

Implementation of Sharī‘ah Governance Framework and Change in Performance of Islamic Banks in Pakistan

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ABSTRACT

The survival of the Islamic financial system depends on Sharī‘ah compliance and profitability. The profitability is linked with good performance of Islamic banks. Several studies are evident of the role of Sharī‘ah governance on the profitability of Islamic banks. This paper is aims to check the change in financial performance in the pre (2011-2014) and post (2016-2019) implementation of the Sharī‘ah Governance Framework. This study is deductive and uses quantitative methods. Descriptive statistics and paired sample t-test used to analyze the quantitative data available in financial statements. The finding reveals that the financial performance of Islamic banks has a decreasing trend from pre (2011-2014) and post (2016-2019) data analysis. This study is one of its kind to see the change in the financial performance of Islamic banking institutions in pre and post implementation of the Sharī‘ah Governance Framework in Pakistan.

Key Words: Shari'ah governance framework, Shari'ah scholars, Implementation, performance, Islamic banking institutions.

Introduction

In recent years, weak corporate governance has led to an instant flop of strong AAA rated companies, along with frequent local, regional and global crises.⁽¹⁾ Lack of religious implementation of laws, rules and regulations is one of the big reasons for the financial crisis in the world. It is a matter of great concern for all the regulatory bodies to address the implementation issue as early as possible. The corporate and financial crisis has fetched corporate governance and accountability in the public eye. The crisis in the subprime market in the US has had a major impact on financial institutions in many countries. Bear Stearns, Citibank, Merrill Lynch, Credit Suisse, RBS and Barclays are a few names that confronted losses on assets.⁽²⁾ The downfall of organizations such as Enron and WorldCom is due to the lack of accountability and transparency in corporate and financial institutions.⁽³⁾

Mehran gate scandal is one of the appalling failures of corporate governance in the history of Pakistan, which shook the financial pillar of the country.⁽⁴⁾ The case of Crescent Standard Investment Bank Limited of Pakistan is another example.⁽⁵⁾ To perceive, Islamic banks are safe and couldn't collapse just because of the prudent Islamic financial system inherent in ethical values is a mistake. Islamic banks are exposed to losses and failures in line with conventional counterparts due to a lack of corporate governance.⁽⁶⁾

The importance of Shari'ah governance has been highlighted by many policymakers, practitioners and researchers to strengthen stable development of Islamic finance industry.⁽⁷⁾ The SBP issued the Shari'ah governance framework (SGF) by considering the

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(2) Kirkpatrick, G. (2009). The Corporate Governance Lessons from the Financial Crisis. Financial Market Trends. Retrieved 2018

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(5) Dawn. (2015, 09 10). 1206019. (Dawn) Retrieved from www.dawn.com: <https://www.dawn.com/news/1206019>

(6) Ginena, K. (2014). Corporate Governance, 14(1), 86-103.

(7) Ginena, 2014; Mizushima, 2014; Rammal, 2010; SBP, Islamic Banking Bulletin, 2020; Shahzad, Saeed, & Ehsan, 2017; Shamsher, Sori, & Shah, 2015

importance of Shari'ah compliance.⁽¹⁾The framework applies to all IBIs and standalone Islamic branches of conventional banks. The main objective of SGF is to strengthen the Shari'ah compliance environment and clearly define the roles and responsibilities of all the organs of IBIs, including Board of Directors (BODs), Executive Management (EM), Shari'ah Board (SB), Resident Shari'ah Board Member (RSBM), Shari'ah Compliance Department (SCD), Internal Shari'ah Audit (ISA) and External Shari'ah Audit (ESA).

Shari'ah compliance is mandatory to sustain the double-digit annual growth of Islamic banking.⁽²⁾It is pertinent to mention that 70% of customers, who deal with Islamic banks is due to *Shari'ah* compliance in Pakistan.⁽³⁾Due to rapid growth of Islamic banking financial institutions, it is imperative to examine the change in financial performance of Islamic banks before and after the implementation of SGF. Agency theory, Signalling Theory and Resource Dependence theory support the implementation of SGF and financial performance.

Previous studies find the effect of particular variables of Shari'ah governance on financial performance. Some studies confirm that Shari'ah governance has positive effect on financial performance and some reach to negative relationship. After the implementation of SGF 2015, there is not a single study, which check the change in financial performance of Islamic banks in pre and post implementation of SGF in Pakistan.

Literature Review

Due to rapid growth of Islamic banking financial institutions, it is imperative to examine the relationship of *Shari'ah* governance and financial performance. Gompers, Ishii & Metrick⁽⁴⁾ and Ho⁽⁵⁾ found that CG is positively related to financial performance. The modification in corporate governance mechanism positively affects the banking

(1) Shahzad, M. A., Saeed, S. K., & Ehsan, A. (2017). Shari'ah Audit and Supervision in Shari'ah Governance Framework: Exploratory Study of Islamic Banks in Pakistan. *Business and Economic Review*, 9(1), 103-118. doi:DOI: dx.doi.org/10.22547/BER/9.1.6

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(3) Raza, H., & Azeem, M. (2014). Customer Satisfaction and Awareness about Islamic Banking System. *Research Journal of Finance and Accounting*, 5(3), 89-97.

(4) Gompers, P., Ishii, J., & Metrick, A. (2003). Corporate Governance and Equity Prices. *The Quarterly Journal of Economics*, 118(1), 107-156. doi:http://dx.doi.org/10.1162/00335530360535162

(5) Ho, C. K. (2005). Corporate Governance and Corporate Competitiveness: An international analysis. *Corporate Governance*, 211-253. doi:http://dx.doi.org/10.1111/j.1467-8683.2005.00419.x

sector of Pakistan in terms of managerial efficiencies and effectiveness. Managerial efficiencies of corporate governance, which influence the financial performance, include variables like Board independence and meeting, board structure, CEO duality, ownership and leadership.⁽¹⁾ Francis et al.⁽²⁾ revealed that the organizations performed well during financial crisis, which have good governance practices. According to Laela⁽³⁾, strong SG comes up with better organizational performance. The banks that have more effective SG mechanism will have better financial performance. Farag et al.⁽⁴⁾ found that financial and non-financial performance of Islamic banks is positively related to the level of SG implementation. Hassan et al.⁽⁵⁾ explains that corporate governance of conventional banks is not much different from Islamic banks due to same principles like transparency and accountability. Corporate governance is more concerned with its organs and develops a relationship between board of directors, management, audit, shareholders and other shareholders⁽⁶⁾. That is why, it is considered that corporate governance is the most important and significant variable to gauge financial performance.⁽⁷⁾ Therefore, it is evident that banks, which have strong corporate governance models, are more likely to generate more profits and can enhance shareholders wealth.⁽⁸⁾ Alsartawi, investigate the relationship between composition of Shari'ah supervisory boards (independence and frequency of meetings) and performance of Islamic banks in GCC countries and finds that composition of Shari'ah supervisory boards have a statistically significant and negative relationship with the financial performance of Islamic banks.

(1) Haider, N., Khan, N., & Iqbal, N. (2015). Impact of corporate Governance on Firm Financial Performance in Islamic Financial Institution. *International Letters of Social and Humanistic Sciences*, 51, 106-110. doi:doi:10.18052/www.scipress.com/ILSHS.51.106

(2) Francis, B., Hassan, I., & Wu, Q. (2012). Do corporate boards affect firm performance? New evidence from the financial crisis. *New Evidence from the Financial Crisis*. Bank of Finland Research Discussion Paper 11. Retrieved from https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2041194

(3) Laela, S. F. (2012). Profit quality and corporate governance: Is the quality of sharia bank profit lower than a conventional bank. *J. Akunt. dan Keuang. Indones*, 9(1), 2.

(4) Farag, H., Mallin, C., & Ow-Young, K. (2018). Corporate governance in Islamic banks: New insights for dual board structure and agency relationships. *Journal of International Financial Markets, Institutions and Money*, 54, 59-77. doi:DOI: 10.1016/j.intfin.2017.08.002

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(6) Sheikh, M. F., Shah, S. Z. A., & Akbar, S. (2018). Firm performance, corporate governance and executive compensation in Pakistan. *Applied economics*, 50(18), 2012-2027.

(7) Aslam, E., Haron, R., & Tahir, M. N. (2019). How director remuneration impacts firm performance: An empirical analysis of executive director remuneration in Pakistan. *Borsa Istanbul Review*, 19(2), 186-196.

(8) Hussien, M. E., Alam, M. M., Murad, M. W., & Wahid, A. N. (2019). The performance of Islamic banks during the 2008 global financial crisis: evidence from the Gulf cooperation council countries. *Journal of Islamic Accounting and Business Research*.

Alsartawi, writes the limitation that he used only one used dependent variable Return on Assets to measure performance so it is recommended to add more performance variables to measure the relationships.⁽¹⁾ The question that is to be answered is that is implementation of SGF effect the performance of Islamic banks in Pakistan.

Objectives

Based on the research gap at hand, the objective of the study is to check the change in financial performance of Islamic banks in pre and post implementation of *Shari'ah* governance framework. This study analyses the performance measures to check the impact of *Shari'ah* governance framework on financial performances of Islamic banks in Pakistan.

Methodology

This study uses quantitative research technique, which is deductive in nature, considers quantification in collection and analysis of data.⁽²⁾

4.1 Variables and Data Sources

To achieve the research objective Table 4.1 enlist all the variables, which are selected for data analysis, The variables include return on assets (ROA), return on equity (ROE) and Tobin's Q (TQ). The sample selected includes all Islamic banks (all five full-fledged IBIs and standalone branches of conventional banks) for the year 2011-2014 compared to the data 2016-2019 in Pakistan. The purposive sampling technique is used to select samples for both inquire for this typical case. The reason to select this period is the implementation time of SGF 2015. The aim is to check the change in pre-post implementation of SGF on financial performance of IBIs in Pakistan. Due to unavailability of data, 5 banks dropped from the list. The sample used in this research is 17 Islamic banks out of 22, which are studied over a four-year period in pre (2011-2014) and post (2016-2019) implementation of SGF which resulted in a total of 68 observations.

Table 4.1: Operationalization of variables

Variable Symbol	Definition	Measurement

(1) Alsartawi, A. M. (2019). Performance of Islamic banks: Do the frequency of *Shari'ah* supervisory board meetings and independence matter?. ISRA International Journal of Islamic Finance.

(2) Bryman, A. (2012). Social Research Methods (4 ed.). New York, USA: Oxford University Press. Retrieved from <https://www.researchgate.net/profile/post/attachment/download>

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

4.2 Estimations

The units of this study are Islamic banks and the sample used in this research is 17 Islamic banks that are studied over a four-year period in pre (2011-2014) and post (2016-2019) implementation of SGF2015 that resulted in 68 observations. This study used the financial statements of 2011-2019 to get the data and information. The financial statements are very valuable source of information to do quantitative analysis. The electronic version of annual reports is downloaded from each IBIs website.

This study used descriptive statistics and paired sample t test in line with positivistic paradigm, which excludes individual perception.⁽¹⁾Mollah et al., used paired sample t-test to check the difference in performance of Islamic banks and conventional banks. The analysis techniques are aligned with the objectives of the study.⁽²⁾

H1: There is a significant difference in financial performance of Islamic banks in pre and post implementation of *Shari'ah* governance framework.

Ho1: There is no significant difference in financial performance of Islamic banks in pre and post implementation of *Shari'ah* governance framework.

Results

5.1 Descriptive statistics

Descriptive statistics (DS) is used to observe, summarize, and describe the data in a meaningful way, which helps in confirming that the analyzed data is accurate. It is

(1) Ardalan, K. (2012). On The Role of Paradigms in Finance. Ashgate Publishing Ltd.

(2) Mollah, S., Hassan, M. K., Al Farooque, O., & Mobarek, A. (2017). The governance, risk-taking, and performance of Islamic banks. Journal of financial services research, 51(2), 195-219.

performed as the first test in data analysis. It provides details in form of mean, standard deviation (SD) and range of dependent and independent variables present in the data.

Table 5.1 and 5.2 are presenting a summary of the descriptive statistics, which include means, SD, minimum values and maximum values for the included variables in the study.

Table 5.1 presents the descriptive statistics of the data for the variables selected to see the performance of Islamic banks for post-SG. The table showed that the ROA has an average value of with 0.829 with standard deviation of 0.6. This means that the average ROA over the 4-year period for all the banks is 0.829 and having minimum value of -1.49%, which is a negative value for MCB in 2018 and maximum value of 2.7% for Standard Chartered Bank in 2019 respectively. Another dependent variable, i.e., ROE has a minimum value of -11.17% which is a negative value for BOP in 2017, and a maximum value of 30.66% in 2019 for Meezan Bank, a mean of 13.0 and a standard deviation of 7.4. For TQ the average value is 1.05 and minimum is 0.1 while the maximum is 2.67. We can observe that all variables are under dispersed as their mean value is higher than their standard deviation. It means that all the selected banks have uniformity in financial performance with reference to ROA, ROE and TQ that is a good sign.

Table 5.1 Descriptive statistics for pre Shari'ah governance framework (2011-2014)

Descriptive Statistics for Pre Shari'ah Governance Framework (2011-2014)					
Variables	Obs.	Mean	Std. Dev.	Min.	Max.
ROA	68	1.16647	0.87417	-1.47	3.18
ROE	68	14.2121	11.9315	-28.53	34.67
TQ	68	1.10838	0.55749	0.34	3.18

Table 5.2 presents the descriptive statistics of the data for the variables selected to see the performance of Islamic banks for post-SG. We can observe that all variables are under dispersed as their mean value is higher than their standard deviation. It means that all the selected banks have uniformity in financial performance with reference to ROA, ROE and TQ that is a good sign.

Table 5.2 Descriptive statistics for post shari'ah governance framework (2011-2014)

Descriptive Statistics for Post Shari'ah Governance Framework (2016-2019)					
Variables	Obs.	Mean	Std. Dev.	Min.	Max.
ROA	68	0.82882	0.60032	-1.49	2.7
ROE	68	13.0577	7.46826	-11.17	30.66
TQ	68	1.04955	0.4387	0.1	2.67

5.2 Paired Sample t-Test

Table 5.3 contains the paired samples statistics, which clearly shows that there is a difference in mean values of ROA, ROE and TQ in pre and post implementation of SGF. It can be seen that the difference is 0.33765 in ROA; 1.15441 in ROE and 0.5882 in TQ, before and after the implementation of SGF2015. Since the p-value is less than 0.05 for ROA, so we declare that there is a significant difference in ROAs of this group. Since the p-value for ROE and TQ is greater than 0.05, we conclude that there is not a significant difference in ROEs and TQs of this group.

Table 5.3 Paired Sample Statistics in Pre and Post implementation of SGF

Paired Differences								
					95% Confidence Interval of the Difference			

		Mean	Std. Deviation	Std. Error	Lower	Upper	t	df	Sig. (2-tailed)
Pair 1	ROA1-ROA2	0.34	1.03	0.12	0.088	0.59	2.7	67	.009** *
Pair 2	ROE1-ROE2	1.15	11.9	1.45	-1.74	4.05	0.8	67	0.43
Pair 3	TQ1-TQ2	0.06	0.59	0.07	-0.08	0.2	0.8	67	0.42

Table 5.4 shows the differences of each variable separately to come with clear picture of difference. Moreover, the values of SDs are less than the mean values of each variable in pre and post implementation of SGF. This shows the uniformity of Islamic banks in returns.

		Mean	Std. Deviation	Std. Error	Obs.
Pair 1	ROA1	1.166471	0.87417	0.10601	68
	ROA2	0.82882	0.60032	0.0728	68
Pair 2	ROE1	14.21206	11.93147	1.4469	68
	ROE2	13.05765	7.46826	0.90566	68
Pair 3	TQ1	1.108382	0.55749	0.06761	68
	TQ2	1.04955	0.4387	0.0532	68

Table 5.5 indicates that the correlations of ROA, ROE and TQ in pre and post implementation. As the correlation values are less than 0.5, which depicts that variables in pre and post are not strongly correlated.

		Correlation	Sig.	Obs.
Pair 1	ROA1-ROA2	0.06	0.6	68
Pair 2	ROE1-ROE2	0.31	.010**	68
Pair 3	TQ1-TQ2	0.31	.010**	68

Descriptive statistics and paired sample t test confirms there is a significant difference between financial performance of Islamic banks in pre and post implementation of SGF and supports hypothesis H1.

Conclusion and Recommendations

The number of studies are evident about the relationship of Shari'ah Governance in the literature. The present study is novel and successfully pick the phenomenon of the implementation of Shari'ah governance framework. This study explore the implementation phenomenon of SGF and check the change in financial performance of Islamic banks before and after the implementation of SGF2015.

This study confirms that there is a significant difference in financial performance of Islamic banks in pre and post implementation of Shari'ah governance framework. The analysis confirms that returns of Islamic banks decreased after the implementation of Shari'ah Governance framework. The returns and market value of the Islamic banks decreased, but if we have a close view, these results can reveal that the implementation of SGF increase the Shari'ah surveillance that ultimately increased the cost of the bank in short run. The establishment of Shariah Boards and Shari'ah Compliance Departments is one big evidence. Moreover, strict compliance reduced the business due to non-approval of number of transactions from SB. The charity is another expense of Islamic banks due to non-compliance. The results confirm that all banks are facing same trend and there is uniformity in returns. According to this study, strict compliance decreased the profitability of Islamic banks.

This study predict that in long run the Islamic banks financial performance will increase due to consistent improvement in Shari'ah compliance. The customer trust will improve due to the implementation of the SGF. This study provides the status of the Islamic banks before and after the implementation of Shari'ah governance framework. This study encourages new researchers to incorporate updated data in coming years to check the trend of financial performance in long run. Hope in long run the SGF plays its role and Islamic banks will earns handsome returns.

This study will help Islamic banks to provide to take this study as an evidence for customers that we as an Islamic banks do not compromise on Shari;ah compliance. We forgo our profits but ensure Shari'ah compliance that is the real objective of every Islamic bank. We not only provide good services but also save customers from Haram.

