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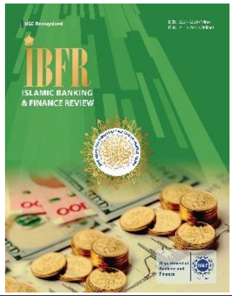

Title:	**Impact of *Shariah* Compliance on Financial Performance of Islamic Banks: Evidence from Pakistan**
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Impact of *Shariah* Compliance on Financial Performance of Islamic Banks: Evidence from Pakistan

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Abstract

Despite the remarkable growth of the Islamic banking industry over the past few decades, its *Shariah* legitimacy is still debated. In this regard, most of the pronouncements of *Shariah* scholars are deduced from secondary sources of Islamic jurisprudence which are open to diverse interpretations. In general, the well-known Islamic legal maxim "*Al-Kharaj bil Dhaman*" suggests that each *Shariah* compliant business should be exposed to some kind of risk. Arguably, while pursuing the goal of profit maximization, Islamic banks offer such risk free modes of financing that undermine their *Shariah* legitimacy. In this context, some studies explored the relationship between *Shariah* compliance and profitability. These studies mostly reported mixed findings because they measured *Shariah* compliance using irrelevant or limited proxies. In light of these findings, the purpose of the current study was to revisit this relationship by applying a more comprehensive proxy to measure *Shariah* compliance of Islamic banks. To this end, it analyzed unbalanced panel data extracted from the annual reports (2008-2020) of five full-fledged Islamic banks operating in Pakistan. Applying the robust fixed effect model, it found a significant positive relationship between *Shariah* compliance and financial performance, suggesting that better *Shariah* compliance leads to improved financial performance.

Keywords: Islamic financial products, *Maqasid al-Shariah*, *Shariah* compliance

JEL Classification: A13, C43, G21, M14, Z12

Introduction

Islamic banking was introduced as an alternative to conventional banking with the basic requirement of *Shariah* compliance in all its services and

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products. The notion of ethical banking was first introduced in 1940s; however, the pioneer effort of establishing an Islamic bank was made in 1963 when Naseer Social Bank was developed in Egypt (Haridan et al., 2018). In Pakistan, efforts for the Islamization of the financial system commenced in 1970s. During the 1980s, financial framework was revised from a legal perspective to facilitate the issuance of interest-free financial instruments and to constitute *Mudaraba* companies. In 2001, State Bank of Pakistan (SBP) introduced a criteria regarding the establishment of full-fledged Islamic banks. Subsequently, in 2002, SBP issued license to Al-Meezan Investment Bank, allowing it to commence its operations as the first full-fledged Islamic bank in the country[1]. At present, the Islamic banking industry comprises 5 full-fledged Islamic banks and 17 standalone branches of conventional banks. The market share of these Islamic banking institutions is registered at 17% in terms of assets and 18.5% in terms of deposits (State Bank of Pakistan, 2021).

Despite the remarkable growth of Islamic banking and finance in the country, the *Shariah* legitimacy of Islamic banks has been constantly debated since the beginning. *Shariah* legitimacy refers to compliance with Islamic law; however, from the perspective of Islamic banks it can be defined as "the compliance of operations and activities with the precepts of *Shariah* in terms of the pronouncements and their implementation, requisites of various contracts, as well as, fulfillment of the welfare objectives" (Khaleequzzaman et al., 2016). The primary sources of Islamic jurisprudence (the Quran and *Sunnah*) provide broad guidelines regarding financial transactions. Accordingly, most verdicts of the *Shariah* scholars are derived from secondary sources of Islamic jurisprudence that include *Ijtihad* (legal reasoning), *Qiyas* (analogical reasoning), *Istihsan* (juristic preferences), *Maslahah* (unrestricted public interest), and *Urf* (customary practice). This fact implicates that Islamic financial products and services cannot be standardized due to varied *Shariah* interpretations. Accordingly, there is no objective approach to evaluate the *Shariah* compliance of the products and services offered by Islamic banks (Moqbel & Ahmed, 2020).

Nevertheless, a significant number of *Shariah* scholars opine that all the business of Islamic banks should be exposed to business risk, as required by the well-known Islamic legal maxim "*Al-Khraj bil Dhaman* (any benefits

[1] https://www.sbp.org.pk/ibd/faqs.pdf (Downloaded on February 20, 2022)

derived from a transaction must be accompanied with the liability arising from a potential loss)". It has been argued that this maxim is violated in many financial products and services offered by Islamic banks. In general, exposure to price risk and market risk differentiate profit-based trading from interest-based lending. Price risk identifies that the sale contract may not cover the associated cost, whereas market risk specifies that commodities may remain unsold. However, in many financial transactions, Islamic banks are not exposed to these risks (Shaikh, 2013).

Murabaha is an example of such transactions in which Islamic banks are not exposed to price and market risks. In its original form, *Murabaha* is a "cost plus profit" sale, where the seller reveals the acquisition cost of goods to the purchaser and the contracting parties bargain over the profit margin. Thus, *Murabaha* is just a type of sale and not a mode of financing. However, Islamic banks use *Murabaha* as a mode of financing and execute it accordingly. Firstly, the client requests the bank to purchase a commodity he needs and the bank sells it to him on a deferred payment basis. After an initial assessment of the client, the bank accepts his request. Both parties make an agreement that specifies the details regarding the purchase and sale of the commodity as well as the profit margin of the bank. The bank appoints the client as its agent and allows him to purchase the commodity and takes its possession on its behalf. Then, the bank makes the payment to the supplier. Later, the client makes an offer to the bank to purchase the commodity. Accepting this offer, the bank sells the commodity to the client. Afterwards, the client makes the payment to the bank on a deferred basis.

Renowned Islamic scholar, Mufti Taqi Usmani, expressed his view regarding *Murabaha* in these words:

> It should never be overlooked that, originally, *Murabaha* is not a mode of financing. It is only a device to escape from 'interest' and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where *Muḍarabah* or *Musharakah* are not practicable. (Taqi, 2002; p. 72)

Nouman et al. (2018) also asserted that the participatory modes of financing constitute the essence of the Islamic financial system. Accordingly, non-participatory trade-based modes of financing should only be applied in situations where participatory modes of financing are not applicable. Avoiding trade-based modes of financing is justifiable as their impact on the economy is the same as that of their conventional counterparts, especially when earned profits are related to some conventional (interest-based) benchmarks.

Nevertheless, *Murabaha* remains the third largest mode of financing (after *Musharakah* and diminishing *Musharakah*) currently used in the Islamic banking industry of Pakistan (as shown in Table 1). This undermines the *Shariah* legitimacy of Islamic banks. Accordingly, some *Shariah* scholars have declared that Islamic banks are not *Shariah* compliant (Mansoori, 2011).

Table 1

Islamic Banking Industry - Mode Wise Financing

Mode	2017	2018	2019	2020	2021
Murabaha	17%	13.4%	13.5%	13.4%	15.3%
Ijarah	6.8%	6.6%	6.1%	4.9%	4.8%
Musharakah	17.9%	20.0%	20.0%	24.8%	21.4%
Diminishing *Musharakah*	29.6%	33.7%	33.6%	34.2%	35.0%
Salam	5.2%	2.8%	2.6%	2.4%	2.1%
Istisna	7.2%	6.4%	8.9%	8.9%	7.6%
Others	16.3%	17.1%	15.3%	11.3%	13.8%
Total	100%	100%	100%	100%	100%

Source: SBP Islamic Banking Bulletins (June 2017-June 2021)

Some scholars assert that *Shariah* legitimacy of different financial products should be validated considering their role in the realization of *Maqasid al-Shariah,* that is, the objectives of Islamic legislation (Ayub, 2018). In the context of financial transactions, these objectives include "circulation of wealth, transparency and justice" (Laldin & Furqani, 2013). Accordingly, some studies developed *Maqasid al-Shariah* based indices to assess the *Maqasid* oriented performance of Islamic banks and reported unsatisfactory results (Javed et al., 2020). This finding implicates that the impact of the financial transactions of Islamic banks is the same as that of their conventional equivalents. Resultantly, there is a need to determine such tactics that can motivate the top management of Islamic banks to improve their *Shariah* compliance, so that they can differentiate themselves from conventional banks. Hence, the objective of the current study is to examine the influence of *Shariah* compliance on financial performance, since better *Shariah* compliance may lead to superior financial performance which subsequently increases shareholders' wealth.

Literature Review

"As per the Islamic worldview, humankind is the vicegerent of Allah Almighty on earth. Being His vicegerent, it is our religious obligation to consume the entrusted resources for the benefit of the whole society" (Quran 2:30). Some ethical theories also support this notion. For example, the Distributive Justice Model asserts that decision-making should be based on justifiable distribution of entrusted resources. Similarly, the External Law Model advocates that ethical decision-making should be based on the directions given by the Holy Scriptures (Fallon & Butterfield, 2005). Indeed, the acquisition of wealth through permissible means and its justified utilization brings Divine blessing, that is, an unexplainable increase in the benefits of the assigned resources (Al-Asfahani, 1961). It implicates that adherence to *Shariah* brings prosperity. Hence, *Shariah* compliance is assumed to have a positive relationship with profitability.

Abundant literature is available that explores the influence of social performance on the financial performance of Islamic banks, as engagement in social activities enhances the legitimacy of Islamic banks (Jahja et al., 2021). However, there are only a few empirical studies available that examine the influence of *Shariah* compliance on financial performance. The findings of these studies are summarized below.

Arshad et al. (2012) explored the influence of "Islamic corporate social responsibility disclosures" on the financial performance of Islamic banks operating in Malaysia. They analyzed three-year data (2008-2010) and concluded that stated disclosures positively impact not only the financial performance of banks but also improve their reputation. Similar results were found by Iqbal et al. (2013). They measured corporate social responsibility disclosures based on three dimensions, namely health, education, and donation. Likewise, Zaki et al. (2014) examined the influence of ethical reporting on the financial performance of 7 Asian Islamic banks for a five-year period (2006-2010). They reported that financial performance is negatively associated with *Shariah* board and *Zakah* performance. On the contrary, after examining the data of 9 Islamic banks operating in Indonesia, Firman et al. (2016) reported positive impact of *Qardh hassana* and *Zakah* on financial performance.

Fahlevi et al. (2017) examined the influence of *Shariah* compliance on financial performance using three-year data (2011-20013) of 18 Islamic banks operating in Malaysia and Indonesia. They measured *Sharia*h compliance using the *Shariah* conformity model which is based on three items, namely Islamic income, Islamic investment, and profit-sharing ratio. Their study revealed a negative relationship between *Shariah* compliance and profitability. Contrastively, Akguc and Rahahleh (2018) compared the operating performance of *Shariah* compliant firms and non-*Shariah* compliant firms. Examining the data taken from the listed firms in GCC countries for a fifteen-year (2000-2014) period, they concluded that *Shariah* compliant firms have a higher operating profit margin and better asset turnover than non-*Shariah* compliant firms. Likewise, Kholidah (2018) also analyzed the influence of the social performance of Islamic banks on their profitability. He measured social performance by constructing an index based on *Muḍarabah* and *Musharakah* financing, *Zakah* ratio, and *Qard* financing. The results revealed that composite index and *Zakah* dimension impact financial performance positively.

Sutrisno and Widarjono (2018) explored the impact of *Shariah* legitimacy on financial performance based on the data from 13 Indonesian banks for a five-year (2012-2016) period. The authors used three proxies to measure *Shariah* legitimacy, namely *Musharakah* financing ratio, *Muḍarabah* financing ratio, and *Maqasid al-Shariah* index. The study concluded that *Musharakah* financing positively affects financial performance, whereas *Muḍarabah* financing negatively affects financial performance. However, it failed to observe any significant relationship between *Maqasid* index and financial performance. Similarly, Nasution et al. (2018) assessed the influence of *Shariah* compliance on financial performance using several proxies including profit sharing ratio, Islamic income ratio, and *Zakat* performance ratio to measure *Shariah* legitimacy.

The results revealed that profit sharing ratio has a significant positive relationship with profitability, while *Zakat* performance ratio has a significant negative relationship with it. However, Islamic income ratio is not associated with financial performance. Likewise, Hamsyi (2019) examined the relationship between *Sharia* compliance and profitability based on the data collected from 9 Indonesian banks for a five-year (2012-2016) period. He measured *Shariah* compliance using two proxies, namely profit sharing ratio and Islamic income ratio, while profitability was measured as return on equity (ROE). The results revealed that *Shariah* compliance has a significant relationship with profitability when it is measured via the Islamic income ratio. However, the two variables have no significant relationship when *Shariah* compliance is measured via the profit sharing ratio. In a recent study, Ahmed et al. (2021) investigated the effect of *Shariah* compliance on customer satisfaction using primary data taken from 334 customers of Islamic banks operating in Bangladesh. They found a significant positive influence of *Shariah* compliance on customer satisfaction and also revealed the mediating role of service quality in this relationship. The mixed findings of the above mentioned studies highlight the inconclusive and often contradictory results regarding the relationship between *Shariah* compliance and financial performance. The application of different proxies (with limited scope) to measure *Shariah* compliance is the main reason behind this contradiction. Keeping in view the said contradiction, the current study contributes to the existing literature by using a more comprehensive proxy to measure *Shariah* compliance.

The current study develops the following hypothesis based on the above literature review.

H1: *Shariah* compliance positively affects the financial performance of Islamic banks.

Research Methodology

Population and Sample

There are five full-fledged Islamic banks operating in Pakistan and these banks comprise the sample of the current study. Unbalanced panel data from 2002 to 2020 was used for analysis. The data set for each variable comprised 57 observations. Islamic branches of conventional banks were excluded for a more vivid analysis, following some earlier studies (Zaheer & Rasool, 2017). Resultantly, the current study is based on a small dataset. Some similar studies also used a small data set for data analysis (Hussain et al., 2021).

Model

The current study used the following empirical model to analyze the impact of *Shariah* compliance on the financial performance of Islamic banks.

$ROAA_{it} = f\,(ShComp_{it}, CV_{it})$

Where

$ROAA_{it}$ = Return on Average Asset of Bank i in year t

$ShComp_{it}$ = *Shariah* Compliance of Bank i in year t

CV_{it} = Control Variables of Bank i in year t

Variables

Dependent Variable

The dependent variable of the current study was the financial performance of Islamic banks. Existing literature measures financial performance using different proxies that include both market-based measures and accounting-based measures. Since the sampled banks of the current study are not listed on the stock exchange, market-based measures cannot be applied to measure financial performance. Among accounting-based measures, return on average asset (ROAA) and return on equity (ROE) constitute the most frequently used measures in prior literature. Arguably, ROAA is a better measure than ROE, since ROE does not take into account the higher risk associated with higher leverage (Dietrich & Wanzenried, 2011). Therefore, the current study used ROAA to measure financial performance following Platonova et al. (2016).

Independent Variable

Shariah compliance was the independent variable of the current study. It has been measured in the existing literature using different proxies. For example, Sutrisno and Widarjono (2018) measured *Shariah* compliance using *Musharakah* and *Muḍarabah* financing, while Nasution et al. (2018) measured *Shariah* compliance using *Zakat* to total assets ratio. Similarly, Hamsyi (2019) measured *Shariah* compliance using Islamic income ratio, whereas Javed et al. (2020) measured it as the ratio of non-controversial mode of financing to total financing.

All of these proxies have their own limitations. For example, measuring *Shariah* compliance on the basis of *Musharakah* and *Muḍarabah* financing ignores other *Shariah* compliant modes of financing. Similarly, *Zakat* to total assets ratio and Islamic income ratio reduce the scope of *Shariah* legitimacy.

Therefore, the current study measured the *Shariah* compliance of different products and services of Islamic banks using weights assigned by Ayub (2018) to these products based on their role in the realization of *Maqasid al-Shariah*. Following Javed et al. (2020), the current study considered only those modes and products that have more than 50% weightage, as shown in Table 2.

Table 2

Modes and Products and their Suggested Weightages

Modes	Weights (out of 100)
Musharakah	95
Muḍarabah	95
Shariah Compliant Stocks	90
Musawamah	70
Salam	80
Istisna	70
Ijarah	70
Al-Tijarah	60
Qard al-Hasan	100

Source: Ayub (2018)

Considering the above weights, the current study measured *Shariah* compliance as follows:

Shariah Compliance = $\sum P_{it} W$

where

P_{it} = Percentage of the given mode of financing to total financing of bank i in year t

W = Weight assigned to the given mode of financing (shown in Table 1)

Control Variable

Some control variables were also used following the recommendations of prior studies. These variables included operating expense ratio, capital ratio, capital intensity, and liquidity risk. The study measured operating expense ratio as “total non-current expense to average total assets”, following Panayiotis et al. (2008). Capital ratio was measured as “equity capital to average total assets”, while capital intensity was measured as “fixed asset to total assets”, following Platonova et al. (2016). Liquidity risk was measured as “total financing to total assets”, following Sutrisno and Widarjono (2018).

Data Analysis

Descriptive Statistics

Table 3 shows the descriptive statistics related to different variables of the current study. The highest and the lowest value of ROAA are 0.0191 and -0.0311, respectively. The mean is reported at 0.0027 and standard deviation is registered at 0.0099. The value of standard deviation is higher than the value of mean due to over dispersion in ROAA, indicating that ROAA did not follow a like pattern across the selected banks during the study period. The underlying reason was that *Al-Baraka* bank and Dubai Islamic bank suffered losses in certain years, whereas other banks reported profits in the same years.

In case of the independent variable, that is, *Shariah* compliance, the value of mean is higher than the value of standard deviation. It indicates that the data for this variable followed a similar pattern throughout the study period (2008-2020). It can be inferred that reliance on *Shariah* compliant products and services by all Islamic banks operating in Pakistan is reducing. In other words, Islamic banks offer risk free modes of financing, instead of loss sharing modes of financing. Similarly, the mean value of all control variables is also higher than their respective standard deviation, indicating that the data of all these variables followed a similar pattern throughout the study period.

Table 3
Descriptive Statistics

Variables	*N*	Mean	Std. Dev.	Min	Max
ROAA	57	0.0027	0.0099	-0.0311	0.0191
ShComp	57	0.4402	0.1951	0.0471	0.9986
CapRato	57	0.1098	0.0806	0.0469	0.5309
OprExp	57	0.0387	0.0129	0.0229	0.0791
LiqRsk	57	0.5245	0.2059	0.0063	0.8474
CapInt	57	0.0332	0.0210	0.0060	0.1001

Diagnostics Tests

Various diagnostic statistical tests were applied to assess the validity of data for regression analysis. Pearson correlation matrix was applied to examine the issue of multicollinearity in the extracted data. Wooldridge test was used to assess autocorrelation, while Modified Wald test was used to examine heteroscedasticity. Moreover, Hausman tests was used to make the selection between fixed and random effect models. Since the number of observations was more than 30, the current study assumed normal distribution of data following the central limit theorem (Gravetter et al., 2020).

Table 4 exhibits the results of Pearson correlation matrix. All the values of correlation matrix are below 0.8, which indicates that multicollinearity does not exist in the data (Gujarati, 2009).

Table 4
Pearson Correlation Matrix

Variables	ROAA	ShComp	CapRato	OprExp	LiqRsk	CapInt
ROAA	1.000					
ShComp	0.5186	1.000				
CapRato	-0.4259	-0.4002	1.000			
OprExp	-0.6383	-0.3378	0.7413	1.000		
LiqRsk	0.0854	0.3234	-0.2669	-0.0681	1.000	
CapInt	-0.6903	-0.5725	0.7467	0.7828	-0.2124	1.000

Hausman test (probability= 0.000) recommends the use of the fixed effect model. Modified Wald test (probability = 0.000) indicates that the issue of heteroscedasticity exists in the data. This issue is managed by using the robust fixed effect model, following earlier studies (Hussain et al., 2021). Wooldridge test (probability = 0.2923) confirms that autocorrelation does not exist in the data.

Results and Discussion

The results of the robust fixed effect model are shown in Table 5. The value of R^2 indicates that the model explains 62.7% disparity in ROAA. The p-value (0.024) suggests that the relationship between ROAA and *Shariah* compliance is significant. The coefficient value (0.0141) of *Shariah* compliance indicates that ROAA increases by 1.4% if *Shariah* compliance increases by one unit. These results prove the hypothesis of the current study, that is, better *Shariah* compliance increases profitability. Additionally, these results are consistent with the good management theory and social impact hypothesis, which suggest that better social performance leads to superior financial performance.

The above findings also show that ROAA has a significant positive relationship with capital ratio, confirming that banks with a high capital ratio can efficiently avail commercial opportunities. Conversely, the results also confirm a significant negative relationship between ROAA and operating expenses. Likewise, the study also found a significant negative relationship between financial performance and liquidity risk, since liquidity risk constrains Islamic banks from availing other financing opportunities. These results are consistent with prior studies (Platonova et al., 2016). However, the current study failed to identify any significant relationship of ROAA with capital intensity.

Table 5

Robust Fixed Effect Model Considering ROAA as Dependent Variable

	Coefficient	*t*-Values	*p*-Values
ShComp	0.0141	3.53	0.024
CapRato	0.0499	4.76	0.009
OprExp	-0.4098	-4.51	0.011
LiqRsk	-0.0167	-2.15	0.098
CapInt	-0.0289	-0.22	0.834
Constant	-1.0398	-1.58	0.189

	Coefficient	*t*-Values	*p*-Values
Model Significance		14.11	0.000
R^2			0.627

Conclusion

Shariah legitimacy of Islamic banks is a hotly debated issue despite the rapid growth of the Islamic banking industry. Most of the verdicts of *Shariah* scholars regarding *Shariah* compliance of Islamic financial products are derived from the secondary sources of Islamic jurisprudence. In general, all Islamic banking products and services should be exposed to price and market risks and should play a significant role in realizing *Maqasid al-Shariah*. However, it has been argued that Islamic banks do not expose themselves to business risk while executing certain business transactions. Additionally, their role in realizing *Maqasid al-Shariah* is also unsatisfactory. Consequently, there is a need to find out such tactics that can motivate the top management of Islamic banks to improve their *Shariah* compliant status.

In this context, the current study examined the relationship between *Shariah* compliance and financial performance. It regressed financial performance on *Shariah* compliance after controlling operation expense ratio, capital ratio, capital intensity, and liquidity risk. It also analyzed the unbalanced panel data extracted from the annual reports of full-fledged Islamic banks for the period 2008-2020. A significant positive impact of *Shariah* compliance on financial performance was determined by applying a robust fixed effect model. Therefore, the study suggests that Islamic banks should improve their *Shariah* compliant status as it leads to better financial results.

Policy Implications

The current study evaluated the impact of *Shariah* compliance on financial performance by using a better proxy to measure *Shariah* compliance, as compared to previous studies. The findings suggest that Islamic banks should increase their reliance on *Shariah* compliant products and services. It will help them to distinguish themselves from conventional banks. Additionally, enhanced *Shariah* compliant services will also result in better profitability. Furthermore, the study recommends that the regulators of Islamic financial institutions should play their role in promoting profit and loss sharing modes of financing.

Future Direction

The current study evaluated the relationship between *Shariah* compliance and profitability using a small dataset extracted from the annual reports of five Islamic banks operating in Pakistan. Future studies can revisit this relationship using a larger data set, preferably incorporating the data of Islamic branches of conventional banks as well.

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