

Review

The Mediating Role of *Shari'ah* Governance Disclosure between Corporate Governance Mechanisms and Firm Performance of Islamic Banks

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Abstract: Corporate governance (CG) structure in Islamic Financial Institutions (IFIs) needs additional measures of governance for the purpose of *Shari'ah* compliance, known as *Shari'ah* governance. *Shari'ah* governance is a mechanism at the institutional, industrial and national levels that ensures IFIs only takes and uses *Shari'ah*-compliant activities, products and services. The social power of the *Shari'ah* governance provides confidence to the stakeholders about the legitimacy of the transactions and activities of the IFIs. The economic powers of the *Shari'ah* governance can be seen from the fact that the profitability and value of IFIs are dependent on the performance of *Shari'ah* scholars. This paper discusses the potential influence and relationship between the CG mechanism and firm performance of Islamic banking sector and the mediating role of *Shari'ah* governance disclosure. Good CG is a must in ensuring the values required by different stakeholder groups, and it enhances the performance of corporations. CG practices and *Shari'ah* governance disclosures support the continuity of a company and help to increase the trust from the society and investors. This study has been conducted because there are limited studies on the *Shari'ah* governance disclosure as a mediator between CG mechanisms and firm performance. *Shari'ah* governance disclosures are expected to be relevant to Islamic banks in explaining and strengthening the infrastructure of IFIs.

Keywords: Corporate governance; *Shari'ah* governance disclosure; firm performance; Islamic bank

1. Introduction

Generating economic and financial returns to its owners is the chief goal of business (Clements, Franses, & Swanson, 2004). Though the relationship between a firm's CG and its financial performance is a topic of hot debate, it is certain that practising good CG provides a reliable and dependable framework for a firm's board of directors so that they may respond, in a timely fashion, to different situations that affect the firm's value. On paper, CG may seem like an abstract goal, but on the contrary, it is there to serve a corporation's purposes by providing, as aforementioned, a reliable and dependable structure within the corporation, which the directors could follow to achieve the corporate goals in the most effective manner. Because of so, the lack of good CG, even in financially successful corporations, is an indication to stockholders that the corporation is vulnerable and prone to collapse, due to a deficient structure that is not optimally positioned for dealing with new financial or managerial challenges.

In recent years, the CG mechanism has received considerable attention in Islamic finance. The dimension of the CG mechanism in Islam which is different from the western concept refers to its fundamentals concept whereas, in the Islamic concept, it is based on the *Shari'ah* principle. The fundamental principles of *tawhīd*, *shura*, property rights and commitment to a contractual obligation that govern the economic and social behaviour require IFIs to comply with the *Shari'ah* rules and principles (Darmadi, 2013; Grassa, 2015; Ratri & Dewi, 2017; Thajudeen, 2013). At this stage, CG structure and *Shari'ah* governance disclosure in IFIs need additional measures of governance for the purpose of *Shari'ah* compliance based on the *Shari'ah* principle, known as *Shari'ah* governance (SG) (Alkhamees, 2013). As part of the CG framework in IFIs, *Shari'ah* governance is the very essence of Islamic finance practice in building and maintaining the confidence of the shareholders and other stakeholders and assuring them that all transactions, practices and activities are in compliance with the *Shari'ah* principles and can be affected the financial performance of Islamic bank (Alkhamees, 2013; Hameed, Wirman, Alrazi, Nazli, & Pramono, 2004; Ratri & Dewi, 2017).

Many researchers have studied the impact of CG mechanisms on firms' performance from different environments in the different perspectives using some variables of interest (Al-Malkawi & Pillai, 2018; Asutay & Harningtyas, 2016; Budiman, Kristanti, & Wardhana, 2016; Darmadi, 2013; Elsiddig, 2017; Ghayad, 2008; Hamza, 2013; Kasim, Nu Nu Htay, & Ahmed Salman, 2016; Khamar Tazilah, Ahmad Rapani, Abdul Halim, & Majid, 2017; Kusuma & Ayumardani, 2016; Mollah, Hassan, & Al-Farooque, 2014; Naushad & Malik, 2015; Noordin, Kassim, Prabangasta, & Hayeeyahya, 2015; Srairi, 2015). The researchers' found mixed results on the relationship between CG mechanisms, SSB mechanisms and firms' performance. For this study, CG and SSB mechanism have been translated to be CG strength and SSB strength. Furthermore, in this study, *Shari'ah* governance disclosure will be used as mediating variables to strengthen the relationship between CG and SSB strengths and firm performance of the Islamic banking.

2. Literature Review

2.1. Corporate Governance and Performance in Islamic Financial Institutions

CG of IFIs allows ensuring fairness to all stakeholders through greater transparency and accountability towards Islamic principle. The CG of a *Shari'ah* business would first look at the transactional structure to see whether the transaction involves elements that invalidate gains or profits since *Shari'ah* principle is involved not only with the material but also with the form of business (Haider, Khan, & Iqbal, 2015). In effect, CG for IFIs stems from two principal elements it is a faith-based approach that directives are running of the company in synchronisation with *Shari'ah* principle and a profit-motive that recognises company and investment transactions to the maximisation of shareholder's wealth (Elsiddig, 2017). Hence, the main feature of the CG in the IFIs is ensuring the compliance with the *Shari'ah* principle. The Effective CG may significantly help to strengthen Islamic banks and to assist Islamic banks in increasing rapidly and performing their responsibility efficiently (Elsiddig, 2017). CG on Islamic banking will become serious when the institutions more extensive. The problems become more complicated when the Islamic banks more extensive, which will doubt their ability. CG in Islamic banks can be leading better management in Islamic banks and to meet the challenges effectively that Islamic banking face.

The CG deals with the way how firms are managed and controlled and how accountability is assured. The efficiency of CG mechanisms in an Islamic bank organisation may help the company to reach its objectives, including its risk management and affect the financial performance of the Islamic bank (Mollah, Hassan, Al Farooque, & Mobarek, 2016). The CG mechanism ensures the management acts in the best interest of the company and minimises the agency cost. The CG framework is one of the

important keys to increasing the efficiency in business monitoring. The implementation of the CG mechanism is expected to attain a balance of many interests that give benefit to the company. Good financial performance is crucial for Islamic banking to be able to keep maintaining the existence of the banking listed as a viable investment for the banking sectors (Mollah & Zaman, 2015). A study by Mollah et al. (2016) shows that the governance structure in Islamic banks agrees them to take higher risks and accomplish better performance as a result of item complexities and exchange instruments. However, the higher capitalisations in Islamic banks are maintained compared to conventional banks.

While there have been numerous studies on CG in the Islamic banking sector (S. Ahmed, Zalailah, Hafiza, & Hashim, 2016; Alkhamees, 2013; Chapra & Ahmed, 2002; Farag, Mallin, & Ow-Yong, 2017; Grais & Pellegrini, 2006; Grassa & Matoussi, 2014; Nienhaus, 2003; Thajudeen, 2013), and there are studies has been written about the relationship between CG and their firm performance of Islamic banking (Bukair & Abdul Rahman, 2015; Elsiddig, 2017; Ghayad, 2008; Haider et al., 2015; Mallin, Farag, & Ow-Yong, 2014; Mollah et al., 2014, 2016; Mollah & Zaman, 2015; Platonova, 2014; Srairi, 2015; Yongqiang, Armstrong, & Clarke, 2014). Mollah et al., (2016) study about the difference in governance structures influences the risk-taking and performance of Islamic banks compared to conventional banks. In this study, Mollah et al., (2016) used 104 conventional banks and 52 Islamic banking from 2005 to 2013 in 14 countries for their sample. In this study, they determine that the governance structure in Islamic banks play an important function in risk-taking as well as firm performance that is different from conventional banks. Particularly, the achievement of better performance in Islamic banks in the transaction mechanisms and product complexities cause of the governance structure that has been complying.

2.2. *The Mediation Effects of Shari'ah Governance Disclosure on the Relationship between CG Strength, SSB strength and Firm Performance*

Corporate governance structure in IFIs needs additional measures of governance for the purpose of *Shari'ah* compliance, known as *Shari'ah* governance (Hamza, 2013). CG is essential for Islamic banks so that their investors can have access to factual and reliable information to make well-informed decisions. However, standard CG mechanisms may not be suited to the Islamic banking industry since Islamic banks work with equity participation, risk and profit and loss sharing arrangement that are different from the conventional banks operating environment (Nomran, Haron, & Hassan, 2016). The Islamic CG based on the stakeholders-oriented model (Iqbal & Mirakhor, 2004). This governance preoccupied with two fundamental concepts of *Shari'ah* principles of property rights and contractual frameworks. *Shari'ah* rules the governance of any corporation in Islam where all the stakeholders including the shareholders, the management, and other stakeholders such as the employees, the depositors, and the community were involved.

The development of Islamic banking and finance industry has led to the importance and the establishment of *Shari'ah* components in IFIs governance. The inclusion of *Shari'ah* elements in the governance of IFIs is recognised as *Shari'ah* governance. *Shari'ah* governance is a mechanism at the institutional, industrial and national levels that ensures an IFI only takes and uses *Shari'ah*-compliant activities, products and services (Chowdhury, Road, Lecturer, & Avenue, 2015). *Shari'ah* governance is equally important to the CG since *Shari'ah* governance plays a critical role in ensuring the IFI's compliance with *Shari'ah* (Haqqi, 2014). The SSB plays a vital role in *Shari'ah* governance by advising and supervising the operation of the bank to ensure that it complies with *Shari'ah* principles (Grassa, 2015). Assessment of *Shari'ah* governance is important, as it is not only demanded by the IFIs' customers but also other stakeholders, including institutional investors and Muslim society who are directly and indirectly involved with the institutions. Under the Anglo-Saxon system, monitoring the firms' performance and governance by stakeholders have been gaining much attention. For example,

Institutional investors engage with the investee companies to ensure that the direction of the firm is aligned with their aims (Black & Coffee, 1994; Hendry, Sanderson, Barker, & Roberts, 2006). Bushee (1998) states that institutional shareholders monitor companies by participating in a company's governance activity or by gathering information and correcting the pricing impact due to managerial decisions.

The importance of *Shari'ah* governance is derived from five different resources namely religious, social, economic, governance and legal (Hidayat, Khaled, & Khalifa, 2018). The religious status is derived from the ability of *Shari'ah* scholars in understanding and interpreting *Shari'ah* rule and principles to others in the transaction. The social power of the *Shari'ah* governance provides confidence to the stakeholders about the legitimacy of the transactions and activities of the IFIs. The economic powers of the *Shari'ah* governance can be seen from the fact that the profitability and value of IFIs are dependent on the performance of *Shari'ah* scholars. As far as legal power is concerned, it is derived from a variety of sources including regulators of the respective countries. The hierarchical position of SSB under the shareholders of the IFIs emphasises its supremacy over other governance organs thus giving them the authority to set their internal policy including task, responsibilities and relations with other governance organs in the IFIs (Garas & Pierce, 2010). The *Shari'ah* governance which refers to all the elements of the active role of the *Shari'ah* board and compliance with *Shari'ah* is fundamental to Islamic banks in particular. The implementation of *Shari'ah* governance disclosure is encouraged by international institutions of regulations like Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) and Islamic Financial Services Board (IFSB), and it can be affected the firm performance of the Islamic banking (Hamza, 2013).

Shari'ah governance is now becoming more diverse and advanced, in parallel with the development of the Islamic finance industry worldwide. Given the impressive growth and increasing sophistication of the Islamic finance sector, the rapidly evolving industry has proved challenging for the *Shari'ah* governance practices. As a consequence, each jurisdiction has adopted different approaches to developing and encouragement its *Shari'ah* governance framework (Hasan, 2011a). At this point, it is important to understand and appreciate the combined approaches of *Shari'ah* governance across regulation, to identify and highlight best practice. It should be noted that, from a regulatory point of view, Malaysia represents the most regulated *Shari'ah* governance model, followed by Brunei, Pakistan and Sudan respectively, while GCC countries and the UK prefer less regulatory interference (Hasan, 2011a). Since *Shari'ah* is the backbone and foundation for the existence of the Islamic banking and finance industry, Islamic finance experts assert *Shari'ah* governance should be considered as the single most important distinction between a conventional and an Islamic financial institution. However, the terminology of *Shari'ah* governance is not easy to understand for persons who live in conventional finance

Compliance towards *Shari'ah* governance is important for IFIs, as it differentiates the core component between conventional financial institutions and IFIs. Therefore, assessment of *Shari'ah* governance is an important aspect towards strengthening the Islamic banking and finance industry. The compliance on *Shari'ah* governance is not only demanded by the IFIs' customers but also other stakeholders, including shareholders institutional investors and Muslim society who are directly and indirectly involved with the institutions (M. Ahmed & Khatun, 2013). Comprehensive compliance with *Shari'ah* principles would boost confidence in the general public and financial markets on the credibility of IFIs operation and be affected by the performance of the IFIs. In addition, non-compliance towards *Shari'ah* aspects would expose the IFIs to risks, such as reputational risks and fiduciary risk. According to BNM (2010), the primary objective of the introduction *Shari'ah* governance is to enhance the role of the board, the *Shari'ah* Committee and the management in relation to *Shari'ah* matters. This includes enhancing relevant aspects of organisations that have the responsibility to execute the *Shari'ah* compliance and research functions (BNM, 2017). The same arguments can be applied to the *Shari'ah*

governance disclosure with the CG disclosure because there are limited studies on the *Shari'ah* governance disclosure and firm performance of the Islamic banks. Based on the same argument on the CG disclosure and performance of Islamic banks (Al-Malkawi & Pillai, 2018; Elsiddig, 2017; Mollah et al., 2014; Srairi, 2015).

The development of Islamic banking and finance industry has led to the importance and establishment of *Shari'ah* components in IFIs governance. The inclusion of *Shari'ah* elements in the governance of IFIs is recognised as *Shari'ah* Governance. Principle 3.1 of the Islamic Financial Services Boards (IFSB) Guiding Principles on CG states that there is appropriate mechanism must be created to ensure compliance with the Islamic finance with the *Shari'ah* principles (IFSB, 2006). The IFSB-10 has defined the *Shari'ah* governance system as a set of institutional and organisational arrangements through which an IFIs ensures that there is effective independent oversight of *Shari'ah* compliance over the issuance of relevant *Shari'ah* pronouncements, dissemination of information and an internal *Shari'ah* compliance review (IFSB, 2009). This definition implies that the institution of the *Shari'ah* board is crucial to the *Shari'ah* governance system as an authoritative body ensuring *Shari'ah* compliance. *Shari'ah* governance disclosure is a very critical area in IFIs and is no less important than CG of any institution (Chowdhury et al., 2015). The significance of *Shari'ah* governance transpires via its role of ensuring the confidence in the Islamic finance industry in the eyes of the stakeholders (Muneeza & Hassan, 2014). The role of the stakeholder is crucial, considering that compliance with *Shari'ah* rules and principles is the requirement of the IFIs. In addition, the previous study showed that improvement in the aspect of *Shari'ah* governance disclosure could assist the rapid and enhanced the growth of the Islamic finance industry (Chowdhury et al., 2015; Haqqi, 2014; Obid & Naysary, 2014).

The principles of Islamic finance place great emphasis on strong CG values and structure, transparency, the disclosure of information and strict adherence to *Shari'ah* principles. The *Shari'ah* governance framework is a set of organisational arrangements through which Islamic financial institutions ensure effective oversight, responsibility and accountability of the board of directors, management and *Shari'ah* committee (Hasan, 2011a; Muneeza & Hassan, 2014). The framework serves as a guide towards ensuring an operating environment that is compliant with *Shari'ah* principles at all times. Based on the definition of *Shari'ah* governance by IFSB-10, it can be observed that the extensive duties need to be performed by the SSB (Haqqi, 2014). Based on the understanding from the definition of *Shari'ah* governance, the duties of SSB is to oversight and supervise the *Shari'ah* compliance of the Islamic financial institutions, as such, their competence is essential to form a robust *Shari'ah* board (Kasim et al., 2016). This definition also implies that the institution of the *Shari'ah* board is crucial to the *Shari'ah* governance system as an authoritative body ensuring *Shari'ah* compliance (Malkawi, 2013).

According to Ramli, Majid, Muhamed and Yaakub (2014), SG is one of the domains of CG. Apart from the implementation of the CG mechanism, IFIs has the responsibility for ensuring that their operations comply with the *Shari'ah* principles, including in their products, practices, and management. Comprehensive compliance with *Shari'ah* principles would boost the confidence of the capital and money markets on the credibility of Islamic banks (Mollah & Zaman, 2015). Additionally, non-compliance towards *Shari'ah* aspects and principles would expose the IFIs especially Islamic bank to the risks, such as reputational risks and fiduciary risk. While explaining the conceptual framework of SG, Iqbal and Mirakhor (2004), argues that SG covers the overall governance issues, the protection of stakeholder's rights and the compliance with the divine rules guided by *Shari'ah* principles. SG actually broadens the area of governance issue from merely a stakeholder's model (Uddin, 2015).

Shari'ah governance and CG are different because the objectives of both are unique (Muneeza & Hassan, 2014). There are many models of CG based on the previous study. It is wrong to generalise all the CG models and consider it as one. Each structure has its own attributes, signifies special corporate models and different objectives of the corporation (Tricker, 2011). In fact, CG models differ from country

to country and from region to region. This fact is evident from the study by Malekian and Daryaei (2010), where they have categorised CG to Anglo-Saxon countries, Germanic Countries, Latin Countries and Japan. However, in *Shari'ah* governance, the decisions of the corporation would be based on *shura* or consultation. The structure may be based on the two-tier system in which an independent *Shari'ah* board would be set up to safeguard the Islam city element of the corporation, and the board of directors would be created to manage and direct the corporation.

The same argument in the CG disclosure, *Shari'ah* governance disclosure can be a mediating variable between CG mechanism, SSB mechanism and firm performance of Islamic bank. According to Khamar Tazilah, Ahamad Rapani, Abdul Halim, and Majid (2017), there are limited studies conducted on the *Shari'ah* governance and compliance instead of and its impact on the business performance. Therefore, it is vital to examine the significant impact of such complaint that eventually affects the IFIs performance and various stakeholders, especially among the Muslims community. This study discusses on the understanding of *Shari'ah* governance compliance and its effect towards the performance of IFIs in Malaysia which contributes to the public, investors, shareholders and other stakeholders' interest (Yadiat, Gustani, & Amrania, 2017).

3. Conceptual Framework

The following diagrammatic framework is developed.

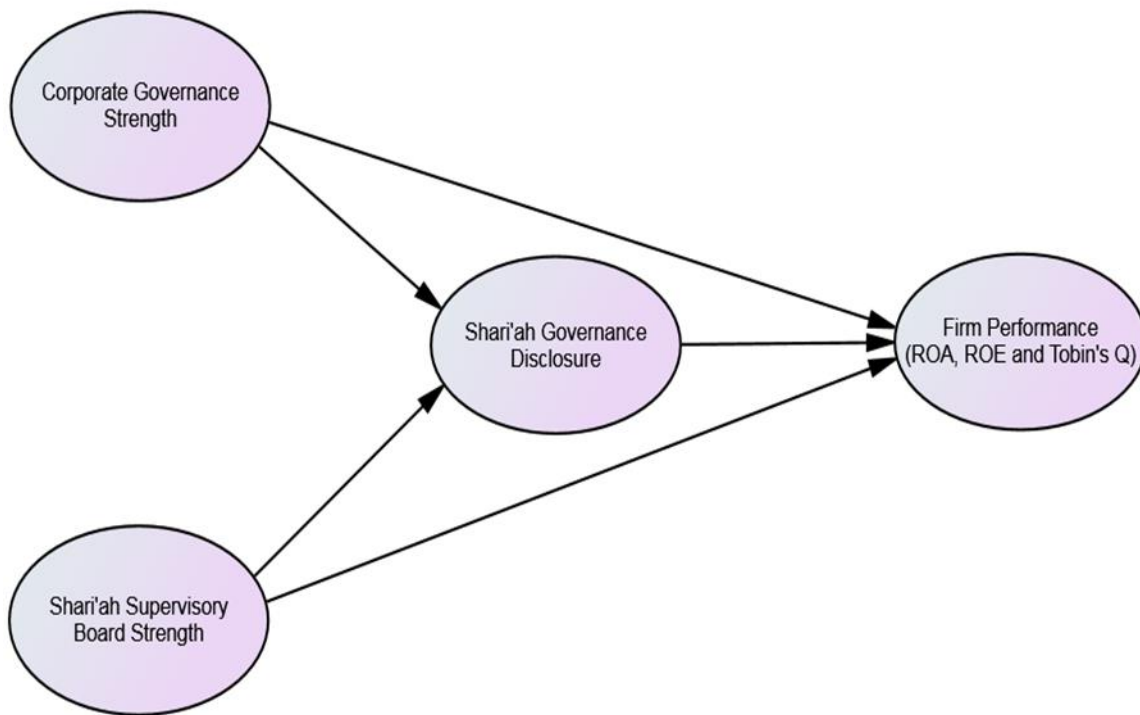


Figure 1: Proposed Conceptual Framework

4. Methodology

Content analysis of published articles and annual report was undertaken in order to identify the CG mechanisms, *Shari'ah* governance disclosure and firm performance of Islamic banks. Bell and Bryman (2007) define content analysis as a method that elaborates the documents and texts to quantify the content in terms of predetermined groupings to the contexts of their use. Many researchers have argued that this method is deemed to be appropriate on the disclosures studies (Haniffa & Hudaib, 2006; Hassan & Harahap, 2010; Maali, Casson, & Napier, 2006; Mollah et al., 2016). The sample of this study consists of an Islamic bank located in the SEA and GCC regions. The selection of Islamic bank in the SEA and the GCC regions because the regions are among the progressive in Islamic finance and also among the first to establish IFIs.

5. Conclusions

This research examines the effect of the CG strength and SSB strength to the financial performance of the Islamic bank. The CG strength has been measured based on the total CG mechanisms, and it is the same with measurement of the SSB strength. These technics are based on the study by Wan Abdullah, Percy, & Stewart, (2015). The financial performance is quantified from ROA, ROE and Tobin's Q based on measurement of accounting and marked based value. Based on the reviewed the past literature, we can conclude that a better CG mechanism will lead to a better firm performance of the Islamic bank. Besides that, the *Shari'ah* governance disclosure has an indirect effect on the CG mechanism and firm performance of an Islamic bank. The implementation of good CG will increase the efficiency and urge the economic growth. The presence of effective CG will help in increasing the trust level needed for the well-functioning financial sector, particularly in the capital market especially in the Islamic banking sectors.

The proposed study makes an original contribution to the literature since it is a limited comprehensive investigation into the combination of CG and SSB in affecting the firm performance of Islamic bank and *Shari'ah* governance disclosure as a mediating variable. Past literature only focuses on specific CG like board size, board independence, CEO duality and otherwise. These studies have been using combine CG mechanism and developed an index of *Shari'ah* governance disclosure based on the study by (Hasan, 2011b), whereas this CG mechanism is more comprehensive for the disclosure on the Islamic bank. Past researchers have shown that CG is an important factor affecting the value or performance of a firm in the specific industry. These studies, which explicitly considers the differences in the social, economic and institutional variations because it is focused on the Islamic banking in the SEA and GCC region.

7. References

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