision (RBS) in the Islamic banking practices as he also proposed wider scope assessment for Islamic banks. Therefore, Bank Indonesia has come up with new PBI No.13/1/PBI/2011 regarding the assessment of the soundness level of Commercial Banks based on the risk profile in force as of January 2012. Nevertheless, Oktaviansyah, Roziq, & Sulistiyo (2018) stated that CAMELS and RGEC both are less comprehensive to assess the soundness level of Islamic banks.

Current practice of Islamic banking soundness level assessment

Currently, Islamic Banks are assessed according to Bank Indonesia Regulation No.13/1/PBI/2011 which is based on Risk-Based-Bank Rating (RBBR) Approach. Composite Rank (known as PK – *Peringkat Komposit* in Bahasa) was formulated from 1 to 5. PK 1 means that an Islamic bank is in the very sound condition.

Table 2. Composite rating of bank health level based on Risk-Based Bank Rating (RBBR) approach

Composite Rank	Rate
PK 1	Very Soundnessy
PK 2	Soundnessy
PK 3	Simply Soundnessy
PK 4	Low-rate soundness
PK 5	Not Soundnessy

Source: Bank Indonesia Regulation No. 13/1/PBI/2011

Notes:

- a. Banks with PK 1 which have a value of 86-100 are said to be very soundnessy
- b. Banks with PK 2 that have a value of 71-85 are said to be soundnessy
- c. Banks with PK 3 which have a value of 61-70 are said to be simply soundnessy

- d. Banks with PK 4 which have a value of 41-60 are said to be low-rate soundness
- e. Banks with PK 5 that have a value of less than 40 are said to be not soundness.

Social function in Islamic banking soundness level assessment

Oktaviansyah, Roziq, and Sulistiyo (2018) used ANGELS approach to assess rating system for Islamic banking industry in Indonesia. The concept of ANGELS comprises Amanah management, non-Economic wealth, Give Out, Earnings, Capital and Asset, Liquidity and Sensitivity to market and Socio-economic wealth. They categorized the banks based on Bank Indonesia Regulation No.13/1/PBI/2011.

Assessment of Amanah management includes sharia strategic management system, innovation, accountability to God, accountability to stakeholders, and accountability to nature. Non-economic wealth measured ethics of morality and ethics as a critical and rational reflection. Give out is measured using 3 (three) variables consists of justice principles, equality, and tranquility. Earning, capital and assets quality measure business efficiency and profitability achieved by the bank concerned in ROA and ROE ratios, minimum capital meets its long-term liabilities and liquidity which is reflected in CAR, and financing performance for assets quality which is measured by its non-performing rate (NPF). Socioeconomic wealth measure justice, partnership, transparency, and universal. Liquidity and sensitivity to market is using LDR for liquidity performance, and market risk ratio to describe the ability of Islamic banks to cover the cost of profit shared between customers (ratio) and the Islamic bank.

The socioeconomic dynamics initiated by the Islamic scholar, Ibn Khaldun, and later developed by Chapra (2007) reflects the concept of development in Islam. The whole socio-economic model of Ibn Khaldun is summarized in eight principles of wisdom (hikamiyyah sentences) of political wisdom:

1. The power of sovereignty (al-mulk) is not realized except through the implementation of Sharia.
2. Sharia cannot be implemented except by the ruling party/authority (al-mulk).
3. The ruling party cannot gain power except through the people (al-rijal).
4. The people cannot be sustained except by wealth (al-maal).
5. Wealth cannot be obtained except through development (al-imarah).
6. Development cannot be achieved except through justice (al-adl).
7. Justice is the criterion (al-mizan) by which Allah will judge mankind.
8. Sovereignty is burdened with responsibility for realizing justice

The power of Ibn Khaldun's analysis lies in its multidisciplinary and dynamic nature because it connects all important socio-economic and political components, including political power or authority (G), beliefs and rules of conduct or Sharia (S), human beings, people/society (N), wealth or resource stocks (W), development (g) and justice (j), in a circular and interconnected manner, each affecting the other and in turn influenced by the other. The relationship of all these components is then formulated into a diagram known as the cycle of progress and decline of a dynasty, nation or civilization, or commonly called the Chapra Cycle (Sholihin 2013). These components are at the core of the formation of Islamic society. The five components move in two cycles, the forward cycle and the backward cycle. The forward cycle moves clockwise, that is, from government, sharia, society, wealth, institutions and then back to government. The backward cycle moves counter-hours from government, institutions, wealth, society, sharia and back to government.

Sharia Role (S)

Sharia refers to the values and institutions or rules of behavior that make human beings (N) willing to fulfill their obligations to others and prevent social deviant behavior. The rules of conduct, both formal and non-formal, both written and unwritten which are the main guidelines for the behavior of Islamic

society are called Sharia (S). Sharia will not be able to play a significant role unless it is properly implemented and impartially implemented in its implementation. Sharia helps humans (N) instill good qualities such as obedience, honesty, integrity, humility, and a sense of community that can contribute to the process of development, justice, mutual understanding, cooperation, peace and harmony as well as control of behaviors that can harm society.

Sharia can also have an effect on the use of resources where it can contribute to the realization of balanced resources. Without these qualities in society (N), it will cause injustice, imbalance, dissatisfaction, and chaos which will eventually lead to the destruction and disintegration of society. A society full of the principle of commonality of goals *homo Islamicus* that will act both individually and collectively in a society that is fulfilled within the framework of special legal-political-political norms, for example, justice, primacy, equality in behavior, assuming that it will produce a just, equitable and optimal economic result in the revival of the Islamic economic system in the economic order as well as life (Mahyudi, 2015).

Human role (N)

Based on the thought of Ibn Khaldun man who played an important role in the rise or fall of civilization which was highly dependent on welfare or misery. However, it relies not only on economic variables but also on the role of closely related moral factors, institutional, psychological, political, social and demographic through causal processes over a long historical period.

The Role of Development (g) and Justice (j)

Development in Ibn Khaldun's socio-economic model does not only affect economic growth. Development also refers to the development of the whole person so that each of these variables (G, S, N and W) enriches each other so that all components contribute to the well-being and progress of civilization. Economic development cannot be achieved by economic forces alone without the support of non-economic sectors within society which include moral, social, political and demographic support. If such support is not available, economic development may not be triggered. If development can happen, it may not be sustainable.

On the other hand, development would also not have taken place without the presence of justice (j). The notion of justice here does not only refer to narrow economic justice but rather to a broader understanding of justice in every aspect of human life. Justice in this broad context cannot be fully realized without creating a society (N) as previously explained. Justice is aimed at ensuring the safety of life, protecting the property and honor of everyone, social, economic and political fulfillment, and the right to freely determine what actions are desired by a person as well as for the prevention of crime and injustice of any kind. Justice (j) will also ensure the welfare of the community through the fulfillment of mutual obligations and equitable distribution of development outcomes (W and G).

Institutional (S) and Governmental (G) Roles

The fulfilment of justice requires certain rules of conduct called institutions or institutions, economic institutions, and moral values in religious views. These institutions and moral values are the standards that human beings (N) use in interacting and fulfilling their obligations towards each other. Society has rules that are made based on their own views. But in Islamic societies, the main basis of such rules is Sharia (S). Rules drafted under sharia can help curb socially harmful behavior, ensure justice (j), and increase solidarity and mutual trust within society, thereby encouraging development (g).

However, Sharia can only provide rules of conduct and cannot impose them. Implementing sharia is the responsibility of political or government authorities (G) to ensure compliance through incentives

and prohibitions. State or government obligations other than defending and maintaining law and order, ensuring fairness, fulfillment of contracts, elimination of complaints, fulfillment of needs and compliance with the rules of conduct. In other words, the state must do things that help people run their legitimate businesses more effectively and prevent them from committing greed and injustice to each other.

Ibn Khaldun considered it bad for the state/government to be directly involved in economic activities. If the state/government does so it will not only harm people (N) by reducing their opportunities and profits (which is referred to as the crowding out effect of the private sector) but also reduce state tax revenues. The state/government visualized by Ibn Khaldun is more of a state that guarantees the implementation of Sharia (S) and serves as an instrument to accelerate human development and welfare.

The Role of Wealth (W)

Wealth (W) provides the resources needed to ensure justice (j) and development (g), the effectiveness of the exercise of its role by the government (G), and the welfare of the whole people (N). The weakness or strength of society depends on wealth/well-being (W) and development (g). Therefore, welfare(W) developed by Ibn Khaldun where wealth/welfare(W) depends on economic activity, the amount and division of labor, the market area, the benefits and facilities provided by the state as well as the equipment which in turn depends on the savings or excess generated after meeting the needs of the people. The greater the economic activity, the greater the income. Higher incomes will contribute to greater savings and larger investment instruments which in turn will contribute to the development of (g) and even greater wealth (W). Furthermore, Ibn Khaldun emphasized the role of investment by saying: "And know that wealth does not grow when it is hoarded and collected in safes. Rather it grows and develops when it is spent on the welfare of the people, to fulfil their rights, and to eliminate their difficulties".

Previous Studies

Table 3. Previous Studies

No.	Author Name (Year), Title	Research Objectives	Research Variables	Research Results
1	Oktaviansyah, Roziq, and Sulistiyo (2018) <i>ANGELS Rating System for Islamic Banking Industry in Indonesia</i>	Analyze the bank soundness assessment using ANGELS approach in Islamic bank uses a non-interactive qualitative approach	Amanah Management, Non-Economic Wealth, Give Out, Earning, Capital and Asset, Liquidity and Sensitivity to Market and Economy Wealth: ROA, ROE, CAR, NPF, LDR and MR	Islamic bank using ANGELS has a score of 86.79, is said to be soundnessy (good soundness).
2	Muhammad Ramzan, Muhammad Amin, Muhammad Abbas (2021)	Analyze the impact of CSR on financial performance, financial inclusion and financial stability in the banking sector using annual data from commercial	CSR, Financial Performance, Financial Stability, Financial Inclusion	The results showed that CSR, age and size have a positive impact on financial performance, financial stability and financial inclusion. However, a

No.	Author Name (Year), Title	Research Objectives	Research Variables	Research Results
	<i>How does corporate social responsibility affect financial performance, financial stability, and financial inclusion in the banking sector? Evidence from Pakistan</i>	banks in Pakistan 2008-2017		high level of leverage reduces financial inclusion.
3	Luthfi Hamidi, Andrew C. Worthington <i>How social is Islamic banking?</i>	Analyze social functions as is the goal of Islamic banks and investigate whether there are social malfunctions in Islamic banking in Indonesia by analysing with the dimensions of Islamic banking performance.	Environmental, Social Objectives, Religiosity, Governance, Employees, Customer Orientation	There is a failure to carry out social functions in all rural banks and half of all Islamic commercial banks and only one in seven UUS that pursue social functions at the accommodative level. <i>Asset-weighted Social Outcomes</i> show that Islamic banking has improved its social function over time, but sometimes comes at the expense of other objectives related to the environment and customer orientation
5	Achmad Tohirin and Fauzan Husnaini (2019) <i>Does Islamic Banking Financing Help the Poor?</i>	To analyze the impact of Islamic banking financing to help the poor	Islamic banking financing, conventional banking loans consumption price index and economic growth	The results showed that Islamic Banking Financing has an impact in reducing poverty better than conventional banking
6	Azis Budi Setiawan (2009) <i>Financial Health and Social Performance of Islamic Commercial Banks in Indonesia</i>	Knowing the financial soundness of Islamic Commercial Banks in Indonesia and knowing the social performance of Islamic Commercial Banks in Indonesia	Asset Quality, Rentability, Liquidity, Economic Development Contribution (KPE), Contribution to Society (KKM), Contribution for Stakeholders (KUS), SDI and Research Capacity Building (PKSR), Distribution of Economic Development (DPE)	The results showed that overall, in the period 2003-2007, BMI's financial health was better than BSM. On average from that period, BMI's financial health level received a credit score after a cumulative weighting of 77.25. As for the level of social performance, in the period 2003-2007 the performance of BSM was better than that of BMI. On average, in that period, BSM's social performance

No.	Author Name (Year), Title	Research Objectives	Research Variables	Research Results
				level received a credit score after a cumulative weighting of 64.07.
7	M. Luthfi Hamidi, Andrew C. Worthington, Tracey West and Rifki Ismal (2019) <i>The Prospects for Islamic Social Banking in Indonesia</i>	This study investigates the social performance of Islamic banks in Indonesia, including their justification as the objectives of Islamic banks and their improvements.	Theological Support, Social Objectives, Social Outcomes, Indicators and Legal Support	Most respondents (52.96%) suggested improvement by combining corporate social responsibility and the ZIS (Zakat, Infaq, sadaqa)-waqf system. Only a few (7.11%) proposed the establishment of Islamic social banking, the main feature of which was to design collateral alternatives so that low- and middle-income customers could more easily access bank financing.

Based on the literature review that has been carried out, various indicators that can be used to measure the social performance of Islamic banks are divided into four dimensions, namely:

1. Components and Formulas of Social Performance of Islamic Banks (On Balance Sheet)
2. Components and Social Performance Formulas (Off Balance Sheet)
3. Components and Formulas of Social Performance Based on the *Maqasid* Sharia Approach
4. Components and Social Performance Formulas Based on Financing Types and ZISWAF

Methodology

Research Design

This study aims to see the effect of the performance of social functions of Islamic banks on the performance of their commercial functions. However, before arriving at the influence analysis, the research first maps out various indicators that can be used to measure the performance of the social function of Islamic banks. Mapping is done by conducting a review of the literature that examines the social function of Islamic banks. After various indicators of the social functions of Islamic banks have been successfully mapped, further research determines which indicators are relevant to be used in assessing the performance of social functions of Islamic banks. This is done by asking the opinion of experts regarding the selection of priority indicators of social function. The results of the expert assessments were analysed using the Analytical Hierarchy Process (AHP) method.

Based on the AHP, priority weights are obtained for each selected indicator of the social function of Islamic banks according to the opinions of experts. These weights are then used as a basis for weighing the social function of Islamic banks as it integrated into the soundness assessment level of Islamic banks in general.

Data, Data Source and Selected Variables

The data used in this study consisted of primary data and secondary data. Primary data is mainly related to qualitative data of Islamic banks, such as social activities carried out, inclusion efforts and internal spiritual activities of Islamic banks. Primary data was obtained through a survey of every BUS and UUS in Indonesia using a previously prepared questionnaire. While secondary data is taken from the OJK database. The secondary data used is bank financial performance data, such as total assets, total liabilities, total equity, total profit, ROA, ROE, NPF, FDR, BOPO, and so on. The secondary data used is annual data from 9 BUS and 20 UUS with a span of five years from 2017 to 2021. Details related to the data used in this study is summarized in the following table.

Table 4. Operational Definition of Variables

Factors	Indicators	Formula
Economic Development Contribution	Intensity of Islamic bank profit sharing financing	Mudarabah + Musharakah / Total Financing
	Intensity of Islamic bank agency function	Third Party Fund Profit Sharing / Total Third Party Fund
	Long-Term Development Contribution	Long-Term Financing / Total Assets
	Agency Function Deepening Ratio	Mudarabah Deposits & Sukuk / Total Liabilities
Contribution to Society	Qardh Financing Ratio	Qard Financing / Total Financing
	Zakat performance ratio	Corporate Zakat Distribution / Profit Before Tax
	Social function execution ratio	Zakat and Benevolent Funds / Core Capital
	Ratio of implementation of educational functions	Promotional Costs / Operating Expenses
Contribution to Stakeholders	Sohibul Maal's Welfare Contribution Ratio	Profit After Tax / Core Capital (Total Equity)
	Mudharib Welfare Allocation Ratio	Salary and Welfare Costs / Operating Income
	Investor Welfare Contribution Ratio	Profit Sharing Distribution / Total DPK-ITT/Mudarabah Mutlaqah Investment
	Wadiah Holder Welfare Contribution Ratio	Wadiah Account Bonus / Total DPK-Wadiah
	Tax Contribution Ratio for Government	Net Income Tax Expense / Operating Income
Human Resource Capacity Building and Research	Contribution to SDI Capacity Building and Research	Tuition and Training Costs / Profit After Tax
	Allocation Ratio for Research and Development	Research and Development Costs / Profit After Tax
	National Asset Distribution Equalization Ratio	Assets Outside Java / Total National Assets

Distribution of Economic Development	National Distribution Ratio	Investment Equalization	Customer Investment Outside Java / Total National Customer Investment
	Ratio of Income from Outside Java	Contribution	Income From Outside Java / Total Investment of National Customers
Religiosity	Zakat		If the Bank has made a Corporate Zakat payment (corporate zakat) and distributed ZIS funds directly and indirectly.
	Qard Al Hasan		If the Bank has distributed <i>Qard al-hasan</i> funds as a benevolent loan.
	Encouraging Activities	Spiritual	If the Bank encourages to encourage to carry out spiritual activities such as morning worship, <i>duha</i> prayers and reciting the Quran and as an initiator to its customers and the communities in it such as its employees.
Environment	Environmental Awareness		If the bank raises the issue of the environment as a conceptual issue and carries out several relevant programs (such as reforestation, reducing the use of plastics and socialization in the form of seminars on environmental issues.
	Green Office		If the bank has explicit policies regarding efficiency in the use of materials, water and energy use and there are concrete initiatives to preserve the environment.
	Green Financing		If the bank has explicit policies regarding Green Business such as financing recycled plastics, organic food and water management and there are already programs in place.
Community	Education and Training to the Community		If the bank has a program for education or training to the community and already has a program.
	Community Improvement	Quality	If the bank has programs to improve the quality of the community such as building public facilities, helping victims of natural disasters

Personnel			and providing health services and is currently running a certain number of projects and is reported on the annual report.
	Community Empowerment	Economic	If the bank has programs on economic empowerment such as helping to market and community businesses, recruiting local employees and expanding connections for local communities and is currently running programs with a certain amount of money and reported on the annual report.
	Reward to employees		The number of policies/programs related to employee welfare implemented by the bank (Number of policies/programs)
	Employment Equality	Opportunity	Proportion of women occupying positions of Board of Directors and senior management (1 level below the board of directors)
	Employee Training		If Bank has a commitment to continue to educate and build competencies for its employees as well as hold training and workshops, as well as report participants from training and training costs.
	Occupational Safety	Security and	Number of work accidents that occurred throughout 2021
Governance	Vision/Mission Statement		If the bank has a vision/mission statement related to social goals and has specific measurements to achieve that vision.
	Prevention of Corruption and Fraud		If the bank has an explicit concept in dealing with fraud and establishing an anti-fraud division and reporting if there is fraud in it.
	Handling complaints	customer	If the bank has an explicit concept of customer complaints and builds some relevant measures to deal with fraud as well as openly to report the results.
	Employee Compliance	Ethics and	If the bank has a code of ethics or policy in serving customers and explaining and

	reporting how they implement it to their employees.
Whistleblowing System	If banks have whistleblowing system procedures in place and explain and report how they implement them to their employees.

We run Principal Component Analysis (PCA) to simplify the variables. PCA and factor analysis are useful for simplifying complex and voluminous data sets into just a small number of factors. A factor is defined as a dimension or construct that is a concise form of correlation between variables. PCA is used to identify indicators of the social functioning of Islamic banks.

Table 5. Selected Variables after PCA

Group of PCA	Indicators
PCA 1	ZISWAF management (Zakat, Infaq, Shodaqoh, Waqf, Grant)
	Awareness of social and environmental responsibility
	Green office
	Green financing
	Implementation of education and training to the community
	Implementation of community quality improvement programs
	Implementation of community economic empowerment programs
	Ratio of research and development (R&D) cost allocation to profit after tax
	Ratio of equitable distribution of bank assets to total national Islamic banking assets
	Equitable ratio of investment distribution of bank customers to total investment of national Islamic banking customers
	Ratio of income contribution from outside Java to total investment of national Islamic banking customers
	Sohibul Maal's welfare contribution to total equity
	Ratio of mudharib welfare allocation to operating income
	Contribution of welfare of wadiah holders to total wadiah deposits
	Providing payment discounts for clients/customers
PCA 2	Prevention of corruption and fraud
	Implementation of whistleblowing system
	Rewards to employees
	Development of employee competencies and careers
	Employee safety and health
	Qardh financing ratio
PCA 3	Employee ethics and compliance
	Handling of customer complaints
	Area services that have not been served by formal financial services
PCA 4	Statement of social objectives on the bank's vision/mission/strategic plan
	Intensity of islamic bank agency function
	Zakat performance ratio
	Ratio of execution of social functions
	Investor welfare contribution ratio

PCA 5	Equality of employment opportunities
	Long-term development contribution
	Ratio of implementation of educational functions
PCA 6	Qardhul hasan
	Intensity of islamic bank profit sharing financing
	Agency function deepening ratio
PCA 7	Encourage spiritual activities
	Diversification of financial products for disadvantaged, women and disabled groups
PCA 8	The ratio of tax contributions to the government
	Contribution to capacity building and research

The results are run into simulation by using Panel Data Regression. Panel Data Regression analyze the effect of social function implementation on the risk profile of Islamic banks and the minimum capital needs of Islamic banks, as well as to analyze the effect of Islamic banks' social performance on the commercial performance of Islamic banks.

$$\begin{aligned}
 &Ln(\text{Islamic bank performance}) \\
 &= \beta_0 + \sum_{t=0}^p \beta_1 \ln(\text{external factor})_{it} + \sum_{t=0}^p \beta_2 \ln(\text{internal factor})_{it} \\
 &+ \sum_{t=0}^p \beta_3 \ln(\text{social function factor})_{it} + u_{it}
 \end{aligned}$$

Table 6. Selected Significant Variables after Panel Data Regression Simulation towards ROA and NPF

Group of PCA	Indicators
PCA 1	ZISWAF management (Zakat, Infaq, Shodaqoh, Waqf, Grant)
	Awareness of social and environmental responsibility
	Green office
	Green financing
	Implementation of education and training to the community
	Implementation of community quality improvement programs
	Implementation of community economic empowerment programs
	Ratio of research and development (R&D) cost allocation to profit after tax
	Ratio of equitable distribution of bank assets to total national Islamic banking assets
	Equitable ratio of investment distribution of bank customers to total investment of national Islamic banking customers
	Ratio of income contribution from outside Java to total investment of national Islamic banking customers
	Sohibul Maal's welfare contribution to total equity
	Ratio of mudharib welfare allocation to operating income
	Contribution of welfare of wadiah holders to total wadiah deposits
	Providing payment discounts for clients/customers
PCA2	Employee ethics and compliance
	Handling of customer complaints
	Area services that have not been served by formal financial services
PCA3	Equality of employment opportunities

PCA4	Long-term development contribution
	Ratio of implementation of educational functions
	The ratio of tax contributions to the government
	Contribution to capacity building and research

After running PCA and Panel Regression Analysis simulation, we analyse the experts' judgement regarding the result through Analytical Network Process (ANP). ANP is deemed to identify what variables/parameters can be used to measure the success of banks in carrying out social functions and to integrate social function performance measurements into the assessment of the soundness level of Islamic banks.

Based on the ANP results for all PCAs, 11 indicators were selected. They were as follows:

1. ZISWAF Management
2. Economic empowerment
3. Investment / financing in environmental-based sectors
4. Customer complaint handling services
5. Employee ethics and compliance
6. Service areas not yet served by formal LKS
7. Equality of employee employment opportunities
8. Long-term development contribution
9. The function of education and literacy to the community
10. The ratio of tax contributions to the government
11. Contribution to human resource capacity building and research

Analytical Hierarchy Process (AHP)

Analytical Hierarchy Process (AHP) is a qualitative analysis and quantitative analysis of multi-objective decision analysis methods. It initially introduced by Saaty (1980). It designed a multilevel hierarchy of goals, criteria, sub-criteria, and alternatives as the basis for the general decision problems. There are three fundamental principles that define AHP: a hierarchical structure, the relative importance (or weight) given to each decision criteria; and consistent judgment. The relative importance (or weight) of each criterion, which reflects reasonable human judgment on elements in the same category, is determined through a pairwise comparison method. Using a pairwise comparison, linguistic judgments can be converted into numerical scales of 1-9. Scale 1 means the two elements are of equal importance, and scale 9 means one is extremely more important than the other.

Tabel 7. Pairwise comparison scale for analytic hierarchy process (AHP) preferences

Verbal Judgments of Preferences	Extremely Preferred	Very Strongly to Extremely	Very Strongly Preferred	Strongly to Very Strongly	Strongly Preferred	Moderately to Strongly	Moderately Preferred	Equally to Moderately	Equally Preferred
Numerical rating	9	8	7	6	5	4	3	2	1

The steps of using AHP to solve problem are: first, create a hierarchical structure of the problem; secondly, determining matrix structural pairwise comparison; then, judging the relative weight by the matrix elements as follow:

$$A = \left(\frac{a_{11} \ a_{12} \ \dots \ a_{1n}}{\begin{matrix} a_{21} & \dots & \dots & \dots & \dots & \dots & \dots & \dots & \dots \\ \vdots & & & & & & & & \end{matrix}} \quad a_{n1} \ \dots \dots \dots a_{nn} \right)$$

Then, calculate the combination weight of each layer element. The actual relative weights of decision elements can be obtained by computing the normalized eigenvector of A that satisfies the following equation:

$$A \cdot w = \lambda \cdot w$$

where λ is the eigenvalue associated with eigenvector w . This process should be performed at all levels of the criteria to obtain all the relative weights of the decision elements.

In the last step, do the consistency test which can be performed to verify the reasonability of the decision makers' pairwise comparison. The measure of consistency is obtained by a consistency index (CI) and a consistency ratio (CR), which are defined as follows:

$$CI = \frac{\lambda_{max} - n}{n - 1}$$

$$CR = \frac{CI}{RI}$$

where n is the number of decision elements, and the random consistency index (RI) is an experimental value provided by Saaty (1990).

The AHP method is used to provide weight to each indicator of the Islamic bank social function and in the new Islamic bank soundness formula. This bank soundness combines the existing measurement standard with the Islamic bank social function formula.

To obtain the results of the AHP, opinions were asked regarding the relevant indicators for measuring the performance of the social function of Islamic banks to the relevant experts. There were 9 experts whose opinions were asked from banking and social finance institutions in Indonesia comprising representatives of Bank Syariah Indonesia (BSI), UUS Bank Permata, OJK Sharia Banking Supervisor, Bank Indonesia, The National Board of Zakat (BAZNAS), Ministry of Religious Affairs, The Indonesia Waqf Board (BWI) and also academics.

Result and Discussion

AHP Results

Based on the results of AHP estimation, the eleven main and final indicators of social function performance of Islamic banks are obtained and summarised in Table 5.

Table 8. Indicators of Social Function of Islamic Bank

No.	Indicators	Weight Priority
1	ZISWAF management	0.143
2	Community economic empowerment	0.128
3	Ethics and compliance of Islamic bank employees	0.109
4	Environmental-based investment or financing	0.105
5	Customer service	0.094
6	HR development and research of Islamic banks	0.086
7	Equal opportunities for Islamic bank employees	0.083
8	Outreach area that has not been served by other financial institutions	0.076

9	Islamic banking education function	0.066
10	Islamic banks long-term financing contribution	0.058
11	Islamic bank tax contribution to the government	0.053

It is found that ZISWAF management has the highest weight priority among other indicators. This is due to the ZISWAF position which reflects the core social function in Islamic economic system. Islamic bank is considered to fulfil its social function when it is able to manage mandatory and voluntary Islamic social funds in the form of ZISWAF.

Community economic empowerment is another important indicator due to the notion stating that realisation of social function should be resulted in a more empowered society. It is also part of social responsibility of Islamic bank to ensure that the society benefiting the presence of Islamic bank. The existence of ethics and compliance of Islamic bank employees indicates that ethical accountability play significant role in affecting people perception on the implementation of social function. The behaviour of Islamic bank employees should be ensured to always in line with the sharia code of conduct.

Furthermore, environmental-based investment or financing indicates growing awareness on green Islamic banking practices. This is in line with the issues of sustainability and ecological balance in economic development to ensure better future. Environmental-friendly banking practice is one of the key issues in the financing of sustainable development goals.

The presence of customer service in the 6th rank of weight priority indicates that the quality of social function is affected by the quality of customer service. Excellent service will lead to excellent delivery of social programmes, which will end up in an impactful social function implementation.

HR development and research of Islamic bank are also important factors affecting social function implementation. Human resource development is the key element determining entire performance of an Islamic bank. The progress and decline of the performance of Islamic bank is very dependent on its human resource availability and quality. Similarly, quality of social function design and programmes is affected by research quality of the bank. This research may affect policy design and application of social function.

Another important indicator is on the capability of Islamic bank to reach areas that have not been served by other financial institutions. This is closely related with Islamic financial inclusion, which has become one of the national key agenda in the development of financial industry in Indonesia. The number of excluded society group in the financial ecosystem should be minimised.

Education function on Islamic banking concept and application should be conducted properly. It will influence general comprehension of the people towards Islamic bank including its value proposition. Hence, social function implementation cannot be separated with Islamic bank's commitment to arrange proper education programmes for the people and other strategic stakeholders.

The presence of Islamic bank is expected to provide long-term impact. Hence, the 10th important indicator is related with long-term financing and development impact. An Islamic bank should maintain its commitment towards financial sustainability that provide benefits for the society.

The presence of Islamic bank is also expected to enlarge fiscal capacity of the government. In the midst of increasing government debt, finding financial resources for government revenue is in the interest of the country. Tax contribution of an Islamic bank is one of these resources. When fiscal capacity increases, government will have more opportunity to deliver various development programmes including poverty and inequality reduction programmes.

After having those social function indicators along with their weight, the next step is to calculate the value of each indicator. It is based on the Likert score obtained from the survey and secondary data from OJK. Based on the AHP results, this study proposes a range of rating scale of each social function indicator to be applied to the performance appraisal of Islamic banks.

The rating scale uses Likert score between 1 to 5. This is conducted in order to measure the value of each indicator prior to final construction of social function score. These rating scales are summarised as follows:

Table 9. A Proposed Rating Scale of Each Social Function Indicators

No	AHP Weight	Indicators	Source of Data	Scale				
				1 (Poor)	2 (Fair)	3 (Average)	4 (Good)	5 (Excellent)
	0.143	ZISWAF management	Survey	0 - 2	3 - 5	6 - 8	9 - 11	12 - 14
	0.128	Community economic empowerment	Survey	0 - 1		2		3
	0.109	Ethics and compliance of Islamic bank employees	Survey	0 - 3	4 - 7	8 - 11	12 - 14	15 - 16
	0.105	Environmental-based investment or financing	Survey	0 - 2	3	4	5	6
	0.094	Customer service	Survey	0 - 2	3 - 5	6 - 8	9 - 11	12 - 14
	0.086	HR development and research of Islamic banks	Secondary	0% ≤	0.1% - 0.4%	0.5% - 0.8%	0.9% - 1.2%	>1.2%
	0.083	Equal opportunities for Islamic bank employees	Survey	1 - 4	5 - 8	9 - 12	13 - 16	17 - 19
	0.076	Outreach area that has not been served by other financial institutions	Survey	0		1		2

	0.066	Islamic banking education function	Secondary	≤ 5%	6% - 10%	11% - 15%	1% - 5% 20%	>20%
0	0.058	Islamic banks long-term financing contribution	Secondary	≤ 20%	2% - 40%	41% - 60%	6% - 1% 80%	>80%
1	0.053	Islamic bank tax contribution to the government	Secondary	≤ 5%	6% - 10%	11% - 15%	1% - 5% 20%	>20%

After observing the actual Likert score, the value of the indicator index is calculated based on the following formula:

$$X_i = \frac{SX_i - Smin}{Smax - Smin}$$

Where X_i is the indicator index, SX_i is the actual Likert score of the i-indicator, $Smin$ is the minimum Likert score and $Smax$ is the maximum Likert score.

Therefore, the formulation of Islamic bank social function index is summarized as follows:

$$Y = 0.143X_1 + 0.128X_2 + 0.109X_3 + 0.105X_4 + 0.094X_5 + 0.086X_6 + 0.083X_7 + 0.076X_8 + 0.066X_9 + 0.058X_{10} + 0.053X_{11}$$

Whereby:

- Y = Islamic bank social function index
- X1 = ZISWAF management
- X2 = Community economic empowerment
- X3 = Ethics and compliance of Islamic bank employees
- X4 = Environmental-based investment or financing
- X5 = Customer service
- X6 = HR development and research of Islamic banks
- X7 = Equal opportunities for Islamic bank employees
- X8 = Outreach area that has not been served by other financial institutions
- X9 = Islamic banking education function
- X10 = Islamic banks long-term financing contribution
- X11 = Islamic bank tax contribution to the government

Integration of Social Function Indicators into the Soundness Assessment Level of Islamic Banks in Indonesia: A Proposal

Integration of social function indicators into the soundness level of Islamic bank will be a major breakthrough in portraying the unique value of Islamic banks compared to their conventional counterpart. There are important stages required to smooth this integration process.

The first stage is the initial stage which incorporates all aspects of social functions as part of the Islamic Bank soundness assessment level. Initially, the soundness level of Islamic bank is determined by four main variables, namely risk profile, good corporate governance, rentability and capital. In this first stage, social function of Islamic bank that has been discussed in the previous part will be added as the fifth variable.

Figure 1. The Indicator of New Islamic Bank Soundness Level

Integrated soundness level of commercial and social function				
Risk Profile	GCG	Rentability	Capital	Social function

This stage will strengthen a stronger value proposition of Islamic finance because social functions are inherent in the soundness level assessment of Islamic banks. This will also provide an incentive in improving the performance of Islamic banks to not only on commercial viewpoint but also to social viewpoint.

In addition, this integration will also encourage optimisation of Islamic banks role in the collection and distribution of community social funds, especially through zakat, infak, sadaqa and waqf (ZISWAF) fund. Optimisation of this ZISWAF fund will affect poverty and inequality reduction programmes and hence, improve welfare of the people.

Furthermore, as has been shown by the study results, the performance of Islamic banks, especially in reducing the level of non-performing financing and increasing total assets and profits, can be improved. This would have positive impact towards financial performance of Islamic banks. Lastly, in terms of Islamic banks' market positioning, this integration will increase public confidence and support towards Islamic banking industry, which leads to a higher level of participation in all products of Islamic banks.

The second stage is related with the formulation of the new assessment of Islamic bank soundness level. Based on the AHP results, the new assessment will be based on the following formula:

$$BSL = 0.307RP + 0.281GCG + 0.130BR + 0.141BC + 0.141SF$$

Whereby:

BSL	= Bank Soundness Level
RP	= Risk Profile of the Islamic bank
GCG	= Islamic bank's GCG
BR	= Islamic bank's rentability
BC	= Islamic bank's Capital
SF	= Islamic bank social function

It is found from this formula that 85.9 percent of the soundness level of Islamic bank is determined by commercial financial performance comprising risk profile of Islamic bank (30.70 percent), good corporate governance (28.10 percent), Islamic bank's rentability (13 percent) and Islamic bank's capital (14.10 percent). Contribution of Islamic bank social function towards the bank soundness level reaches 14.10 percent.

The third stage is closely related with the amendment of existing regulation. In the context of Islamic banking industry in Indonesia, integration of social function into the bank soundness level requires fundamental change in the OJK regulation. OJK should establish new regulation that accommodates new assessment of Islamic bank soundness.

This new formula is believed to be a significant finding that may fundamentally improve the quality of Islamic banking system. This incorporation of social function in the Islamic bank soundness assessment will strengthen continuous impact of Islamic banking presence in the society.

Conclusion and Recommendation

This study attempts to identify and explore factors affecting Islamic bank social function. There are 11 indicators determining social function of Islamic bank. The better the performance of these indicators, the higher the level of Islamic bank social function implementation. Through AHP method, each indicator can be weighted and calculated as an index of social function.

To integrate the social function into the bank soundness level, three stages are required, started from incorporating all aspects of social functions in to the bank soundness variables, followed by formulation process of new soundness assessment method and regulation amendment. Formulation process, which is done through AHP method, yield an integrated bank soundness level. It is believed that the existence of this new Islamic bank soundness level will open a new paradigm on the Islamic banking industry and strengthen unique values of Islamic bank which are different from conventional banks.

It is also suggested to conduct further study, particularly on the strategic transformation that must be managed by both OJK as financial authority and Islamic banking institutions as financial players. For OJK, it will change its approach on measuring the soundness level and in monitoring Islamic banking activities since social function is measured. For Islamic banks, the inclusion of social function will change their approach in formulating the bank's annual business plan, programme implementation, and reporting system.

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