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Muhammad Sohaib Ashraf, Norizan Bint e Remili, Nurhidayah Binti Abu Bakar

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## Do Shariah Governance Attributes Impact the Islamic Banks' Performance? Evidence from Pakistan

Muhammad Sohaib Ashraf, Dr. Norizan Bint e Remili, Dr.  
Nurhidayah Binti Abu Bakar

Faculty of Business & Management, University Sultan Zainal Abidin, Terengganu, Malaysia  
Email: sohaibayoobi@gmail.com (Corresponding author)

### Abstract

The current study purposes to evaluate the extent of the Shariah Governance (SG) attributes and their effect on Islamic banks (IBs') financial performance. To the extent of the SG attributes, the governance index was created on the four sub-indices which are Shariah board size, number of board meetings, qualification, and Shariah audit committee. Findings exposed that SG attributes in Pakistani IBs significantly influence IBs' performance. The study results indicated that IBs' in Pakistan appreciated the efficiency of the Shariah board considerably and better than the interest-based mechanisms of corporate governance (CG). The present study uses a multiple regression model. The study findings recommended a significant statistical relationship between SG attributes and IBs performance that would suggest that better SG had a causal connotation with immense performance in Pakistani IBs'. The current paper may serve to assist IBs' stakeholders in better understanding the SG practices of IBs'. In addition, the observed significant relationships among the SG attributes and performance should explain to the IBs' administrators the necessity of improving the existing SG requirements. The present study will be contributed to help the stakeholders connected with IBs' be aware of the SG practices of the IBs' in Pakistan

**Keywords:** Shariah Governance, Shariah Board, Attributes, Islamic Banks, Pakistan

### Introduction

Globally various countries have started interest-free financial institutions. These financial institutions have been established at several levels like community, individual, and at government levels. In recent years, Islamic banks (IBs') have expanded significantly as a result of rising demand from customers who are more interested in financial institutions that adhere to Shari'ah law and are more attentive to religious issues (Khatoon et al., 2016). The IBs' governance framework adheres to Shari'ah-compliant qualities and is strictly supervised by the Shari'ah boards, is what sets them apart from their conventional counterparts (Grassa, 2015). In addition to the standard boards, including the board of directors, these two distinctive characteristics of the IBs' add another level of governance. The IBs' additional layer

of control transforms their formerly sole-layer governance structure into a unique layer that is a multi-layer (Haridan et al., 2018)

This is due to the fact that the IB's operations' basically performing mechanism is a Shariah-based procedure. This indicates that, unlike conventional banking, IBs' operate on a risk-sharing model rather than based on an interest-based model (Azmat et al., 2020). Dusuki and Abdullah (2007) expressed that IBs' have been viewed as commercial companies that primarily serve those clients who seek to fulfill their religious responsibilities. According to the research, when choosing a bank, these clients consider a number of significant factors, including reputation, economic, and, religious considerations.

The key purpose of the Shariah board is to monitor and supervise the application of Shariah rules and regulations in all activities and processes of IBs'. The Shariah board has the authority and power to stop or reject any activity that is not adhering the Islamic laws and principles (Kayadibi & Guclu, 2021).

For the IBs' confidence and trust are key determinants in the customer decision-making process. These factors include not just reliance on the Islamic bank as the provider but also confidence that it adheres to Shari'ah laws (Ashraf et.al., 2015). These IBs' ought to sustain their commitment to Shari'ah to gain a competitive advantage. In this aspect, the availability of SG contributes significantly to increasing customers' loyalty and interest in IBs'. Hence, it is essential for IBs' to provide effective Shari'ah supervision because failure to do so could have a negative impact on the Islamic financial sector overall (Muhamad, et al., 2022). If the IBs' are unable to follow Shari'ah standards, guidelines, and instructions, then the depositors and stockholders may withdraw their financing contracts. Resultantly that would reduce their performance and raise their risk. Additionally, if the lack of interest comes from the IBs' management side, the customers' loyalty and commitment will harm the IBs' standing in the market (Novianty et al., 2022).

Hence, the achievement of IBs' targets mainly depends on good Shariah governance. This Shariah governance is dependent on a competent and qualified experienced Shariah board. Bakar et al (2016) stated that several stakeholders and top management of IBs' criticized Shariah board members for the weakness arising from the calculation of fines and documented as bank income in the income statement. The objection could impose on Shariah board members due to the approvals for the IBs' profitability or any loss in the head of Zakat accounting that might influence the IBs' performance.

In some jurisdictions, the practices SG are free, whereas in nearly, other authorities, the routine work is planned. This alarming condition increases the concerns about the SG feasibility, as well as the qualification and independence in the IBs' of Shariah board members across authorities that have several supervisory situations (Jamaludin, & Bahaudin, 2022). Moreover, several Shariah attributes have shown good performance in supervision, and some SG practices have weak performance. This condition increases the distress concerning the SG practices' feasibility and displays the narrow scope of the Shariah advisory board in the environment of IBs'. In several cases, the competent authority allows the regulatory body intervention while according to some it is not beneficial. This is a questionable issue that regulatory bodies' more interference is good than minor involvement or no chance of involvement at all (Wijayanti & Setiawan, 2022). According to Jan et al (2022) in Pakistan, the framework of IBs are very strong as associated with other countries. The legal framework of Pakistan suggests a good governance model.

In Pakistan, the Shariah board supervise and monitor all transaction and compliance under the Shariah guidelines. The criteria and standard for gauging Islamic banking transactions are the Shariah rules and laws taken from Holy Quran and Hadith (Wasim et al., 2021). Several studies show that the number of Shariah board members does not reflect better performance but the individual Shariah board member influences the quality. Although the qualification in accounting, economics, and finance background and especially the ratio of doctoral qualification significantly impacts the quality. The experienced and well-qualified Shariah board members improve the SG framework in IBs' performance. This can be done by raising the total number of Shariah board members along with advanced qualifications, level of independence, and supervision. Hence the quality and performance level of the Shariah board in IBs' shows improvement (Muhammad et al., 2021).

If the Shariah board fails to deliver efficient and proper Shariah monitoring, it might create severe issues for the Islamic finance industry overall. Failing to comply with Shari'ah rules, may result in losing depositors as they may cancel their investment thus may create and elevate risks to the IBs'. This will consequently lead to losing customers' confidence thus posing a negative image to the IBs'. It may also lose the depositors and the chance of cancellation of investment increases, so the levels of risk arise (Masruki et al., 2018). Swandaru & Muneeza (2022) explore the Shariah board attributes (education, size, cross membership). The researcher expressed that due to Shariah board attributes, the risk-taking of major IBs' are more influenced than smaller IBs'. The larger IBs' have good prominence that attracts the attention of Shariah scholars in completing their required targets related to small IBs'.

The previous studies show that some SG attributes like qualification, SB size, reputation, expertise, and, cross-membership might impact the performance of Shariah governance. A very small part of the research has been done in the case of bank size affecting the SG impact on IBs' performance (Prasojo, et al., 2022). Mollah and Zaman (2015) explored the effect of SG attributes on IBs' performance. The researcher examined whether the size of IBs has any impact on how the SG attributes influence performance.

### **Research Questions**

In particular, the study aims to answer the following research questions:

1. Is there any relationship between Shariah governance attributes and, Islamic banks' financial performance in Pakistan?
2. Does the Shariah governance attributes positively impact on Islamic banks' performance?

### **Research Objectives**

1. To examine the relationship between Shariah governance attributes and, Islamic banks' performance in Pakistan.
2. To examine the impact of Shariah governance attributes on Islamic banks' performance.

### **Literature Review and Hypotheses Development**

The literature expressed that limited studies have been conducted on SG attributes and IBs' performance relationship. A study examined that the components influencing the BoD might have influenced SG as the audit committee, SG and BoD have played the same role. Similarly, the IBs' governance framework and conventional banks' board structure appear to be identical. Moreover, the theories of CG like agency theory and resource dependence theory

stewardship theory expressed the effect of SG attributes on the IBs' performance of (Hanif, & Haron, 2022).

### **Shariah Board Size**

Previous literature findings show that the Shariah board size plays a key role in supervising managers. The small size Shariah board significantly impacts on IBs' performance as this is expected that small size efficiently monitors the IBs' managers for the shareholders' interest for better IBs' profitability (Kachkar & Yilmaz, 2022).

The small size of Shariah board members may increase the cost of coordination and reduce the agency cost as suggested by the agency theory. The small size of the board also assists the good coordination consequently the process of decision-making would be more competent (Aslam & Haron, 2021). The large size BoD performed better efficiently than the small size but in IBs the small size board easily supervises and manages the operations. The supporter of a large size Shariah board argues that the major size of a Shariah board comprised of experienced scholars with different schools of fiqh that might be directed to a good clarification of products. Hence the large size of the Shariah board positively influence the IBs' performance (Haddou & Mkhinini, 2022).

*Hypothesis 1: Shariah board size will significantly impact on IBs' performance.*

### **Shariah Meeting**

The meeting of the Shariah board is held with the management team of IBs' in a year as quarterly, semiannually, and annually but sometimes on an irregular basis. The objective of decreasing the meetings is to broadly examine all the recommendations and transactions received to the sanction that adhere to the standard of Shariah as they deliberate excessive transparency. Apart from that, the Shariah advisors are answerable for eliminating the wrong transactions and writing the specific issues (Aljughaiman & Salama, 2019).

The governance code of Gulf countries provides a role model that near about one-third size of the BoD would be autonomous and meetings between management and directors would be held six times a year. In IBs' the profile score of the Shariah board is high which acknowledged an efficient framework and hence the performance of IBs' increases (Khedidr, et al., 2021).

*Hypothesis 2. Shariah board meetings will significantly impact on IBs' performance.*

### **Shariah Board Qualification**

The Shariah board members' qualifications significantly impact the performance quality of IBs'. This factor shows that the effectiveness of the Shariah board increases the value of IBs, (Haddou & Mkhinini, 2022) generally, the Shariah scholars are Islamic law and jurisprudence specialists however only a few Shariah specialists have economics, accounting, finance, and banking proficiency.

The qualification and education of Shariah members expand the IBs' governance information and accounting disclosure (Abdullah et al., 2015). Hicham 2013 expressed that Shariah qualification is of influencing component of the IBs' performance. This factor indicates that the more educated and strong religious qualification background easily adheres to the compliance of Shariah products in IBs'.



*Hypothesis 3. Shariah Board qualification has a significant positive relationship with IBs' performance.*

### Shariah Audit Committee

The key purpose of the Shariah audit committee (SAC) was to assure an improved and advanced quality of released financial reporting. Although the SAC efficiency is distinct in operations of several variables such as meeting frequency, numbers of members, and board independence. The increasing number of members Shariah audit committee provides advanced supervision (Khatib, et al., 2022). Almarayeh, et al (2022) explored that the relationship between audit committee (AC) and the performance of firms indicates a combined connection. The evidence argued that AC independence and the experience of members improved the performance of the firm. The action of SAC frequent meetings indicates the attentiveness that enhanced the accounting and financial procedures in a smooth way and resultantly running to improve the performance of IBs' (Nguyen, Q. K. 2021). Almuzaiqer, et al (2022) expressed that the meeting frequency is negatively associated with income efficiency. The literature found that generally, the association between audit committees and financial performance emphasized the firm activities. The current study is proposed to encompass research and indicate particularly the effectiveness of SAC and IBs' performance.

Shariah audit or Shariah review is a mandatory condition for effective monitoring and supervision model. Shariah audit is supervised by the Shariah governance framework and positively influences loan portfolio risk-taking (Muhammad et al., 2021)

*Hypothesis 4. Shariah Audit Committee effectiveness has a significant positive relationship with IBs' performance.*

### Theoretical Framework

The present study was shown by a conceptual framework. The conceptual framework comprised two variables. In which the first is the independent variable and the second is the dependent variable (see Figure 1).

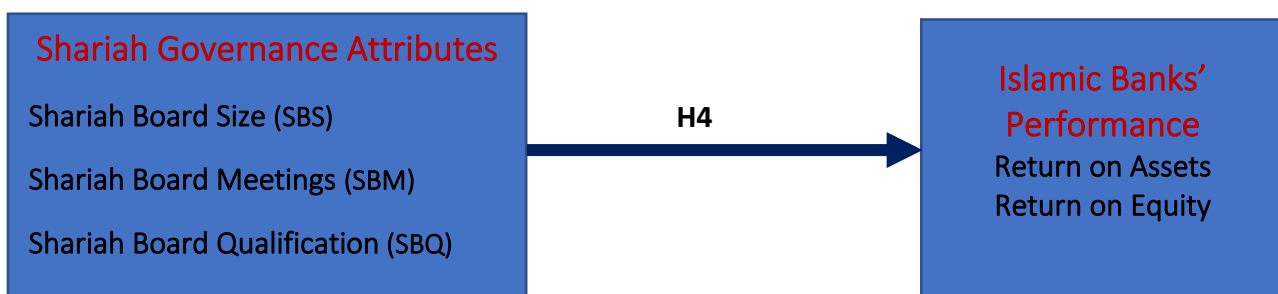


Figure 1: Conceptual Framework

The above figure 1 shows the relationship between SG attributes and IBs' performance.

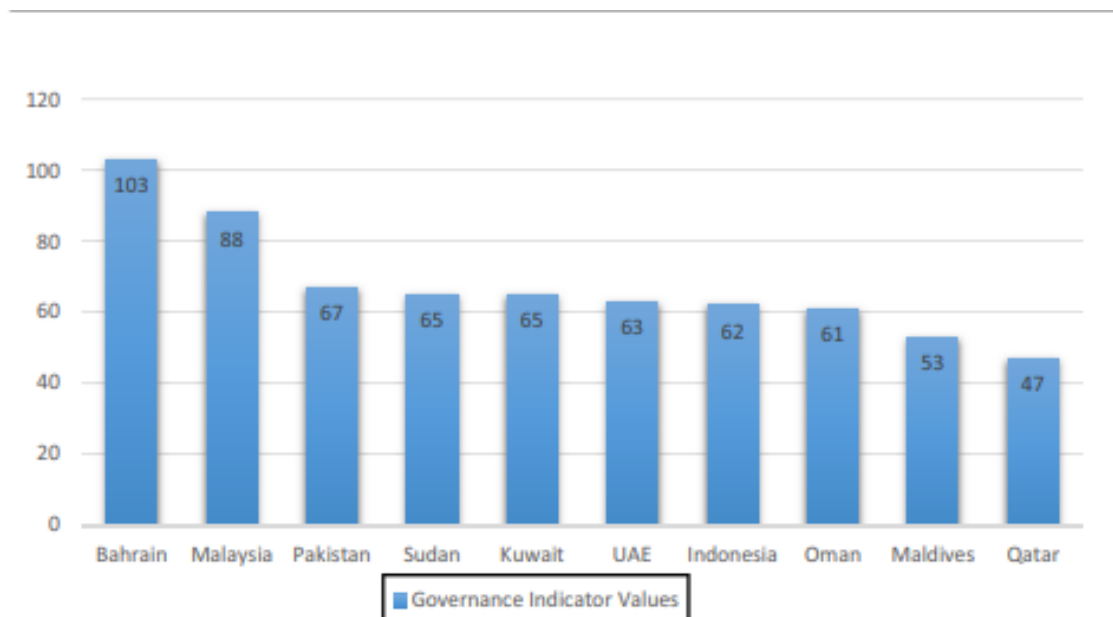


Figure 2: Shraiah Governance World rankings of Muslim Countries

Source: Reuters (2016b)

This figure indicates the Shariah governance ranking worldwide. Pakistan got the third position in adopting Shariah governance standards.

### Sample Size

The sample size of the present study was 22 IBs listed in a database of the State bank of Pakistan (SBP). The duration of the study analysis consists of 5 years of data between 2015 and 2019 with 110 observations. The reason for selecting the time duration is the accessibility of data. The research study data was taken from several sources such as SBP and some SG attributes from financial reports. By incorporating professional association reports, journals, articles, and other secondary sources in addition to books and websites, the secondary data is used to accomplish the study's objectives and goals to complete the hypothetical framework. While the balance sheets, daily reports, and income statements are made public on the websites of the Islamic Bank as the sources of the data used in studies 2020. Due to the following reasons, a small number of banks are eliminated from the sample. The current study investigated the impact of SG attributes on the performance of IBs' in the presence of managerial knowledge.

### Measures of Variables

The current study consists of two main variables, Shariah governance attributes as the independent variable and IBs' performance as the dependent variable. The SG attributes can be measured by four proxies namely, Shariah board Size (SBS), Shariah board Meetings (SBM), Shariah board Qualification (SBQ), and Shariah Audit Committee (SAC) using content analysis. These attributes are incorporated in the Shariah governance score called the SG strength as the sample size is limited. These constraints are associated with the Shariah governance framework to authorize the investigation of different attributes. On the basis of previous

literature, a patterned list of accountability and disclosure has been prepared. The patterned list points out the attributes for codifying the information of SG attributes. This checklist is included the financial reports of IBs' SG mechanism, the Islamic financial services act (IFSA). A score of 1 is coded if the item is disclosed otherwise, 0.

Table 1  
*Shariah Governance Attributes (Independent Variable)*

Shariah Governance Attributes	No. of Items Max (28)
Shariah Board size	8
Shariah Board meetings	4
Shariah Board Qualification	4
Shariah audit committee	4
Disclosure	8

The dependent variable, IBs' performance is measured by two proxies, namely, return on equity (ROE) and return on assets (ROA). In the IBs, performance, the first proxy return on equity (ROE) is calculated by net income by total equity, and the second proxy ROA is c by dividing net income by total assets (Ashraf et al., 2021).

Table 2  
*Research Variables and Definitions*

Variables	Variable Proxies	Character	Reference
Shariah board Size (SBS)	Shariah board size is measured by the number of board members on the Shariah board	SBS	Haddad & Souissi (2022).
Shariah board Meetings (SBM)	Annual meetings held by the Shariah board	SBM	Nurhastuty & Shaista (2012); Darmadi (2013b)
Shariah board Qualification (SBQ)	Board competency is measured in terms of board qualifications, which comprise Shariah degrees and other types of Islamic law degrees.	SBQ	Shahrier, et.al (2020)
Shariah Audit Committee (SAC)	The size of the audit committee (SAC) is also measured based on the number of audit committee members	SAC	Ridwan & Mayapada, (2022).
Islamic Banking Performance	Return on assets: $\frac{\text{Net income (After tax)}}{\text{Total assets (bank)}}$ Return on equity: $\frac{\text{Net income (After tax)}}{\text{Total assets (bank)}}$	ROA ROE	Ashraf et.al(2021)



### Regression Model

In the current research model, return on assets (ROA) and return on equity (ROE) are the proxies of Islamic banking performance.

To examine the relationship between the dependent and explanatory variables, five regression models were developed.

In the first model (1) we examine the impact of SG attributes (SBS, SBM, SBQ, SAC) on IBs' performance (ROA).

In the second model (2) we examine the impact of SG attributes (SBS, SBM, SBQ, SAC) on IBs' performance (ROE).

Model 1: Relation between Shariah Governance Attributes and IBs' performance (ROA)

$$IBPERroa_{ib,t} = \alpha_0 + \beta_1(SBS) + \beta_2(SBM) + \beta_3(SBQ) + \beta_4(SBAC) \dots + \epsilon_{i,t}$$

Model 2: Relation between Shariah Governance Attributes and IBs' performance (ROE)

$$IBPERroe_{ib,t} = \alpha_0 + \beta_1(SBS) + \beta_2(SBM) + \beta_3(SBQ) + \beta_4(SBAC) \dots + \epsilon_{i,t}$$

The table presents regression models. These models are used to check the hypotheses.

**SBS-index**<sub>it</sub> = Shariah supervisory board index of IBs' i in year t;

**SBM-index**<sub>it</sub> = Shariah board meeting index of IB's i in year t;

**SBQ-index**<sub>it</sub> = Shariah board qualification index of IBs' i in year t;

**SAC-index**<sub>it</sub> = Shariah audit committee index of IBs' i in year t;

**ROA**<sub>it</sub> = return on assets of IBs' i in year t;

**ROE**<sub>it</sub> = return on equity of IBs' i in year t;

$\beta_0$  = Y-intercept

$\beta_1$  = Regression coefficient; and « it = error term.

### Results and Discussion

The above table expressed the descriptive statistics for both variables i.e. dependent variable is Shariah governance attributes and the independent variable (SBS, SBM, and SBQ SAC) and IBs' performance. The result is displayed among the 22 IBs. On the basis of data calculation and descriptive statistics table 3 display the observations, mean, min, max, and standard deviation.

The mean value for the Shariah board is 2.26 %, whereas the min and max values are 2.00 % and 4.00 % respectively.

## Table

## 3 Descriptive Statistics

Dependent variables and Independent Variables	Abbreviation	No. of Observations	Min	Max	Mean ( $\bar{x}$ )
Shariah Board Size	SBS	110	2.00	4.00	2.2675
Shariah Board meetings	SBM	110	2.00	4.00	2.1347
Shariah Board qualification	SBQ	110	2.00	4.00	2.0767
Shariah audit committee	SAC	110	2.00	4.00	2.1856
Disclosure	Dis	110	1.00	1.6938	1.4894
Return on assets	ROA	110	0.41	2.58	1.0467
Return on equity	ROE	110	0.00	2.49	0.4019

The table shows the descriptive statistics of the variables

The table presents the values of the variables. The mean of SG attributes i.e. Shariah Board size falls between 2.07 to 2.26. The present study findings show that in the IBs, Shariah board size is dominantly performed. While the other attributes meetings, qualification, and Shariah audit present minor effects in IBs. The result also specifies that Shariah board competency has a significant influence on the SG framework.

### Regression Results

The explanation of SG attributes and IBs' performance have been given in the following table.

Table 4

#### *Relationship between Shariah governance attributes and IBs' Performance*

SG Attributes	ROA	Sig.	ROE	Sig.
Shariah Board Size	0.4771	0.043	0.1901	0.215
Shariah Board meetings	0.0409	0.074	0.2783	0.091
Shariah Board qualification	0.3073	0.221	0.2732	0.191
Shariah audit committee	0.3881	0.125	0.3134	0.119
Disclosure	0.4691	0.005	0.1571	0.151

The above table no.4 displays the association between the independent SG attributes and the dependent variable, IBs' performance. The relationship indicates that there is a significant relationship exists between SG attributes and IBs' performance (ROA). While the relationship between SG attributes and ROE indicates less association. The result of descriptive statistics the R-value and  $R^2$  were calculated. The R-value presents the correlation between the dependent and independent variables whereas  $R^2$  is the overall fluctuation in the dependent variable. Hence, in the above calculation, the  $R^2$  value lies between 0.72 to 0.78 which is more than 0.70, this shows that SG attributes show 72% practice.

Customers' opinions and the outcome of the IBs' assessment were positively impacted by the quantity of the Shariah board. Additionally, the board size enhances the users' perception of IBs'. One of the factors that determine a bank's reputation is the number of trained members, as the larger the board size, the more consumers it attracts and the better it meets its requirements and expectations performance (Rahayu et al., 2019; Ausat, 2018). Table 4

shows how our findings compared to earlier research supported the main theories. The SAB size demonstrated a favorable cumulative impact on the IBs'.

Moreover, several studies found an association and existence between SG characteristics and IBs' performance, and the results of the previous research fluctuate. The results of IBs' performance (ROE). Findings indicated a negative significant relationship between performance and disclosure. This outcome runs counter to what we predicted. Hence, we came to the assumption that transparency has a detrimental impact on IBs' performance.

### Conclusion

In Pakistan, the Islamic banking sector is expanding quickly. As Islamic banks have strong investing decision-making capabilities, their average profit is increasing quickly year over year. The combined efforts of the Board of Directors and Shariah Board are what allow for effective decision-making. More consumers and interest-based banks are starting IBs' due to the positive shocks of Islamic banks' balance sheets. According to regression analysis, Shariah Board has a positive correlation with the performance of Islamic Banks (ROA & ROE) while Board Size has a negative correlation. The performance of Islamic banks is not significantly correlated with bank size or board independence.

It has been discovered that board size has a positive, considerable impact on IBs' performance. However, the size of the board should be appropriate; it should be composed of highly trained individuals with knowledge of proper banking practices and supervisory responsibilities. Moreover, there should always be a balance of executive and non-executive directors on the Board. Islamic banks' success is also impacted by bank size.

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