

IMPACT OF SHARI'AH GOVERNANCE FRAMEWORK IMPLEMENTATION ON THE FINANCIAL PERFORMANCE OF ISLAMIC BANKS: A CASE STUDY OF PAKISTAN

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Abstract

Purpose - The observance of Shari'ah and adherence to every fundamental Islamic principle are necessary for the Islamic financial system to succeed. But what it means for an institution to be successful in following the Shari'ah. What type of connections it could have with the implementation of Shari'ah governance guidelines and returns is still unanswered. This study tries to answer this question. The purpose of this study is to check the impact of *Shari'ah* Governance Framework implementation on the financial performance of Islamic banks. The results would be beneficial for investors, Islamic banks, regulator, academicians and practitioners for decision making to exploit maximum economic benefits.

Design/Methodology/approach – Panel data on 17 Islamic banks (full-fledged and Standalone branches) have been used in this study for the period of 2015-2019 after the implementation of Shari'ah Governance Framework.

Findings – The findings indicate that Shari'ah Governance Framework implementation improve the performance of Islamic banks.

Originality – This study add value to the existing literature by presenting the statistical results for the impact of *Shari'ah* Governance Framework implementation on the financial performance of Islamic banks of Pakistan.

Keywords – *Shari'ah governance framework, financial Performance, Islamic banks*

JEL Classifications: E58, G21, G38

Introduction

In recent years, AAA rated companies closed in global crisis due to weak corporate governance (Ginena & Hamid, 2015). Big names (Barclays, Citibank, RBS, Merrill Lynch, Bear Stearns and Credit Suisse) couldn't survive with good assets (Kirkpatrick, 2009). Weak accountability and lack of transparency forced Enron and WorldCom to close its operations (Rammal, 2010). Mehran Gate scandal and case of Crescent Standard Investment Limited of Pakistan are the examples of bad corporate governance (Bukhari, Ayaz, & Kalim, 2022).

Shari'ah governance is a backbone for Islamic financial system (Mizushima, 2014; Shamsheer, Sori, & Shah, 2015; Shahzad, Saeed, & Ehsan, 2017, SBP, 2022). SGF is implemented to ensure Shari'ah compliance environment by making all the organs of IBIs responsible (SGF, 2018). *Shari'ah* compliance is compulsory to keep up the tremendous growth of Islamic banking (Adawiah & A, 2017).

It is worth mentioning that 70% of customers use Islamic banking due to religion (Raza & Azeem, 2014). Islamic finance industry is growing steadily and touching new peaks. Islamic banking assets have crossed the 5 trillion mark and now stood at Rs. 5,577 billion in FY21 in Pakistan with five (5) full-fledged Islamic banks and seventeen (17) conventional banks having standalone Islamic banking branches (SBP, 2022).

Given the rapid growth of Islamic banking financial organizations, examining the relationship between Shar'ah governance and financial success is essential. Good Shari'ah governance definitely improves trustworthiness, accountability and transparency. Agency theory, Institutional theory and Stakeholders theory provide conceptual support in the implementation of SGF. Institutional theory is the most

significant in progressing the Shari'ah governance framework and helps formulate guidelines and procedures for Islamic banks (Karbhari et al., 2020).

Many researches discover the impact of peculiar constructs of Shari'ah governance (SG) on financial performance (FP) of Islamic banks (IBs). Previous studies presents mix results, some studies endorse the positive and significant impact of SG on FP and some affirm negative relationship. The researcher could not find a single study which finds the impact of SGF implementation on financial performance of IBs in Pakistan after the implementation of SGF 2015.

1.1 Shari'ah Governance and Development of Islamic Banking in Pakistan

The globalized situation of Islamic banking institutions differs, some countries are implementing external *Shari'ah* review by central bank of country, some Islamic banking intuitions have a separate full-fledged Islamic banks, have their *Shari'ah* supervisory boards and some IBIs have both full-fledged IBs, and Islamic standalone branches and windows (Samra, 2016). In early operations and launch of Islamic banking institutions, there was no formal entity to supervise the IBIs to address *Shari'ah* issues. The Faisal Islamic Bank of Egypt places the first brick by setting up the first *Shari'ah* Supervisory Board (SSB) in 1976 and tracked by Jordan Islamic Bank and Islamic Bank of Sudan in 1978 (Bahari & Baharudin, 2016).

This study moves around one of the emerging markets, Pakistan. By the end of September 2022, there are 22 Islamic banking institutions in the network, with 4191 branches spread across 129 districts, 5 fully-fledged Islamic banks (IBs), and 17 conventional banks with autonomous Islamic banking branches (IBBs). There are 1,467 Islamic banking offices administered by established financial institutions with IBBs (SBP, 2022). However, Islamic banking industry in Pakistan has both full-fledged IBs, Islamic branches of conventional banks (CB) and Islamic windows with CB model. To tackle this complex situation therefore, a robust *Shari'ah* governance regulations and guidelines are the need of the hour. Islamic banking institutions have *Shari'ah* boards, which are responsible to supervise *Shari'ah* related matters of the banks, which are binding for Islamic banks in Pakistan (SBP, 2022).

Since the inception, *Shari'ah* is an integral part of Pakistan. The article, 38(a) of the constitution of Pakistan states: "The state shall...eliminate *riba* as early as possible". Council of Islamic Ideology established in 1962 to propose how prevailing laws could fetch in according to Shari'ah. In 1979, the Pakistani government decided to create the Federal Shariat Court, which in 1991 ruled that "markup" was not Islamic. However, the 1991 Federal Shariat Court decision was overturned on appeal to the Supreme Court's Shariat Appellate Bench. With effect from June 30, 2002, the interest was abolished by the SAB of the Supreme Court. Nevertheless, in response to a review petition submitted by United Bank Limited, the Supreme Court's SAB in the middle of 2002 threw aside the Riba verdicts and remanded the matter to the Federal Shariat Court for a new trial (Rammal, 2010).

Meantime, in September 2001 the government started to promote Islamic Banking on flexible dual system where both Islamic banks with conventional banks move side by side. On December 1, 2001 complete guidelines were provided to open a full-fledge Islamic bank and first commercial banking license was issued in January 2002. State Bank of Pakistan (SBP) established Islamic Banking Department (IBD) on September in 2003 (SBP, 2008). Since establishment, the SBP's Islamic Banking Department has issued a number of laws, including the Shariah governance and supervision model in

2008 and fit and proper standards for the nomination of Shariah consultants.(Rammal, 2010) and a sound step, SGF issued by SBP in 2014 which implemented in 2015 (Shahzad, Saeed, & Ehsan, 2017).

1.2 Related Literature Review

Number of researches have worked out on *Shari'ah* governance and more specific to *Shari'ah* governance framework and implementation like, Bahari & Baharuding, 2016; Ginena & Hamid, 2015; Shahzad, Saeed & Ehsan, 2017; Samra, 2016; Shamsher, Sori, & Shah, 2015; Hasan, 2014; Shafii, Abidin, Salleh, Jusoff & Kasim, 2013 and Omar & Hassan, 2014, Ayaz and Mansoori (2017) and Ayub (2019). This study is pioneer with reference to Pakistan regarding implementation of SGF and its impact on financial performance.

Gompers, Ishii & Metrick (2003) and Ho (2005) analyze the relationship of CG and financial performance and found that both are positively related. Improvement in corporate governance improves financial performance. Corporate governance have different mechanisms, change in mechanism of Corporate Governance (CG) positively affects the managerial efficiencies in banking sector of Pakistan. Managerial efficiency in corporate governance that influence financial success include board independence, board meetings, board structure, CEO dual role, ownership, and leadership. (Haider, Khan, & Iqbal, 2015).

Francis et al. (2012) find that organizations with good governance practices did well during the financial crisis. According to Laela, strong SG is linked to greater organizational success (2012). Banks, have sound SG rules and regulations definitely perform better as compared to those have weak SG. Farag et al. (2018) found a positive relation between the level of SG implementation and Islamic banks' financial and non-financial performance.

According to Hasan et al. (2009), corporate governance of conventional banks and that of IBs are similar in that they both uphold the same values of accountability and transparency. The development of a relationship between the board of directors, management, audit, shareholders, and other shareholders are more important aspects of corporate governance (Sheikh et al., 2018). Because of this, corporate governance is regarded as the most critical and vital factor in determining financial performance (Aslam et al. 2019). It follows that excellent corporate governance frameworks in banks increase the likelihood that they will make more money and increase shareholder value (Hussien et al., 2019). In 2019, Alsartawi looked into the relationship between the independence and frequency of meetings of Shari'ah supervisory boards and the performance of Islamic banks.

Alsartawi (2019) advised to include more performance elements to measure the relationship because he could only use one Return on Assets, to analyse performance. To ascertain whether Islamic financial system is more stable than the conventional counterpart, academics started looking at it (Alam, 2009; Beck et al., 2013; Hazzi, 2013).

After all, the shareholders of the company's "wealth" includes the stock value in addition to the market value, permanency, goodwill, etc. It can be stated that:

$$\text{Economic value of Assets} = \text{Value of Debt} + \text{Value of Equity}$$

The studies mentioned above demonstrate that study is being done to ascertain how various facet of SG relate to financial performance. In this study, the performance of Islamic banks is examined from 2016 to 2019 to check the implementation of the SGF. The position of Islamic banks will be determined by this analysis, including whether or not Islamic banks function improves with the implementation of the Shari'ah Governance Framework. After the implementation of the Shari'ah governance framework, Islamic banks should perform better because transparency, integrity, honesty, and and accountability improve performance (Aswadi et al., 2009).

This study can help regulator, Islamic banks, investors, academicians and professionals in future decision-making to ensure improved performance. The main purpose of this research is to find the impact of SGF implementation of Islamic banks performance with the following hypothesis:

H1: Implementation of Shari'ah Governance Framework impacts financial performance of Islamic banks positively.

1.3 Objectives

The objective of the study is to check the impact on financial performance of Islamic banks after the implementation of Shari'ah Governance Framework 2015.

2. Methodology

Quantitative research technique is used to collect and analyse data for this study, which is deductive approach following positivist philosophy (Bryman, 2001).

2.1 Data

This study used the financial statements of Islamic banks 2016-2019 for the collection of data and analysis. The financial records are very worthy source of information to conduct analysis in finance. The annual records are downloaded from the websites of all Islamic banking institutions. The population consists of all Islamic banks and standalone Islamic branches of all conventional banks. The researcher selected all Islamic banks (full-fledged IBIs and standalone Islamic branches of CBs) for the year 2016-2019 in Pakistan for analysis. The sampling technique is very crucial to get the correct results. The researcher used the purposive sampling technique to collect data. The reason to select this time period is the implementation time of Shari'ah Governance Framework 2015. The objective is to check the impact of implementation of SGF on financial performance of IBIs in Pakistan. To ascertain the validity and robustness of analysis, we obviate 5 banks due to inaccessibility of data from the list. The sample consists of 17 Islamic banks out of 22, which are analyzed over a four-year period 2016-2019 after the implementation of SGF which resulted in a total of 68 observations.

This study uses descriptive statistics and the multiple regression model as a positivistic paradigm, which excludes individual perception (Ardalan, 2012). To analyze the impact of SG on performance of Islamic banks; we applied Fixed Effect Model as it is not only efficient but also consistent in all conditions (Arshed, 2016). Data collection and analysis techniques are aligned with the desired objectives of the study.

Table 2.1: Operationalization of variables

| Variable Symbol | Definition | Measurement |
|------------------------------|------------------------------|---|
| Dependent Variables | | |
| ROA | Return on assets | Net Income / Total Assets *100 |
| ROE | Return on equity | Net Income / Total Equity *100 |
| TQ | Tobin's Q | Market Value of Firm / Total shareholder's equity*100 |
| Independent Variables | | |
| OWN | Ownership structure | Local if ownership is 51% and over and Foreign if ownership is 49% and less |
| AC SIZE | Audit committee size | Number of members in an audit committee. |
| BIND | Board Independence | Number of independent directors. |
| BSIZE | Board Size | Total number of directors. |
| SB SIZE | Shari'ah Board Size | The number of members appointed. |
| SB QUAL | Shari'ah Board Qualification | Mufti Degree. |
| SB MEET | Shari'ah Board meetings | The number of meetings held in a year by sharia board. |
| Control Variables | | |
| SIZE | Bank size | Natural log of total assets |
| AGE | Age of bank | In years: 10 or more = 1; less than 10= 0 |
| LEV | Leverage ratio. | Total capital/total asset |

2.2 Equations and Estimations

The regression models that we use in testing the bank performance after implementation of shari'ah governance framework are as follows:

$$ROA_{it} = \beta_0 + \beta_1 OWN_{it} + \beta_2 ACSIZE_{it} + \beta_3 BIND_{it} + \beta_4 BSIZE_{it} + \beta_5 SBSIZE_{it} + \beta_6 SBQUAL_{it} + \beta_7 SBMEET_{it} + \beta_8 SIZE_{it} + \beta_9 AGE_{it} + \beta_{10} LEV_{it} + \epsilon_{it}$$

$$ROE_{it} = \beta_0 + \beta_1 OWN_{it} + \beta_2 ACSIZE_{it} + \beta_3 BIND_{it} + \beta_4 BSIZE_{it} + \beta_5 SBSIZE_{it} + \beta_6 SBQUAL_{it} + \beta_7 SBMEET_{it} + \beta_8 SIZE_{it} + \beta_9 AGE_{it} + \beta_{10} LEV_{it} + \epsilon_{it}$$

$$TQ_{it} = \beta_0 + \beta_1 OWN_{it} + \beta_2 ACSIZE_{it} + \beta_3 BIND_{it} + \beta_4 BSIZE_{it} + \beta_5 SBSIZE_{it} + \beta_6 SBQUAL_{it} + \beta_7 SBMEET_{it} + \beta_8 SIZE_{it} + \beta_9 AGE_{it} + \beta_{10} LEV_{it} + \epsilon_{it}$$

The variables for the model are:

i=number of Islamic banks i.e. 17, t=time period from 2016-2019, Performance=Islamic bank's performance, ROA=return on assets, ROE= return on equity, TQ= Tobin's Q, OWN= Ownership structure, ACSIZE=Audit committee size, BIND=Board independence, BSIZE=Board size, SBSIZE=SB size, SBQUAL =SB qualification, SBMEET= SB meetings, SIZE= size of bank, AGE= bank's age, LEV=leverage

The sample used in this research is 17 Islamic banks which are studied over a four-year period post (2016-2019) implementation of SGF which resulted in a total of 68 observations.

3. Results and Discussions

Table 3.1 presents the descriptive statistics of our data. The result shows returns of all Islamic banks and standalone Islamic branches of CBs depicts good positive performance with mean value of ROA, ROE and TQ 0.829, 13.06 and 1.05, respectively. Return on Equity is quite good to improve clientage. Banks working under Shari'ah laws required to strictly follow the Shari'ah Governance Framework. This will definitely improve the confidence of customers who want to invest in Islamic banks due to their faith. Islamic banks also required to involve in real economic activities as instructed by [Quran](#).

Table 3.1 Descriptive statistics for post shari'ah governance (2016-2019)

| Variable | Obs | Mean | Std. Dev. | Min | Max |
|----------|-----|--------|-----------|--------|-------|
| ROA | 68 | .829 | .6 | -1.49 | 2.7 |
| ROE | 68 | 13.058 | 7.468 | -11.17 | 30.66 |
| TQ | 68 | 1.05 | .439 | .1 | 2.67 |
| OWNSTR | 68 | .353 | .481 | 0 | 1 |
| BFSIZE | 68 | 9.206 | 1.808 | 6 | 13 |
| BIND | 68 | 3.33 | 1.617 | 2 | 10 |
| ACSIZE | 68 | 3.971 | .81 | 3 | 6 |
| SBSIZE | 68 | 3.118 | .587 | 2 | 7 |
| SBQUAL | 68 | 87.674 | 21.619 | 14.28 | 100 |
| SBMEET | 67 | 4.328 | .991 | 3 | 9 |
| SIZE | 68 | 13.362 | 1.054 | 10.25 | 16.23 |
| AGE | 68 | .647 | .481 | 0 | 1 |
| LEV | 68 | 5.103 | 3.481 | 2.38 | 29.82 |

Tables 3.2 present the results from OLS, FE and RE approach. The results show that implementation of Shari'ah Governance Framework has a significant impact on the performance of Islamic banks, which means that the ROA, ROE and TQ of Islamic banks depicting positive results. It is concluded from above analyses that for **post-SG**, the **Model I** (ROA) illustrate that Islamic bank characteristics such as BIND, ACSIZE, SBSIZE, SBQUAL, SBMEET, SIZE and LEV are positively associated with performance and BSIZE has a negative impact on performance, as increase in BSIZE will decrease the performance. **Model II** (ROE) shows the results that BIND, ACSIZE, SBSIZE, SBQUAL, SBMEET, SIZE and LEV have a positive impact on the financial performance indicator ROE and BSIZE has a negative impact on financial performance, as increase in value of this factor, performance falls. **Model III** (TQ) represents that ACSIZE and SBQUAL have a positive impact on TQ as an indicator of financial performance. The finding reveals that Shari'ah related variables (SBSIZE, SBQUAL, SBMEET) have positive relationship with ROA, ROE and TQ, which depict that in long run the performance will improve with the implementation of SGF. This is an explanation as to why, as of 2021, Islamic banking has captured 18% market share and stood at almost Rs. 5 trillion in assets (SBP, 2021).

Table 3.2 Regression Analysis Results for Post-SG

| VARIABLES | (1) ROA | (2) ROE | (3) TQ |
|-----------|-----------------------|-----------------------|----------------------|
| OWNSTR | 0 | - | - |
| BSIZE | -0.1208 (0.0778) | -2.3884** (1.1388) | -0.0511 (0.0579) |
| BIND | 0.3014*** (0.1109) | 3.8948** (1.6228) | -0.0254 (0.0826) |
| ACSIZE | 0.0801 (0.0928) | 1.0255 (1.3586) | 0.0556 (0.0691) |
| SBSIZE | 0.2355*** (0.0806) | 2.755** (1.1794) | -0.0102 (0.0600) |
| SBQUAL | 0.0052 (0.0038) | 0.1042* (0.0569) | 0.0014 (0.0029) |
| SBMEET | 0.0399 (0.1384) | 0.2865 (2.025) | -0.2060* (0.1031) |
| SIZE | 0.0476 (0.1319) | 1.7698** (1.9295) | -0.0463 (0.0982) |
| AGE | 0 | - | - |
| LEV | 0.0696*** (0.0171) | 0.5586** (0.2507) | -0.0085 (0.0127) |
| Constant | -1.740* | -27.4955 | 2.8405* |

| | | | |
|--------------|---------|-----------|----------|
| | (1.974) | (28.8766) | (1.4704) |
| Observations | 68 | 68 | 68 |
| R-squared | 0.4784 | 0.3851 | 0.1829 |
| Model | FEM | FEM | FEM |

Note: * significant at 1% ($p < 0.01$), ** significant at 5% ($p < 0.05$), * significant at 10% ($p < 0.1$)**

The results validate the results of earlier studies which show that Shari'ah conformity impacts the performance of firms positively (Hassan and Chachi, 2008; Kr and Fu, 2014; Bansal & Sharma, 2016; Almutairi and Quttainah, 2017; Fakhruddin and Jusoh, 2018). Experts contend that because of the numerous limits placed on investments, business domains, and leverage ratios, Shari'ah-compliant enterprises find it challenging to carry off their profitability. On the other hand, the limitations set by Shari'ah do assist the companies in acting with greater caution, openness, and commercial ethics, while avoiding excessive risk and leverage. Another element that contributes to the success of Shari'ah-compliant enterprises is the amount of investor trust.

4. Conclusion and Recommendations

Implementation of SGF is directly proportional to the performance of IBIs of Pakistan. The quantitative analysis in implementation of SGF on performance of IBIs suggests that implementation of SGF must be improved because it has a direct impact on the performance of IBIs in long run. Therefore, it is suggested to improve and ensure implementation of SGF. SBP must establish a committee to check implementation. Secondly, the results of the study reveal that large Shari'ah board size, SB meetings and SB qualification improve performance due to the knowledge, experience and good coordination. Therefore, it is suggested to SBP to increase SB size, SB meetings and involve more Mufti degree holders in SB. It is also recommended to do quantitative research by adding list of dependent and independent variables and check the pre-post implementation of SGF on financial performance. Future studies can examine the results with the change of methodology; this will be helpful in generalizing the results. All the signs are valid and consistent with earlier research. The study has political implications as well. The study suffice as a trustworthy and real advocate of the theoretical propositions of improved firm performance through Shari'ah conformity. Since it helps to objectively demonstrate the beneficial influence of Shari'ah compliance on firm performance. The study provides a neutral, quantitative perspective and highlights the benefits of Shari'ah compliance beyond of the constrained orbit of religious beliefs. By illuminating the real-world implications of theoretical statements, it therefore helps to positively impact public perceptions of Shari'ah compliance.

Thirdly, the present research also limits the scope of study by focusing on Shari'ah governance framework 2015, implemented in IBIs in Pakistan. In other words, research findings are not applicable to Shari'ah governance frameworks implemented in other countries. In this regard, the scope of study could be broadened further to other countries. Fourthly, the researcher faced difficulties in collection of data for quantitative side of this research; some variables were skipped due to non-availability of data to check the pre-post implementation of SGF 2015. Only four years data was available for post implementation of

SGF. Nonetheless, the study has yielded adequate facts, evidence, figures, tables and information to achieve the research objectives.

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