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# The influences of Shariah Governance Mechanisms in Islamic Banks Performance and Shariah Compliance Quality

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## Abstract

This paper examines the influences of Shariah Governance (SG) mechanisms in Islamic banks' performance and Shariah compliance quality in Bangladesh. Applying semi-structured face-to-face personal interviews, this study discovers that the quality of the BOD, SSB, management, and Shariah executives has more positively and negatively influenced the Islamic banks' performance, Shariah compliance quality, image, and goodwill proven in Bangladesh. The composition, formations and quality of SSB and Shariah officers positively influence Islamic banks' fatwas, Shariah decisions, compliance quality and firm performance. The study significantly contributed to the national and global regulatory bodies' operations suggesting that the Islamic banks, regulators, and BOD should provide competent, knowledgeable and efficient executives that will positively impact Islamic banks' performance, image and quality compliance. This research extends the literature concerning the influences of SG mechanisms of Islamic banks in Bangladesh. The study enhances the concerns on the theoretical base of the agency and stakeholder theory, not only on efficient and effective tools but also the prevailing banking pressure, current political situation, and social limitations impact on Islamic banks' performance and Shariah compliance quality.

**Keywords:** Shariah governance; Shariah governance mechanisms; Islamic banks performance and Shariah compliance quality

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## 1. INTRODUCTION

Islamic banks' obligatory is to enhance the institutional image and reputation through Shariah compliance quality, the unique feature that differentiates itself from its conventional counterparts (Belal et al., 2015:). As the philosophies and principles recommended by Islamic belief diverge distinctly from the structures implemented in general corporate governance (CG), there are extensive normative (Islamic doctrines and values) and critical examinations concerning the uniqueness of Islamic governance frameworks (Abu-Tapanjeh, 2009). For instance, conventional CG underlines profit maximisation and financial performance. At the same time, Shariah Governance (SG) emphasises applying Shariah principles in a Shariah Governance Framework (SGF). Theoretically, Islamic banks are devoted to social well-being. Their business promotion diversified from conventional banks (Hasan & Dridi, 2011). Islamic banks are supposed to follow the Islamic principles of "fair and just" earnings (i.e., profit and loss sharing model), impartially distributing the earnings and disallowing "riba" (interest). Therefore, Islamic banks have inaugurated the SSBs to confirm compliance with these principles as their backers and promoters (Mollah & Zaman, 2015).

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Islamic banks should concentrate on the profit maximization of the institution. Indeed, a reasonable consensus in the literature has recommended that Islamic banks increase firms' profitability. However, research on Shariah supervisions concerning firms' performance has been ventured, particularly SG on Islamic banks' performance and credit rating (Mollah & Zaman, 2015; Grassa, 2016; Almutairi & Quttainah, 2017). Nevertheless, the studies did not cover the influence of SG mechanisms on both sides as Islamic banks' performance and Shariah compliance quality. Thus, there is an opportunity to investigate the impacts of SG mechanisms on Islamic banks' performance and Shariah compliance quality in Bangladesh. Therefore, previous researchers examined the SG practices, problems and challenges, legal and regulatory issues of the SG, Shariah compliance and disclosure, and application of SG guidelines in Bangladesh's context (Alam et al., 2020a; 2020b; Alam et al., 2019).

This paper examines the influences of SG mechanisms in the performance and Shariah compliance of Islamic banks, which is theoretically the cornerstone of Islamic banks, is associated with performance. Explicitly, the influence of SG mechanisms is examined in Islamic banks' performance and quality compliance in Bangladesh. By concerning the governance and performance relationship (Aebi et al., 2012), this study focuses on the appointment criteria, composition, qualification, and quality of Boards of Directors (BOD), SSB, management Shariah department officers about Islamic banks performance and Shariah compliance quality. In this regard, the enriched and improvised SG mechanisms of 'Islamic Bank Bangladesh Limited (IBBL),' the first Islamic Bank in South East Asia, was established in 1983; it has proven itself a successful pioneer. Therefore, the qualified and experienced BOD, SSB, management, Shariah executives, and general executives have influenced the Shariah principles, compliance, and performance

The study is significant as it varies from previous inquiries and contributes to the existing literature in numerous ways. This is the first education to explore SG mechanisms' influence on Islamic banks' performance and Shariah compliance quality. The literature concerning Islamic banking is normally normative and theoretical. There are few experimental pieces of evidence on their performance and Shariah compliance. It contrasts with the past research, which mainly focused on the conventional banks' performance (i.e., Andres & Vallelado, 2008) or provides theoretical implications concerning the Islamic banks' uniqueness due to SG (Hassan, 2011). The empirical findings of this study focused on the influence of SG mechanisms in the performance and Shariah compliance quality of the Islamic banks in Bangladesh.

Secondly, the research extends the literature of Islamic banking and SG mechanisms, performance, and quality compliance in Bangladesh, which has been unexplored for several decades. Thirdly, the study significantly extends SG's literature by outlining the composition and formations of the SSB and Shariah officers, which positively influence fatwas development, Shariah decision making, institutional performance, and Shariah compliance quality. These directly enhance the confidence and beliefs of the general people and customers. The study significantly contributed to the national and global regulatory bodies by suggesting that the Islamic banks, regulators, and BOD should provide competent, knowledgeable, and efficient executives to positively impact Islamic banks' performance, image, and quality compliance. Finally, the study extends the concerns that the efficiency and effectiveness of mechanisms and the prevailing banking pressure, current political situation, and social limitations also hinder the functions and employment system of the Islamic banks. As a result, these affect the Islamic banks' image, performance, Shariah implementations, and compliance. Thus, the theorist needs to consider these mechanisms to extend the agency and stakeholder theories and select the resources.

## **2. LITERATURE REVIEW**

CG model of Islamic banks are constructed based on property rights and contracts' principles, the need to develop a structure to confirm the Shariah law for safeguarding the stakeholders' rights (Bhatti & Bhatti, 2009). Therefore, SG is a complete system that outlines how Islamic Financial Institutions (IFIs) follow the Shariah principles in conducting their business functions (Ginena & Hamid, 2015). IFSB-9 (2009) has illustrated SG systems as "a set of structural procedures where IFIs assure the Shariah compliance throughout its operational activities".

Literature has investigated the association between governance mechanisms and firm performance, comprising the shareholder value in non-financial institutions. However, the experiential studies are diversified (Larcker et al., 2007). Therefore, numerous earlier researches report a positive outcome of CG on the value of non-financial institutions. Gupta et al. (2009) do not see any effects of CG on firm value. Consequently, some studies have also investigated the association between governance and performance in the banking industry and found a positive, negative, and no relationship (Pathan & Faff, 2013; Andres & Vallelado, 2008). Besides, the previous study recommended that sound BOD enhanced bank performance. Andres and Vallelado (2008) find similar outcomes concerning the size of the BOD.

## **2.1 Theoretical Framework**

Agency theory illustrates the prearranged connection between the managers and shareholders identical to an agent and principal relation complete the functions supporting the principal (Jensen & Meckling, 1976; Fama & Jensen, 1983). Agency theory claims that management roles are to protect the interest of shareholders and monitor management behaviour to minimise the management (Jensen and Meckling, 1976). However, the BOD's oversight function is one of the monitoring mechanisms of the monitoring roles of the shareholders. The BOD signifies "a market-induced institution, the ultimate internal monitor of the set of contracts called a firm" (Fama, 1980).

However, the SSB role is comparatively similar to external auditors and audit committees (Abdul Rahman & Bukair, 2013). Hereafter, SSB members are inclined to the same issues that affect external auditors and audit committees (Abdul Rahman & Bukair, 2013). Therefore, SSB members try to uphold their honesty by evading doubtful functions (Garas, 2012). Owing to their vast knowledge regarding Islamic principles, which gives higher trustworthiness, Shariah intellectuals enjoy strong standings (Abdul Rahman & Bukair, 2013). Islamic banks having reputable SSB members are thus, often anticipated to get higher revenues.

Equally, the stakeholder theory suggests a broader concept of CG and SG be executed in the corporations. The stakeholder theory outlines better freedom in broadening the idea of CG as management take care of the interest of shareholders and other stakeholders through its activities (Freeman, 1994; Collier, 2008). Therefore, management has provided responsibilities to formulate numerous corporate guidelines for maintaining business legitimacy, foremost to improve corporate stakeholders (Ashforth & Gibbs, 1990; Suchman, 1995; Khan et al., 2013).

## **3. METHODOLOGY**

This study is based on qualitative research to understand how and why things occur (Cooper & Schindler, 2011). It comprises "an array of interpretive techniques which seek to describe, decode, translate, and otherwise come to terms with the meaning, not the frequency, of certain more or less naturally occurring phenomena in the social world" (Cooper & Schindler, 2011: 162). The education has implemented qualitative research rather than quantitative research as the researchers intend to discover the answer for "how" questions rather than "how many" questions (Silverman, 2010: 11). Besides, the researchers consider this study as an exploratory investigation that comprises "an attempt to determine whether or not a phenomenon exists" (Dane, 1990: 5). The case study technique (Yin, 1994) explains the BOD's complete roles and responsibilities and connections with the employed management. Another reason for choosing a case study is that the researchers cannot deploy real behavioural actions (Yin, 2003). Therefore, the interview question is related to the Islamic banks' regulators, SSB members, field experts, and Shariah department executives. A similar method was applied in previous research in exploring the reasons behind the absence of comprehensive SGF, the formation of a central Shariah authority, and implementations of SG guidelines in Bangladesh (Alam et al., 2020a; 2020b).

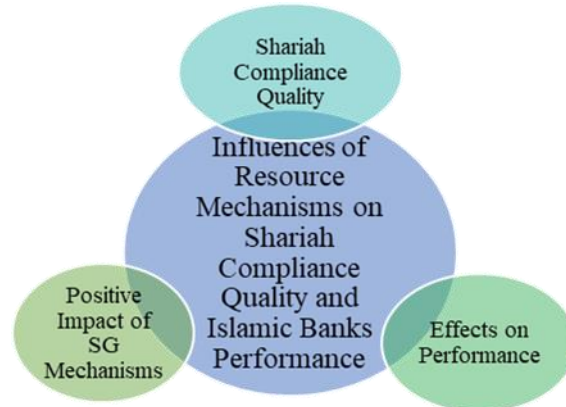
The researchers selected the semi-structured interview to provide additional data about this study and have a more comprehensive understanding of the practical feature of the subject issues. Therefore, the face-to-face interview may comfort the procedure of getting a clear understanding of the research issues. This process assists the participants in understanding the questions more clearly (Sekaran & Bougie, 2010). In total, 17 respondents were to accomplish the research objective. The selected respondents for the interviews are regulators, SSB members, Shariah department executives, and finally, the field experts from the Islamic banks and the central bank of Bangladesh, whose functions are associated with Islamic banks' SG functions. To maintain the confidentiality of the respondents, the study has used symbolic identifications for the respondents where regulatory respondents coded as 'RA' (Regulatory Aspects), 'SP' (Shariah Practitioners) for SSB members, and Shariah department executives and 'E' (Experts) for field experts concerning the Islamic banking and SG knowledge. However, a research strategy is a judgment that associates the study objective and research question to experimental data gathering and analysis procedures to reach the final decisions based on the data collected (Rowley, 2002; Yin, 2009). The NVivo analyses massive textual data in qualitative research. It permits in-depth analysis and delivers more advanced tools to envisage data (Gibbs, 2002).

## **4. DISCUSSIONS AND FINDINGS**

The researchers have collected from Bangladesh, and the respondents were related to the Islamic banking industry and regulatory bodies. The NVivo data analysis identifies three major categories of the question, "how do you think that the appointment criteria, composition, qualification and quality of BOD, SSB, management, and Shariah

department officers influence Islamic banks' performance and Shariah compliance quality? If yes, how? If not, why?". The resource mechanisms of every Islamic bank influence Shariah compliance quality and overall performance. The identified categories are Shariah compliance quality, effects of performance, and positive impacts of SG mechanisms.

Figure 1: Theme of influences of resource mechanisms on Shariah compliance quality and Islamic banks performance



The Shariah governance mechanisms impact Islamic banks' performance and Shariah compliance quality. Most of the respondents (E#4, 5; RA#2; SP#2, 3, 4, 7) agree in one point that people who are more qualified would confirm the success of Shariah principles and ensure Shariah compliance quality.

In this case, one of the respondents emphasises that qualified people and the intention of the management and BOD are essential to ensure the Shariah principles and quality assurance. Therefore, if the executive of the Shariah departments and the SSB members are qualified and well experienced in Shariah, fiqh-al-muamalat, or Islamic banking business, then it will have a positive impact on the performance, SSB decision making, and quality compliance. Additionally, their formation, composition, and education qualification will also affect the general people's relation, confidence, and trust. Almutairi and Quttainah (2017) also discover the size of SSB, composition, education, qualifications, and knowledge in Islamic jurisprudence. Conventional and Islamic finance have positive relations in IFIs performance.

*"Because if the members do not have sufficient qualification or experience about the fiqh al muamalat or the banking transactions, then his decisions sometimes will not be consistent with the present situation even for the smooth operation of the bank. It will influence the relations of the public". [SP#2] "The education qualification, Shariah knowledge and contemporary banking concepts of SSB members influence the decision-making process." [SP#4]*

Practically, it is evident in Bangladesh that the qualified SSB and BOD positively influence the performance of Islamic banks and Shariah implementations. Due to the current banking structure, political pressure, and social bindings, Islamic banks cannot recruit skilled Shariah candidates as required and BOD's proper function, resulting in banking performance, image and Shariah applications, and compliance.

*"We saw previously those from the Shariah background when they entered the banking. They are competent in both areas, but now we are not getting such a combination because the candidate comes from various courses such as social, political, and so on. .... When the BOD recruits the SSB members, there is a lack of competency among these people due to the different reasons such as low qualified members recruited and prioritised rather than the highly qualified people". [SP#7]*

Additionally, similar views of the participants (E#3, 4, 5; SP#2, 9) show that the bank's performance and success largely depend on BOD roles, functions, quality, experiences, and knowledge. Conversely, if BODs are not qualified and well experienced, it will negatively impact banks' financial performance.

*"BOD can influence their financial performance." [E#4] "If they are not qualified, not experienced, there will be an influence on the performance." [E#3] "Yes, of course, their quality and experience are very important." [SP#2]*

However, BOD members with better knowledge and abilities ensure more compliance with Islamic principles. The institutional procedure of SG sets SSB as the mainstream of the structure. This construction has become an essential part of the SGF of IFIs (Hasan, 2011). The external members in BOD from the other countries and institutions brought diverse knowledge and experience from their countries and global perspective, which influence the bank's performance and as proven in terms of IBBL performance. Conversely, one of the respondents argues that it is partially true, rather than adequately, because some banks have performed well and ensured more Shariah compliance only for the commitment and intention of BOD and management.

*"In my view, it is quite true, not fully." [SP#6] "..... Their system trains to provide knowledge and have an organized Islamic banking system directed by top management to consider everything. However, we will not consider or accept the Shariah violation". [SP#6]*

Another respondent points out that Shariah compliance and financial performance are different things. Additionally, suppose the developed products and services and the promotion of the product are acceptable. In that case, it will influence the Islamic banks' performance. The SSB checks Shariah compliance quality and product promotion instead of product selling.

*"There are two things; one is financial performance and Shariah compliance. Financial performance is not related to the Shariah experts..... Shariah experts can influence Shariah compliance, and BOD can influence their financial performance. So, both are different". [E#4]*

Based on the above discussions, Shariah governance mechanisms positively and negatively influence the Islamic bank's performance and ensure Shariah compliance quality in Bangladesh.

## 5. CONCLUSION AND RECOMMENDATIONS

The study has outlined that the SG mechanisms influence Islamic banks' performance and Shariah quality compliance. The study delineates how SG mechanisms influence Shariah compliance quality and the performance of Islamic banks. This research highlights qualified and experienced SSB, Shariah executives, general executives, management, BOD, and people to ensure successful Shariah principles, compliance, and performance. Therefore, we draw the concept that the proper SG mechanisms and the willingness of the BOD, management, and the appropriate system to play a significant role in ensuring Shariah compliance. Secondly, the composition, formations, reputation, and quality of SSB and Shariah officers positively influence Islamic banks' fatwas, Shariah decisions, Shariah compliance quality, and firm performance that increase trust, confidence, and faith of the customer and general people. Thirdly, in Bangladesh, it is already proven that knowledgeable and qualified BOD and SSB promote their role in ensuring Shariah applications, compliance, and firm performance. Thus, one of the reasons for the success of Islamic banks.

As proven by other studies, this research also has beneficial implications. First, our review is helpful for Islamic banks and regulators operating in diverse jurisdictions. This study's results can be a valuable source of knowledge for regulators and policymakers, mainly for the Islamic banking and finance areas, in formulating policies to manage qualified and proper SG mechanisms for appropriate Shariah applications, better performance, and quality Shariah compliance. Secondly, we argued that if BOD can accomplish adequate tools with a combination of qualified, experienced, and renowned personalities, definitely it will influence the Islamic banks' performance positively, as well as Shariah decisions, implementations, Shariah compliance quality, institutional image, transparency, competence, and goodwill. Therefore, the recommendation is that if the Islamic banks recruit qualified and experts BOD, SSB, management, Shariah executives, and general executives by following formal requirements, it will enhance the applications of Shariah principles, quality compliance, Islamic banks performance, image, and goodwill.

The study is limited to SSB and Shariah officials of Islamic banks and executives of Bangladesh's central. However, we cannot generalise our findings to be relevant and similar in other Islamic banking practising countries. Therefore, researchers can investigate the influence of resource mechanisms in Islamic banks' performance and Shariah compliance quality in other dual banking practising countries such as Malaysia, Pakistan, Indonesia, and Gulf countries such as Saudi Arabia, Iran, Bahrain, and Qatar justifications. New research can also explore these influences in other Islamic institutions such as service, real-estate companies, Islamic microfinance, and cooperative institutions. Therefore, future researchers can justify these findings in diversified jurisdictions with a combination of the same respondents or other participants' involvement from numerous sources qualitatively. Besides, the researchers can justify the findings in a quantitative methodology in the context of Bangladesh and other jurisdictions.

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