

RELATIONSHIP BETWEEN SHARIAH GOVERNANCE DISCLOSURES AND ISLAMIC FINANCIAL INSTITUTIONS PERFORMANCE IN MALAYSIA

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ISLAMIC FINANCIAL INSTITUTIONS PERFORMANCE IN MALAYSIA

MOHD DANIAL AFIQ BIN KHAMAR TAZILAH

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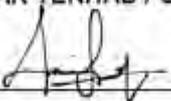
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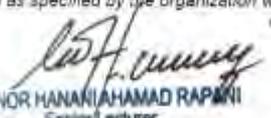
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ABSTRACT

Shariah governance framework has been established by the Bank Negara of Malaysia (BNM) to ensure an effective Shariah governance among the Islamic Financial Institutions in Malaysia. Nevertheless, since its implementation in 2010 the financial performance of the institutions is in doubt due to financial crisis and fraudulent acts that have been triggered worldwide. Hence, the confidence level of the shareholders and stakeholders towards the institutions is at stake. In addition, due to the lack of understanding of the Shariah governance requirements and unclear roles among the shareholders shall lead to poor disclosure and Shariah non-compliant issues. Therefore, this study is to identify the level of disclosure of Shariah governance characteristics, examine the relationship between Board characteristics (Board size and Non-executive directors) and the Shariah governance characteristics and disclosures (Shariah committee, Shariah committee report, Shariah board meeting, Shariah audit, Shariah review, and Shariah risk management) towards Islamic financial institutions performance using return on assets and return on equity. There are 16 Islamic banks listed in the BNM and these banks are chosen as a sample for this study for 10 consecutive years from 2010 to 2019 by reviewing the banks' annual reports. It is a longitudinal study looking at events during and after the implementation of the Shariah Governance Framework from 2010 onwards and the results of finding are being analysed using E-view software 10.0 version. Findings were found that the size of the Shariah committee, Shariah committee report, Shariah committee meeting, Shariah risk management, Board size, and non-executive directors are significantly associated with firm performance. This study shall give impacts on the policymakers such as the government and BNM, the functions of the board and committees of the banks, and theoretically on the additional literature review to ensure the Shariah governance disclosure can be further strengthened.



HUBUNGAN ANTARA PENDEDAHAN TADBIR URUS SHARIAH DAN PRESTASI INSTITUSI KEWANGAN ISLAM DI MALAYSIA

ABSTRAK

Rangka kerja tadbir urus Syariah telah diwujudkan oleh Bank Negara Malaysia untuk memastikan tadbir urus Syariah yang berkesan di kalangan Institusi Kewangan Islam di Malaysia. Walau bagaimanapun, sejak pelaksanaannya pada tahun 2010, prestasi kewangan institusi diragui kerana krisis kewangan dan tindakan penipuan yang telah tercetus di seluruh dunia. Oleh itu, tahap keyakinan para pemegang saham dan pihak berkepentingan terhadap institusi-institusi ini dipertaruhkan. Di samping itu, disebabkan kurangnya pemahaman tentang keperluan tadbir urus Syariah dan peranan yang tidak jelas dalam kalangan pemegang saham akan membawa kepada sesuatu keputusan yang tidak efektif dan juga isu-isu tidak patuh Syariah. Oleh itu, kajian ini adalah untuk mengenal pasti tahap pendedahan ciri-ciri tadbir urus Syariah, mengkaji hubungan antara ciri-ciri Lembaga pengarah (saiz Lembaga dan pengarah bukan eksekutif) dan pendedahan tadbir urus Syariah (jawatankuasa Syariah, laporan jawatankuasa Syariah, mesyuarat lembaga Syariah, audit Syariah, semakan Syariah, dan pengurusan risiko Syariah) ke arah prestasi institusi kewangan Islam menggunakan pulangan ke atas aset dan pulangan ekuiti. Terdapat 16 bank Islam yang disenaraikan di Bank Negara Malaysia dan bank-bank ini terpilih sebagai sampel untuk kajian ini selama 10 tahun berturut-turut dari 2010 hingga 2019 dengan mengkaji pendedahan tadbir urus Syariah melalui laporan tahunan bank. Ia adalah kajian membujur melihat peristiwa semasa dan selepas pelaksanaan Rangka Kerja Tadbir Urus Syariah dari tahun 2010 dan seterusnya dan hasil dapatan dianalisis menggunakan perisian E-view versi 10.0. Dapatan kajian mendapati bahawa saiz jawatankuasa Syariah, laporan jawatankuasa Syariah, mesyuarat jawatankuasa Syariah, pengurusan risiko Syariah, saiz Lembaga, dan pengarah bukan eksekutif mempunyai hubungan yang signifikan terhadap prestasi Institusi Kewangan Islam di Malaysia. Kajian ini memberi kesan kepada penggubal dasar seperti kerajaan dan Bank Negara, fungsi lembaga dan jawatankuasa bank, dan secara teorinya kajian literatur dapat ditambah baik untuk memastikan pendedahan tadbir urus Syariah dapat diperkukuhkan lagi di masa hadapan.

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LIST OF ABBREVIATIONS

AAOIFI	Accounting, and the Auditing Organisations for IFIs
BNM	Bank Negara Malaysia
BOD	Board of Director
CEO	Chief Financial Officer
DFI	Development Financial Institutions
GCC	Gulf Countries Cooperation
IASB	International Accounting Standard Board
IFIs	Islamic Financial Institutions
IIFS	Institute of Islamic Financial Services
IFSA	Islamic Financial Services Act
IFSB	Islamic Financial Standard Board
SC	Shariah Committee
SGF	Shariah Governance Framework
SGPD	Shariah Governance Policy Document
SSB	Shariah Supervisory Board
ROA	Return on Assets
ROE	Return on Equity
USD	United State Dollar



CHAPTER 1

INTRODUCTION



1.1 Introduction

This chapter provides a broad research background and overview of the study. It discusses the Shariah corporate governance and board characteristics within Malaysia's Islamic financial institution performance. Further discussion on the background, problem statement, research objectives, research questions, research hypotheses, conceptual framework, and significance of this study will be covered in this chapter. Furthermore, the structure of this thesis, summary, and conclusion will be outlined at the end of this chapter. Additionally, Chapter 2 discussed on the literature review about all variables, including the results of past studies that can be supported for this study and a conceptual framework. Meanwhile, Chapter 3





discussed on the research methodology that would explain the data collection, sampling, hypothesis development, and the measurements of the independent and dependent variables. Data collection and analysis of the descriptive, panel data, diagnostic and inferential test, as well as the hypotheses results will be covered in Chapter 4. Lastly, the discussion of results, implication of study, recommendation and conclusion will be discussed in Chapter 5.

1.2 Research background

Since the economic crisis reverberation from 1997 onwards, many private domestic or foreign banks in Malaysia were tormented by the financial performance triggered by the catastrophic impact of the Asian financial crisis among East Asian countries. Due to this crisis, many banks are indicted for being inadequately prepared to face such risks that lead to severe consequences for their financial and non-financial performance. The unprecedented amounts of losses recognised by world-leading financial institutions resulted in the spotlight issues regarding regulatory oversight, risk management, and disclosure (Mollah and Zaman, 2015). In addition, reporting and disclosure of financial and non-financial information are the main elements that need to be emphasised to ensure the organisation can sustain itself in the financial industry.

Various ways and approaches have been taken into consideration to ensure this substance can be avoided among the financial institutions, such as strict





regulations, participation of specific authority and enforcement bodies, government intervention, and policymakers.

As a result of these approaches, the world has recognised corporate governance as a mechanism that will ensure the institutions govern the operational activities more effectively and efficiently.

The implementation of sound corporate governance enables the institutions to provide better services to the shareholders and stakeholders. It is crucial that the shareholders' and stakeholders' expectations are being met to have continuous financial and strategic support for the business operations.

The Malaysian Code of Corporate Governance (2017) defines corporate governance as the process and structure used to direct and manage the business and affairs of the company towards promoting business prosperity and corporate accountability with the ultimate objective of realising long-term shareholder value while taking into account the interest of other stakeholders.

However, it is known worldwide that the nature of business activities for the conventional financial institution's system is based on interest, uncertainty, and gambling. These activities are prohibited and against Islamic teaching and belief. This conventional financial system would not be applicable for a specific industry such as the IFIs (IFIs) and among the Muslim population or society to embrace it, which is against the Shariah compliance. Hence, the IFIs would require a different set of systems that enable them to operate the business based on Shariah principles.





This institution is growing tremendously when it was first proposed worldwide by Muslim scholars (Kasim, Nu Htay & Salman, 2013). Therefore, it is crucial to have a sound governance system that can assist the Islamic institutions in complying with the rules and regulations. By having effective and efficient operating activities, the financial performance of the institutions can be further improved and eventually will affect their shareholders' and stakeholders' interests.

According to Grais and Pellegrini (2006), good governance enables the banks to enhance performance and increase the stability of financial systems, which benefit the community by contributing to people's welfare. It also covers the interest of shareholders and stakeholders who have high expectations of the performance of the institutions. Moreover, having a corporate governance system can provide detailed information, increasing the banks' operations' credibility, disclosures, accountability, and transparency.

According to Akpan (2015), corporate governance is being implemented to increase the consciousness on the significance of the need to safeguard the stakeholders' rights with the minority shareholders and promote the flow of investments, lower cost of capital, and provide strong capital markets. Further studies by Rehman and Mangla (2010) stated that improving corporate governance practices is widely recognised as one of the essential elements in strengthening the foundation for the long-term economic performance of countries and corporations. This will increase the level of confidence and trust among shareholders and





stakeholders in using the banks' products and services provided with a secured system according to Shariah's requirements.

The Islamic products and services introduced by the institutions must comply with the Shariah principles that are important to the users, especially among the Muslim community. The Shariah requires all types of *muamalat* or financial transactions to be free from interest (*riba*), uncertainty (*gharar*), gambling (*maysir*), and other prohibited activities.

The *muamalat* shall ensure the satisfaction of the human needs; any exchange of goods using the currency with third parties and business trade can be a medium to widen the Islamic teachings.



The main principle of conducting businesses in Islam is to ensure freedom for Muslims to perform any business as long as it does not contradict or against the prohibition on interest, productions involving pork products and alcohol, and dealings that contain the elements of uncertainty in term of prices and contract matters (Hanefah, Shafii, Salleh & Zakaria, 2012). This is to ensure the stability of the IFIs in providing Islamic products and services that are correctly being governed through Shariah compliance.

According to the Islamic financial services sector stability report (2015), worldwide Islamic banking assets were expected to be around USD1.56 trillion at the end of 2014, with the Middle East and a few Asian nations accounting for the majority.





This demonstrates that the worldwide Islamic banking system's stability is based on the smooth running and sustainability of institutions that adhere to Shariah rules and that Muslims' faith in the banking system is growing. Hence, the banking system, especially in Islamic financial services, is governed by strict regulations and guidelines to monitor business operations and economic activities effectively and efficiently.

Due to the emergence of the Islamic finance industry, Shariah governance guidelines have been introduced to create a financial environment free from interest or *riba* and other issues that non-compliance towards Shariah principles.

For example, charging interest payments are not allowed according to Shariah principles which only goods and services are allowed to have a price and prohibits any illicit financial activities (Beck, Kunt, & Merrouche, 2013). This would enable the Islamic banks to perform better in the future and sustain in the financial sector align with the needs of Shariah requirements and stakeholders' interests.

Nevertheless, to enhance the confidence level among the shareholders and stakeholders, solid and effective Shariah governance practices should be implemented towards the IFIs (Mahmud, AbdulKareem, Ali & Arifin, 2021). Absence of such an adequate Shariah governance mechanism, the banks shall face many serious issues such as risks due to non-compliance to the Shariah principles, risks towards organisation reputational, and loss of revenues.





Due to this matter, most countries worldwide have introduced many regulations and authorities to strengthen further the existing Shariah governance practices among the IFIs via the issuance of various references and standards.

As a result, in 2010, the Shariah Governance Framework (SGF) for IFIs in Malaysian was issued out by the BNM in overseeing the governance of Islamic banking activities. Effective in January 2011 for all IFIs authorised and supervised by BNM. These new ones have replaced the BNM/GPS1 guidelines from 2004. The fundamental goal of this framework is to improve the Board's, Shariah committees, and management's roles in Shariah matters (Hanefah et al., 2012).

This framework outlined BNM's expectations for IFIs' governance structures, processes, and activities to be Shariah-compliant, as well as the functions of Shariah review, audit, risk management, and research. It will also provide comprehensive guidance to the Board, Shariah committee, and management (BNM, 2010). This monitoring mechanism shall strengthen the banks' operations and management more effectively.

The SGF is the Islamic form of corporate governance and has specific corporate governance characteristics in the IFIs sector (Muneeza & Hassan, 2014). According to the Islamic Financial Services Board (IFSB), a Shariah governance system is a set of institutional and organisational structures.





The Institute of Islamic Financial Services (IIFS) ensures that all IFIs are subject to effective independent oversight of Shariah compliance. In addition, an influential religious board is being developed to guarantee that Shariah rules carry out shariah governance procedures among IFIs that focus on the goods and services offered to consumers (Hassan, 2014).

Further definition, as discussed by Ginena (2014), was that the Shariah governance overall is a system related to all the activities involved with commercial transactions and behaviours that align or conform to the IFIs through Shariah principles. Meanwhile, Alnasser and Muhammad (2012) mentioned that Islamic banks imposed specific requirements that deal with Islamic transactions, including the existence of a Shariah board that monitors and assures such transactions are performed in line with Shariah law. These will benefit the Muslim believers to use all sorts of Islamic banking products confidently and without any doubt related to *riba* or other non-compliance towards Shariah principles.

In the Islamic banking sector, all Islamic products and services are being introduced to the consumers in line with the Shariah-compliant. According to Beck, Kunt, and Merrouche (2013), academics and policymakers highlighted the benefits of Shariah-compliant financial products because Shariah governance allows financial products to provide on-the-spot demandable deposit contracts while avoiding long-term, uncertain loan contracts through equity and risk-sharing elements.





Furthermore, according to these writers, Shariah compatible goods are particularly appealing to sectors of the population of users who want financial services consistent with their religious convictions. As a result of its implementation, Shariah-compliant assets now account for a significant fraction of total international banking assets.

Their significance has grown dramatically in both Islamic and non-Islamic nations. Total assets held by Shariah-compliant financial institutions have risen to USD 900 billion since 2006, and this trend is projected to continue in the foreseeable future (Ariss, 2010). As a result, it demonstrates that IFIs' performance is fast improving, with a relatively large market share in numerous rising nations, particularly Malaysia.



Past studies (Maurya, Sharma, Aljebori & Arora, 2015, Bukair & Rahman, 2015; Yusoff & Alhaji, 2012; Levrau & Van den Berghe, 2007), CEO duality and board composition (Maurya et al., 2015; Bukair et al., 2015; Rashid 2009; Yusoff & Alhaji 2012) have explored and found an exciting outcome in identifying the performance of conventional banks and corporate governance in Malaysia. However, further studies that examine the performance of IFIs since the commencement of the Shariah governance framework in 2010 is still minimal.

Therefore, it is essential to identify the significance and importance of such implementation of the Shariah governance system and practices that, in line with Shariah principles compliance, would further improve the business performance of IFIs in Malaysia.





Any recommendations for future improvement can be further improvised to enhance the country's banking and finance market. This will give an opportunity to boost the country's economic condition through IFIs' performance, users' expectations, and confidence level of using the Islamic banking products that are free from interest (*riba*) and other non-compliance of Shariah principles.

IFIs and commercial banks are fundamentally different, with IFIs do not collect interest (*riba*) and prohibit the financing of specified criminal acts (Beck et al., 2013). As a result, IFIs rely on profit and loss sharing ratios on both liabilities and assets. However, there is no clear indication if IFIs should be more cost-effective or more reliable than traditional banks in terms of financial performance. Compliance with Shariah principles is necessary among the Islamic banking activities, including the operational and financial system.



A few studies have been conducted on Shariah corporate governance system disclosure since its implementation; however, studies that signify the performance of the IFIs since the inception of Shariah corporate governance in 2010 by the BNM remain unfound. The contribution of this study will further analyse the significance and importance of Shariah corporate governance that provide better insight on the literature review, which can be further improved where necessary.





1.3 Problem statement

There are many literature reviews and studies conducted on exploring the importance of corporate governance mechanisms towards firm performance. It is triggered due to the financial crisis and fraudulent cases that currently become the primary diseases among corporate organisations. It led to the failure of big corporations such as Enron, Tyco, Worldcom, Parmalat, Bearn Stearns, Baninter, HIH Insurance, etc. that eventually outcast the level of confidence and trust among stakeholders towards these corporations.

According to United States Inland Revenue Services (IRS) (2015), a banker was sentenced to 37 months in prison due to accepting \$1 million in bribes due to a poor internal control system. Furthermore, in Malaysia, the Bank Islam suffered losses of RM 2.2 billion made to South African and Sarajevo enterprises due to unanticipated provisions for non-performing loans in 2005. In the most recent event due to the COVID19 pandemic, the banking sector is estimated to suffer the Malaysian Financial Reporting Standards (MFRS) losses of RM1.06 billion for every month due to the moratorium is in place.

In total, the losses will be about RM6.4 billion, equivalent to the reduced capacity for banks to provide new loans to borrowers (Daim & Yunus, 2020). Hence, the lack of proper risk management and controls on the unexpected events shall contribute to major losses among the financial institutions. Several of these organisations are in jeopardy of existence due to the poor internal control systems and the weak governance in managing risk in the banking industry.



Based on these cases, fraudulent activities occurred among the corporate sectors and affected the financial sector, including IFIs. The IFIs will not avoid such fraudulent activities if there is an absence of proper monitoring and strict governance requirements from the relevant authorities such as the BNM and Securities Commission. Suppose this crisis happens and it is affecting the financial institutions market. This will impact not only the public but also the stakeholders, investors, and even the government itself, which has contributed a lot of funds and efforts toward developing the financial market sector.

Rosman, Wahab, and Zainol (2014) emphasised that the world economy is still suffering from the severe global financial crisis that caused the failure of several banks, including the Islamic banks. Therefore, it has been considered that the banks must have alternative financial solutions and attention that focus on the rapid growth of Islamic banking and finance. Several factors on this rapid growth such as improvement towards the regulatory and legal framework, finance interest rate free, innovation and the capacity of the industry to change, high demand Shariah compliance disclosures, and develop financial instruments that meet the needs of investors (Khediri, Charfeddine, & Youssef, 2015).

According to (Ullah, 2014), even though all Islamic banks operate in the same regulatory and economic framework, their levels of sharia compliance differ. For economic and regulatory reasons, Islamic banks may be unable to comply with some Sharia principles. Sharia compliance will necessarily impose certain constraints on Islamic business (Meutia, Adam & Wardhani, 2019).

Due to religious restraints, Islamic banks, for example, do not have an unrestricted investing scope in equities. Sharia-compliant projects are the only ones that Islamic banks may invest in (Hassan & Bashir, 2005). Even if they can earn a better rate of return, they cannot invest unless the Sharia Board approves the venture. According to (Zarrouk, Ben Jedidia, & Moualhi, 2016), offering new goods to Islamic banks is not permitted without prior approval of sharia council.

Due to these issues, the BNM has introduced the guidelines on Shariah Governance Framework (SGF) for IFIs, which became effective in January 2011 for all IFIs regulated and supervised by BNM. This new guideline has superseded the BNM/GPS1 issued in 2004. It is to strengthen the Islamic banks governance structure by providing guideline and prevention tool in mitigating fraudulent activities, non-compliance issues, and maintaining the Islamic principles and reputation among IFIs.

However, to what extent the framework has been complied with is still debatable, and several studies have been conducted to ensure the compliance of this framework is appropriately followed.

Non-compliance towards this framework will lead to poor monitoring and supervision lead to non-compliance of the framework. Furthermore, the absence of these functions will directly affect the performance and reputation of IFIs in providing services to the stakeholders.

Thus, IFIs shall lose trust and confidence among stakeholders, especially the Muslim community that entrusted the institution to manage their funds or investments according to Shariah principles.

Khan and Zahid (2020) stated that to develop more on economic sustainability and having external or exterior capital funding, effective corporate governance provides good support for the business to grow better. Further studies supported by Maurya, Sharma, Aljebori, and Arora (2015) and Khediri et al. (2015) studied the relationship between corporate governance and financial performance of banking sectors using various parameter estimation which includes a characteristic (i.e., Shariah advisory board) of Shariah governance and comparison between Islamic and conventional banks.

A further study conducted by Bashir (2012) analysed the bank characteristics with the overall financial statements, which affect the performance of Islamic banks. Rehman and Mangla (2010) studied the relationship between corporate governance and the performance of financial institutions, a comparison between conventional and Islamic banks.

Other studies discussed corporate social responsibility and financial performance (Mallin, Farag and Yong, 2014), corporate governance and profitability (Khan and Zahid, 2020), comparison between conventional and Islamic banking on the business model, efficiency and stability (Beck et al., 2013) and the comparison of performance between Islamic and conventional banks by Johnes, Izzeldin, and Pappas (2014).

Based on the Islamic financial services industry stability report (2015), the overall global Islamic banking assets will reach approximately USD1.56 trillion by the end of 2014. Based on these studies, many factors contribute to the performance of IFIs, such as operational activities, processes, and business models. However, evidence and analysis on the relationship between characteristics of Shariah governance (i.e., shariah supervisory board, audit, review or compliance, and risk management) towards performance among the IFIs mainly in Malaysia are still inconclusive and questionable. Therefore, the banks need to comply with the SGF requirements to ensure Shariah compliance and its effects on the performance of the banks.

To date, there are many literature reviews on the importance of corporate governance characteristics that have been discussed for decades. Nevertheless, detailed discussions and debates on the Shariah governance characteristics are still minimal since the inception or the implementation of this framework, especially in Malaysia, is still developing and growing. However, no specific study is conducted due to this implementation, even though it is legally binding not voluntary to IFIs.

Further study is required to identify the significance of the Shariah characteristics outlined by BNM that probably will enhance the IFIs performance in Malaysia. The stakeholders should be aware of this matter if there is any possibility that the institution would be able to perform better due to the implementation of SGF that can be further improvised to cater to the needs and expectations of stakeholders.

Furthermore, a lack of literature research and a deeper grasp of the features of Shariah governance would influence stakeholders' trust and decision-making when it comes to the functioning of IFIs. According to Ramli, Majid, Muhamed, and Yaakub (2014), Shariah governance compliance is requested by IFI clients and stakeholders and shareholders, investment firms, and Muslims who are directly or indirectly associated with the institutions. The involvement of these parties would enhance the economic growth of the Islamic banking sector in Malaysia.

Furthermore, according to this study, full adherence to Shariah principles will boost public and financial market confidence in the institutions' legitimacy, openness, and responsibility for the financial success of IFIs' activities. Moreover, Hassan (2014) stated that despite the fast rise of Islamic banks in the 1970s and the expanding presence of Islamic banking in the financial market, there is nothing written about governance structure in Islamic banking. This shows a lack of suitable governance mechanisms in monitoring the IFIs in Malaysia.

The SGF was introduced in Malaysia in early 2011 with the primary goal of ensuring excellent and robust governance among IFIs. In addition, an efficient and appropriate board of directors and the top management of the organisation play an important role in ensuring good governance in the institutions.



Besides that, supports from the internal Shariah research, an independent Shariah committee, and being monitored by an active Shariah risk management, audit, review, would further enhance the quality of the governance system among the banking sector (BNM, 2010). However, the results of a study looking at the link between Shariah governance characteristics and the performance of IFIs after its introduction are still unknown.

A focus on protecting the interests of investment account holders, Shariah compliance, governance and risk management of Mudaraba and Musharaka contracts, and the emergence of an extensive corporate governance framework, according to further discussion, will lead to an increase in the level of confidence and trust in the Islamic finance sector (Iqbal, 2001).



These can be achieved if the IFIs can maintain a sound accounting standard for Islamic financial products that align with Shariah principles, Shariah audit, and close relationship with the Shariah supervisory board. However, since as of today, there is no study conducted by looking at these elements of Shariah governance to ensure the confidence level of the users towards the performance of IFIs in Malaysia. These gaps will be an indicator for the stakeholders and shareholders' decision-making whether to invest or not to invest in the IFIs. Furthermore, a lack of study on these areas shall affect the confidence level of the stakeholders and shareholders towards the management of IFIs due to any non-compliance of Shariah principles and BNM guidelines, especially among the Muslim community and those who have trusted with Islamic products offered.



1.4 Research objectives

The primary objective of this study is to examine the relationship of the Shariah governance characteristics towards the performance of the IFIs in Malaysia. This study is to:

- 1) identify the level of disclosures on Shariah governance characteristics among the IFIs (IFIs).
- 2) examine the relationship between Shariah governance characteristics of Shariah committee, Shariah committee report, Shariah board meeting, Shariah audit, Shariah review, and Shariah risk management towards IFIs performance.
- 3) examine the relationship between the Board's characteristics (board size and non-executive directors) and the IFIs performance.

1.5 Research questions

- 1) What is the disclosure level of Shariah governance characteristics among IFIs in Malaysia?
- 2) What is the relationship between Shariah governance characteristics and the IFIs performance?
- 3) What is the relationship between Board characteristics and the IFIs' performance?

1.6 Conceptual framework

Based on the literature review in Chapter 2, a conceptual framework is developed to have an overview and relationship of overall independent variables (Shariah committee, Shariah committee report, Shariah board meeting, Shariah audit, Shariah review, Shariah risk management, Board size and Non-Executive directors) towards the performance of IFIs as the dependent variable of this study. In addition, the main theory used for this study is Agency theory and supported by Resource Dependency and Stakeholders theories. Below is the list of variables used for this study:

Table 1.1

List of variables

Independent variables

Shariah governance characteristics:

- 1) Shariah committee
- 2) Shariah committee report
- 3) Shariah board meeting,
- 4) Shariah audit
- 5) Shariah review
- 6) Shariah risk management

Board characteristics:

- 1) Board size
- 2) Non-executive directors

Dependent variables

IFIs financial performance

1.7 Research hypothesis

Chapter 3 methodology will further discuss the development of the research hypothesis to identify the possibility and the significance of each independent variable with the dependent variables. Finally, the data collected are analysed to determine the alleged relationship of the independent variables with the dependent variables using statistical software. Below are the lists of hypotheses for this study:

Table 1.2

List of hypotheses

Shariah governance characteristics	Hypotheses
	H1. The size of Shariah Committee members is significantly and positively related with IFIs' performance (ROA and ROE).
	H2. The disclosure of a Shariah Committee report is significantly and positively related with IFIs' performance (ROA and ROE).
	H3. The number of Shariah Committee meetings significantly and positively related with IFIs' performance (ROA and ROE).
	H4. The disclosure of a Shariah Audit function is significantly and positively related with IFIs' performance (ROA and ROE).

H5. The disclosure of a Shariah review function is significantly and positively related with IFIs' performance (ROA and ROE).

H6. The disclosure of a Shariah risk management function is significantly and positively related with IFIs' performance (ROA and ROE).

Board characteristics

H7. The size of board members is significantly and positively related with IFIs' performance (ROA and ROE).

H8. The proportion of non-executive directors is significantly and positively related with IFIs' performance (ROA and ROE).

1.8 Operational definition

Table 1.3

List of the operational definition

Items	Definition	Source
IFIs	Islamic financial institution” or “IFI” refers to– (a) licensed Islamic banks; (b) licensed takaful operators including professional retakaful operators; (c) licensed banks and licensed investment banks approved under section 15(1)(a) of the FSA to carry on	Shariah Governance Policy Document (2019)

Items	Definition	Source
	Islamic banking business; and (d) prescribed institutions approved under section 33B(1) of the DFIA to carry on Islamic financial business;	
Shariah committee	The Shariah committee has the responsibility to provide objective and sound advice to the IFI to ensure that its aims and operations, business, affairs and activities are in compliance with Shariah.	Shariah Governance Policy Document (2019)
Shariah committee report	Monitoring of Shariah non-compliance risks to facilitate efficient and effective management of such risks. A report on the Shariah non-compliance risks indicators shall be escalated to the board, Shariah Committee and management periodically	Shariah Governance Policy Document (2019)
Shariah board meetings	A Shariah committee member must attend at least 75% of the Shariah committee meetings held in each financial year and must not appoint another person to attend or participate in Shariah committee meetings on his behalf.	Shariah Governance Policy Document (2019)
Shariah audit	Shariah audit refers to a function that provides an independent assessment on the quality and effectiveness of the IFI's	Shariah Governance

Items	Definition	Source
	internal control, risk management systems, governance processes as well as the overall compliance of the IFI's operations, business, affairs and activities with Shariah.	Policy Document (2019)
Shariah review	Shariah review refers to a function that conducts regular assessment on the compliance of the operations, business, affairs and activities of the IFI with Shariah requirements.	Shariah Governance Policy Document (2019)
Shariah risk management	Shariah risk management refers to a function that systematically identifies, measures, monitors and reports Shariah non-compliance risks in the operations, business, affairs and activities of the IFI.	Shariah Governance Policy Document (2019)
Board size	board size is a crucial interna mechanism of corporate governance and plays a major role in firm's management.	Isik and Ince (2016).
Non-executive directors	The independence of directors on the boards that focus on the role of independent directors.	Liang, Xu, & Jiraporn, (2013).



1.9 Significance of study

It is believed that conducting this research study shall contribute towards maximising the shareholders' values, investors, the public, and other stakeholders in understanding the value of the Shariah governance characteristics as per BNM guidelines and requirements (2011) for IFIs in Malaysia. In addition, policymakers such as the BNM can rely on this study to identify the most significant vital areas for IFIs. By strengthening and monitoring the Shariah governance system in Malaysia, it will increase the public and investors' confidence level, eventually increasing the nation's economic growth in the finance sector.

Furthermore, the Board of Directors and top management of the organisation shall have a more comprehensive view of understanding the Shariah governance system and enhance their ability and skills in achieving business objectives. It is essential that the disclosure of such information on risk identification and assessment must evaluate the level of performance of the IFIs sector in ensuring the financial transactions comply with the Shariah principles.

This study may also provide the institutional investors and Board of directors with a better understanding of Shariah governance practices according to the Shariah principles and principles. Moreover, since both parties are involved in management decision-making, a better understanding of the practices will improve.





In addition, this study would benefit various parties in evaluating compliance and monitoring the effective implementation of the Shariah governance framework in ensuring the Shariah compliance is achieved within the Islamic banks' products and services. Some of the parties involve Malaysia regulatory bodies, Bursa Malaysia, Securities Commission, BNM, and other institutions related to banking sector activities.

Furthermore, the results of this study may assist these bodies to restructure and develop new frameworks and regulations where necessary with other additional disclosures needed concerning Shariah governance practices. The requirement of complying with the Shariah principles is essentially similar to the conditions within other conventional governance in the commercial sector.



This study also hopes to identify the benefits and implications of having good Shariah governance practices in ensuring the performance of IFIs, which involves the Shariah supervisory role, meetings, audit, risk management, review, independence issue, and board size.

Lastly, this study can provide some results on the achievement of Shariah governance since its implementation in Malaysia and additional literature review on the Shariah governance practices for future reference and enhancement. This will increase the level of confidence among the users, especially Muslim society, on the IFIs' performance and Shariah compliance practices.





1.10 Conclusion

Because it is founded on the Quran and the Sunnah, Shariah compliance in the financial industry will become a mandatory and inevitable requirement. Furthermore, according to the BNM a complete Shariah compliance following Shariah principles would increase stakeholders' and shareholders' trust in the dependability and integrity of Islamic finance activities and the financial industry. This shall provide a better platform for the industry to strengthen the existing governance practices in ensuring the Shariah compliance can comply strictly and efficiently.

The BNM introduced the Shariah governance framework for governing the activities of the IFIs in Malaysia. The main objective of this establishment of governance is to maximising the roles and responsibilities of the Board of directors, the participation of the Shariah Committee, and the top management towards the Shariah compliance issues.

It also includes improving the important positions responsible for carrying out Shariah compliance to achieve a Shariah-based operating environment. By having appropriate functions and roles of the Board, the performance of the organisation shall be improved either in a short or long-term period.





Although BNM issued the Shariah Governance Framework in 2010, the implementation took place in 2011 effectively. This is because it is legally binding and IFIs to adopt all requirements within their business operations and activities. However, a study on this matter should be done to identify whether such conditions in the framework have any significant relationship with the performance of IFIs.

Hence it can further increase the level of confidence and trust among the stakeholders, especially the Muslims to use any products offered by the IFIs in Malaysia, which is based on Shariah compliance. Hence, the aim of this study is to examine the relationship between Shariah governance and Board characteristics on the performance of IFIs in Malaysia.

There are five main chapters in this thesis. Chapter One contains an introduction, a research problem, research objectives, research questions, and the study's importance. The Chapter Two is devoted to the literature review, which includes an overview of past studies on Shariah governance and board characteristics such as Shariah committees, Shariah committee reports, the number of Shariah board meetings, audit, review, risk management, the board size, and non-executive directors, as well as their impact on the performance of IFIs in Malaysia. This chapter also explains the theoretical model utilised to create the hypotheses.



The variables measurement, hypothesis generation and research technique utilised in this study are discussed in Chapter Three, including data collection, sample selection, data testing and analysis and the research model employed in statistical data analysis using E-views software. The findings and results of the data analysis such as descriptive, normality test, diagnostic tests and regression are presented in Chapter Four. Finally, Chapter five offers the conclusion and discussion of this study which outline the findings, shortcomings, and recommendations for future studies.