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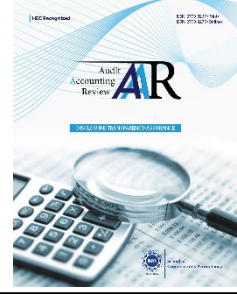
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Impact of Partnership Based and Non-Partnership Based Shariah Complaint Products on the Financial Performance of Islamic Banks

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Abstract

The present study evaluates the impact of *Shariah* compliance on profitability. By applying the fixed effect model, this study examines the impact of investment in partnership-based and non-partnership-based modes of financing on the financial performance of Islamic banks. Unbalanced panel data has been extracted from the financial reports (2008-2021) of all full-fledged Islamic banks operating in Pakistan. Shariah compliance is measured using two self-constructed proxies following experts' survey; whereas financial performance is calculated as "net income to average total assets". The study finds that investment in partnership-based modes of financing had a positive association with financial performance. However, the study fails to find any association between investments in non-partnership-based modes of financing and financial performance of Islamic banks. Moreover, the study recommends that Islamic banks should increase their investment in partnership-based mode of financings as it will increase their profitability and improve their public image of being 'Islamic'.

Keywords: financial performance, fixed effect model, financial banks Islamic banks, *Shariah* compliance

JEL Classification: C43, G21, Z12

Introduction

Shariah refers to that part of Islamic law, which is revealed and known as the primary source of Islamic law. These primary sources include the Holy Quran and the Sunnah (recited and non-recited revelations). Along with these primary sources, there are some other sources, which are derived through *Ijtihad*. *Ijtihad* is the process of reasoning by a *Shariah* scholar to develop Islamic legislation related to a new issue, while ensuring the true essence of *Shariah* and by applying other legitimate sources (Moqbel & Ahmed, 2021). These other legitimate sources can be further classified into

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secondary sources and tertiary sources. The secondary sources are *ijma* (unanimous agreement) and *qiyaas* (analogy); whereas tertiary sources include additional tools like *isthisaaan* (juristic preference), *istishaab* (presumption of continuity), and *maslahah* (unrestricted interest). The main difference between these two sources is that all major *fiqhi* (jurisprudential) schools recognize the application of secondary sources; however, they are not unanimous in the application of tertiary sources. For example, *Hanfi* School allows the application of *isthisaaan* (juristic preference); whereas *Shafi* School strictly prohibit it. This infers that *Shariah* compliance cannot be measured objectively (Moqbel & Ahmed, [2021](#)).

In the context of Islamic finance, *Shariah* compliance is described 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](#)). Therefore, *Shariah* compliance framework can be considered as a benchmark, which provides assurance regarding the *Shariah* legitimacy of financial products offered by Islamic banks. In other words, the *Shariah* compliance framework assists Islamic banks to differentiate themselves from their other conventional equivalents.

After its modest start in 1970, the Islamic banking industry has evolved globally. This rapid development can be considered as a success story; however, many experts opined that this dramatic growth was not a natural progress, which raised many questions regarding the legitimacy of Islamic financial products. This subjective criticism is based on the notion that instead of innovating new products, Islamic banks replicated conventional product and overlooked the social-economic values of the Islamic law in its true spirit.

Conversely, it was argued that in the absence of ‘Islamic financial structure’, Muslim financial practitioners had to reluctantly rely on the conventional structure by adopting ‘replication approach’ (Laldin & Furqani, [2016](#)). The ‘replication approach’ was adopted for two major reasons. Firstly, the functions of financial intermediaries and associated problems were similar in both Islamic and secular economies. Secondly, both Islamic and conventional finance were sharing the same financial market. Consequently, Islamic banks had to compete conventional banks to attract customers. Therefore, Islamic finance practitioners had to replicate conventional products and align profit rates to some conventional

benchmarks to compete in the financial market. Contextually, the structuring of Islamic financial products was limited towards the transformation of conventional products, which occurred only by meeting minimum Islamic legal requirements (Saeed, [2004](#)).

The financial products offered by the Islamic banks are mainly classified into two groups, namely , partnership-based products and non-partnership-based modes (Tegambwage & Kasoga, [2023](#)). The partnership-based products were developed by applying the concepts of *Musharakah* and *Muḍarabah*. Non-partnership-based modes were further divided into Trade-based products and leased-based products. Trade-based modes are based on the notions of *Murabaha*, *Istisna*, and *Salam*. The leased-based products were based on the Shariah concept of *Ijarah* (renting).

The partnership-based products are the spirit of Islamic finance as they ensure the sharing of both risk and reward by the contracting parties. However, trade-based products and leased-based products do not differ from their conventional alternatives, considering their economic substance, therefore, should only be used when *Shariah* compliant alternatives are not available (Hanif, [2018](#)). Kalim and Arshed ([2018](#)) argued that the dependency on trade-based modes of financing would decrease the deposit returns of Islamic banks. The main criticism on trade-based and leased-based products is that Islamic banks are not expose to any kind of business risk, while offering such trade-based financing. Consequently, they failed to meet the key requirement of the Islamic law that stated “any benefits derived from a transaction must be accompanied with the liability arising from a potential loss.” This undermined the Shariah legitimacy of these non-partnership based mode of financing (Javed et al., [2022](#)).

Nevertheless, as per Islamic Banking Bulletin by State Bank of Pakistan (September 2022), more than 85% of the financial products of Islamic banks are trade-based. According to this report, diminishing *Musharakah* is the most frequently used mode of financing, which is offered for non-current asset financing such as auto, plant, and house financings (Javed et al., [2015](#)). Diminishing *Musharakah* is a combination of three separate contracts, namely *Musharakah* (partnership), *Ijarah* (leasing), and *bay'* (sale). The sequence of the transactions is as follows. Firstly, partnership contract is executed where the customer and the bank jointly purchase a particular asset. Second, *Ijarah* contract is executed where the bank gives units of its share to the customer on rent. Lastly, sale contract is executed where the

customer gradually purchased the units of the bank's share; accordingly, the rent starts decreasing (Hassan, [2020](#)). *Shariah* require that all contracts should be independent of each other (Ayub, [2007](#)). However, arguably it was claimed that Islamic banks violate this requirement and negotiate these three contracts in one deal (Shaikh, [2023](#)).

Similarly, *Murabahah* is a type of sale where the seller discloses purchasing cost of the product to the buyer and profit margin is decided through bargain. However, Islamic banks execute this type of sale as a mode of financing. The customer approaches the bank to purchase a certain commodity. The bank appoints the customer as its agent and assign him a duty to purchase the required commodity on bank's behalf, whereas the bank directly makes the payment to the seller. Later, the customer purchases the commodity from the bank on cost plus profit and makes deferred payment. Thus, the bank never takes even the constructive procession of the commodity and does not expose to any type of trading risk; consequently, the transaction becomes invalid. Furthermore, some Islamic banks offer *Murabahah* financing for the payment of operating expense, which is also unacceptable as no acquisition of commodity involves such transactions (Usmani, [2021](#)).

Likewise, *Salam* is a type of sale contract where payment of the commodity is received in full at spot but goods are delivered at some specified future date. Thus, the *Salam* can be used as a mode of financing especially for agriculture sector. The Islamic banks provide financing as a cash price for goods to be produced and delivered in future at some lower rate as compared to the rate of those goods delivered on spot. The difference between two prices is a legitimate profit for Islamic banks. Later, Islamic banks sell the purchased commodity to a third party through a contract of parallel *Salam*. However, sometimes bank sell back the same commodity to the original seller even before taking the delivery of goods through a pre-arranged sale back contract. This practice is against the dictates of *Shariah* (Waluyo & Rozza, [2020](#)).

Similarly, *Ijarah* is originally a contract of transferring the usufruct of some asset to another person for an agreed rent and for a specified period. However, most Islamic banks use this rental contract as a long-term mode of financing and link the rental rate to some conventional benchmark. This arrangement of *Ijarah* is identical to conventional financial lease. Moreover, in *Ijarah* contract, many other *Shariah* requirements are also overlooked.

For example, being the owner of the leased asset, it is the bank's responsibility to bear *takaful* (Islamic insurance) expenses. However, in practice, Islamic banks (lessor) recover these expenses from the customer (lessee), which is questionable. Likewise, as per Islamic law, lessee can be responsible for the loss incurred due to his negligence and cannot be responsible for the loss incurred by any unavoidable circumstances. However, in practice, both situations are not considered separately and lessee has to bear all types of expenses (Saleem et al., [2022](#)).

Usmani ([2021](#)) argued that one of the main differences between conventional and Islamic banks is that profit maximization is not a sole objective of Islamic banks. In fact, as per Islamic ideologies, business transaction is related to the ethical objective of the prosperity of the society. This ethical objective can be achieved by realizing *Maqasid al-Shariah* (rationale behind *Shariah* ruling). In other words, financial products offered by Islamic banks cannot be considered *Shariah* compliant unless these products have a role in achieving the *Maqasid al-Shariah*. In the context of Islamic finance, these *Maqasid al-Shariah* requires "circulation of wealth, transparency, and justice" (Laldin & Furqani, [2013](#)). Circulation of wealth ensures that wealth is not accumulated in a few hands (Quran 6:141). Transparency ensures that contracting parties are well aware of all the details of the contract (Quran 2: 282). Justice ensures that all individuals have equal opportunities (Quran 2:188).

However, prior empirical studies reported that Islamic banks failed to realize the above stated *Maqasid al-Shariah* due to their reliance on the controversial financial products. (Javed et al., [2020](#); Javed & Kalim et al., [2022](#)). Therefore, Islamic banks are required to improve their *Shariah* compliant rating to differentiate themselves from other conventional banks in true spirit. In this context, to encourage the top management of Islamic banks, this study evaluated the impact of *Shariah* compliance on financial performance, as better *Shariah* compliance may lead to better financial performance.

This research is sub-categorized as follows: section 2 summarizes the existing literature, section 3 describes the research methodology deployed for this study, section 4 explains the findings of the study, and section 5 concludes the overall research.

Literature Review

The premise of the association between *Shariah* compliance and profitability is based on the concept of Islamic worldview, which considers each person as Allah's vicegerent who has been bestowed with resources to be consumed for the benefit of the whole society. The fulfillment of this obligation brings Divine blessing, which can be defined as an increase in the benefits of the entrusted resources. It infers that compliance to Divine ruling or *Shariah* compliance increase utility and profitability (Javed & Bukhari et al., [2022](#))

In the context of the objective selected for the current study, the existing literature can be classified into two groups. The first group observes the impact of *Shariah* compliance on customers' behaviour, and the second examines the effect of *Shariah* compliance on the financial performance and profitability of Islamic banks as discussed below.

Impact of *Shariah* Compliance on Customers' Behaviour

A large number of studies have concluded that *Shariah* compliance has a positive impact on the customers' satisfaction (Okumus, [2015](#); Ongera & Ndede, [2019](#)). However, some studies identified various mediators and moderators that influence this relationship. For example, Suhartanto et al. ([2018](#)) claimed that the positive impact of religiosity on loyalty of customers is mediated by customers' trust. Likewise, Suhartanto et al. ([2019](#)) asserted that customer loyalty is based on religiosity and emotional attachment regardless of service quality. On the other hand, Ahmed et al. ([2022](#)) reported that service quality mediate the association between *Shariah* legitimacy and customer satisfaction. Usman et al. ([2022](#)) found that *Shariah compliance*, belief in *Shariah compliance*, and knowledge about *Shariah compliance* have a significant positive effect on the satisfaction of customers using e banking. In a recent study, Tegambwage and Kasoga ([2023](#)) reported that religious affiliation is a significant moderator of association between customer satisfaction and customer loyalty, as well as service quality and loyalty. However, they reported insignificant effect of religious affiliation based on the association between relationship quality and loyalty.

In contrast, some studies claimed that *Shariah* compliance has no impact on the customer behaviour as customers prefer Islamic banks due to some non-religious reasons. For example, Javed et al. ([2015](#)) analyzed the demand of Islamic house financing in Pakistan and found that majority of

the potential customers of Islamic banks are conventional who use Islamic financial services only when they are less expensive regardless of their *Shariah* compliant status.

Impact of Shariah Compliance on Financial Performance

Numerous studies have evaluated the association between social and financial performances of Islamic banks. Nevertheless, only a limited number of studies have explored the impact of *Shariah* compliance on the financial performance as summarize below.

Arshad et al. (2012) used Islamic CSR disclosures as a proxy to measure *Shariah* legitimacy of Islamic banks and examined its impact on the financial performance of Malaysian Islamic banks. After analyzing three years' data (2008-2010), they reported that Islamic CSR disclosures had a positive relationship with both financial performance and bank reputation. Similar results were reported by Iqbal et al. (2013) who measured *Shariah* compliance using three dimensions, namely health, donation, and education. Zaki et al. (2014) measured *Shariah* compliance through *Shariah* board characteristics and Zakah performance and examined its influence on financial performance taking the sample from seven Islamic banks operating in Asia. They found a significant negative impact of both *Shariah* board characteristics and Zakah performance on financial performance. Similarly, Fahlevi et al. (2017) measured *Shariah* legitimacy using a *Shariah* conformity index based on three elements, namely profit-sharing ratio, Islamic investment, and Islamic income. After analyzing three years' data of 18 Malaysian and Indonesian Islamic banks, they reported a negative relationship between *Shariah* legitimacy and profitability. On the contrary, Firman et al. (2016) reported a significant positive relationship between Zakah performance and profitability after analyzing the data form nine Indonesian Islamic banks. Conversely, Kholidah (2018) measured *Shariah* compliance by constructing Islamic social performance index, which was based on four items, namely Qard financing, Zakah ratio, Musharakah financing, and Muḍarabah financing. He found a positive relationship between *Shariah* compliance based on composite index and the financial performance. However, he did not find any relationship between Musharakah financing and financial performance, and Muḍarabah financing and financial performance.

Conversely, in a similar study, Sutrisno and Widarjono (2018) reported a positive association between Musharakah financing and profitability and negative relationship between Mudarabah financing and profitability. In another study, Nasution et al. (2018) found a significant positive correlation between profit sharing ratio and profitability, which had a negative association between Zakat performance ratio and profitability. Additionally, they reported insignificant relationship between Islamic income ratio and profitability. These results are in consistent with the findings of Romadhonia and Kurniawati (2022). On the other hand, Hosen et al. (2019), measured Shariah compliance based on the *Maqasid al-Shariah* orientation using three constructs, namely educating individuals, justice, and public interest as proposed by Dzuljastri et al. (2008). By analyzing three years' data (2010-2012) of eight full-fledged Indonesian Islamic banks, they found an insignificant correlation between Maqasid al-Shariah orientation and the financial performance. In a similar study, Hidayat et al. (2019) analyzed six year's data (2010-2015) of six full-fledged Indonesian Islamic banks and revealed that the composite *Maqasid* oriented performance has a positive correlation with the financial performance. However, they reported that only public interest dimension of Maqasid oriented performance had a positive association with profitability.

However, in a similar study, Hamsyi (2019) reported contradictory results as he found a significant positive correlation between Islamic income ratio and profitability and insignificant correlation between profit sharing ratio and profitability.

Siswanti et al. (2021) found that the impact of Islamic income ratio on profitability is moderated by corporate social performance. On the other hand, Alam et al. (2022) found that Shariah Supervisory Board management had a positive relationship with *Shariah* compliance and bank reputation. In a similar study, Nidyanti and Siswantoro (2022) found that most Islamic banks operating in Asia meet *Shariah* compliant criteria. However, their study could not find any significant relationship between *Shariah* compliance and profitability, considering both accounting-based and market-based measures. Sari et al. (2023) found that Islamic investment ratio has a positive impact on the internal fraud, whereas profit sharing ratio had a negative impact on internal fraud.

The inconsistent results of the existing literature warrant further research in this area. In this context, the current study contributes to twofold

results. First, it constructs an improved proxy to measure *Shariah* compliance. Second, the study evaluated the impact of both *Shariah* compliant participatory and non-participatory financial products on financial performance of Islamic banks, whereas, as per authors' knowledge, existing literature excludes the effect of non-participatory financial products.

The current study developed the following two hypotheses based on the above literature.

H1= *Shariah* compliant partnership-based products positively affect the profitability of Islamic banks.

H2 = *Shariah* compliant non-partnership-based products positively affect the profitability of Islamic banks.

Methodology

The current study's population comprised all full-fledged Islamic banks operating within Pakistan. Since there are only five such banks all of them were considered as the sample for conducting this study's analysis. These banks are Meezan Bank, Dubai Islamic Bank, Al-Baraka Bank, MCB Islamic Bank, and Bank Islami, respectively. The unbalanced panel data was extracted from the financial statements of these banks ranging from 2008-2021.

Following regression model was developed to examine the effect of *Shariah* compliance on the financial performance of the selected Islamic banks.

$$ROAA_{it} = f(\text{ShP}_{it}, \text{ShN}_{it}, \text{CV}_{it})$$

Where

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

ShP_{it} = *Shariah* Compliant Participatory Products of Bank i in year t

ShN_{it} = *Shariah* Compliant Non-Participatory Products of Bank i in year t

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

The variables used in the model are explained below.

Dependent Variable

Profitability is the dependent variable of the current study. Therefore, the existing literature measured profitability using a wide range of market-based and accounting-based proxies. However, market-based proxies cannot be used, while examining the relationship between profitability and Shariah compliance as all the sampled banks are not listed on Pakistan Stock Exchange (PSX). Therefore, this study used accounting-based proxy, namely return on average asset (ROAA), which is frequently used in the existing literature (Platonova et al., [2018](#)). The current study also measured ROAA as net income to average total assets (Platonova et al., [2018](#)).

Independent Variable

Shariah compliance is the independent variable of this study. Therefore, the existing literature measures Shariah compliance by using different proxies such as Musharakah and Mudarabah financing to total financing ratio (Sutrisno & Widarjono, [2018](#)), Zakat to total assets ratio (Nasution et al., [2018](#)), Islamic income ratio (Hamsyi, [2019](#)), and ratio of non-controversial modes of financing (Javed et al., [2020](#)). The major limitations of all these proxies was that they reduced the scope of *Shariah* compliance and tried to measure *Shariah* compliance objectively; whereas *Shariah* compliance cannot be measured objectively due to its diverse interpretations of various sources of Islamic jurisprudence.

Considering the above limitations, the current study measured the *Shariah* compliance through an expert survey method following some similar studies (Javed et al., [2020](#)). Eight *Shariah* experts, who had a relevant experience, were requested to assign weights to different financial products, considering their application in the modern Islamic banking and their compliance to *Shariah* principles. The average of these weights are shown in Table 1.

Table 1
Average Weights

Type	Modes	Average Weights
Partnership-based Financial Products	Musharakah	96%
	Mudarabah	94%
	Diminishing Musharakah	72%
	Running Musharakah	69%

Type	Modes	Average Weights
Non-Partnership based Financial Products	Murabaha	58%
	Musawamah	74%
	Salam	68%
	Istisna	70%
	Ijarah	68%

Using the above weights, this study develops following two proxies to measure *Shariah* compliance so that the effect of *Shariah* complaint partnership-based products and *Shariah* complaint non-partnership-based products can be compared.

$$\text{ShP}_{it} = \sum P_{it}W$$

$$\text{ShN}_{it} = \sum N_{it}W$$

Where

ShP_{it} = Shariah Compliant Partnership based Products of bank *i* in year *t*

ShN_{it} = Shariah Compliant Non-Partnership based Products of bank *i* in year *t*

P_{it} = Percentage of the given partnership based product to total products of bank *i* in year *t*

N_{it} = Percentage of the given non-partnership based product to total products of bank *i* in year *t*

W = Average Weight assigned to the given product (shown in Table 1)

Control Variables

Following some earlier studies, this study uses some control variables, while examining the relationship between *Shariah* compliance and profitability. These control variables are shown in Table 2.

Table 2

Description of Variables

Variable	Measurement	Reference
Dependent Variable		
Return on Average Asset (ROAA)	Net income to average total assets	Jewell and Mankin (2011)

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Variable	Measurement	Reference
Independent Variable		
Partnership Based Products (ShP)	Self-constructed proxy	Authors' contribution
Non-Partnership Based Products (ShN)	Self-constructed proxy	Author's contribution
Control Variables		
Capital Ratio (CapRto)	Equity capital to average total assets	Platonova et al. (2018)
Operating Expense Ratio (OprExp)	Total non-interest expense to average total assets	Iskandar (2017)
Liquidity Risk (LiqRsk)	Total financing to total assets	Hassan and Khan (2019)
Capital Intensity (CapInt)	Fixed assets to total assets	Maqbool and Zameer (2018)

Results and Discussion

The above Table 3 exhibits descriptive statistics related to various variables. The values of ROAA vary between -.0311-.0294. The mean of ROAA is .0034, whereas its standard deviation is .0103. The value of standard deviation is higher than the value of mean. This indicates that ROAA is over dispersed such as the ROAA of the sampled banks is not following a similar pattern. The reason of this dissimilar pattern is that some Islamic banks earn profits, whereas other Islamic banks suffer from major loss during the same period.

Similarly, the values of ShP range between .0435-0.7985 with mean value of .4289 and standard deviation 0.1594. Likewise, the values of ShN vary between 0.1254-.9986. Its mean value is registered at 0.4512, whereas standard deviation is recorded .2306. The minimum and maximum values of CapRto are registered at 0.469 and 0.5309, respectively with a mean value of .1062 and standard deviation of .0782. Similarly, the maximum and minimum values of OprExp are recorded at .0206 and .0791, respectively. Its mean value is .0377 and standard deviation is .0129. Likewise, the values of LiqRsk range between .0063-1.836, whereas its mean value is .5512 and standard deviation is .2613. Similarly, the values of CapInt vary between

.0060-.100. Its mean value is recorded at .0325 and standard deviation is registered at .0205. The values of standard deviation of all these variables are lower than the value of mean, indicating that these variables are under dispersed and their data is following the same pattern.

Table 3
Descriptive Statistics

Variable	N	Mean	Std. Dev	Min	Max
ROAA	62	0.0034	0.0103	-0.0311	0.0294
ShP	62	0.4289	0.1594	0.0435	0.7985
ShN	62	0.4512	0.2306	0.1254	0.9986
CapRto	62	0.1062	0.0782	0.0469	0.5309
OprExp	62	0.0377	0.0129	0.0206	0.0791
Lqrisk	62	0.5512	0.2613	0.0063	1.836
CapInt	62	0.0325	0.0205	0.0060	.1001

The current study applied some diagnostic tests to confirm the validity of the given data for the application of regression analysis. These tests include Pearson Correlation Matrix, Wooldridge test, Modified Wald test, and Hausman test. Correlation values of the given variables (shown in Table 4) confirmed that no multicollinearity exists among the stated variables (Brooks, [2008](#)). However, Modified Wald test (p value = 0.000) confirms the existence of heteroscedasticity in the data set. This issue is resolved by applying robust model. On the other hand, Wooldridge test (p value = 0.2504) confirmed that data has no autocorrelation. Hausman test (p value = 0.004) confirmed that fixed effect model was more reliable than random effect model.

Table 4
Pearson Correlation Matrix

	ROAA	ShN	ShP	CapRto	OprExp	Lqrisk	CapInt
ROAA	1.0000						
ShP	0.6722	1.0000					
ShN	0.0442	0.1546	1.0000				
CapRto	-0.4319	-0.5321	-0.2068	1.0000			
OprExp	-0.6454	-0.4871	-0.1885	0.7456	1.0000		
Lqrisk	0.0498	0.3234	0.2796	-0.2433	-0.1070	1.0000	
CapInt	-0.6376	-0.6929	-0.2395	0.7411	0.7755	-0.1865	1.0000

Figure 1 presents the graphical relationship between financial performance of Islamic banks and their investment in participatory modes of financings. The figures show that banks with higher investment in participatory modes of financings have better financial performance. On the other hand, no such relationship is found in case of investment in non-participatory modes of financings as shown in Figure 2.

Figure 1

Association between Performance and Participatory Modes of Financings

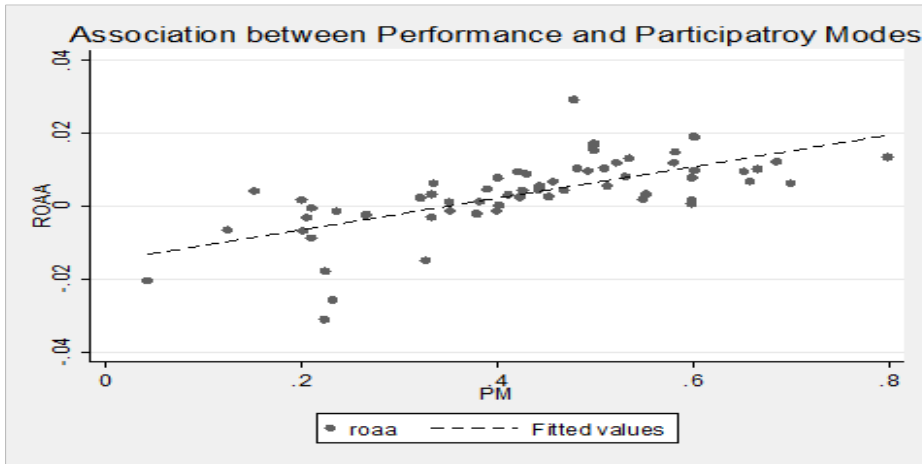
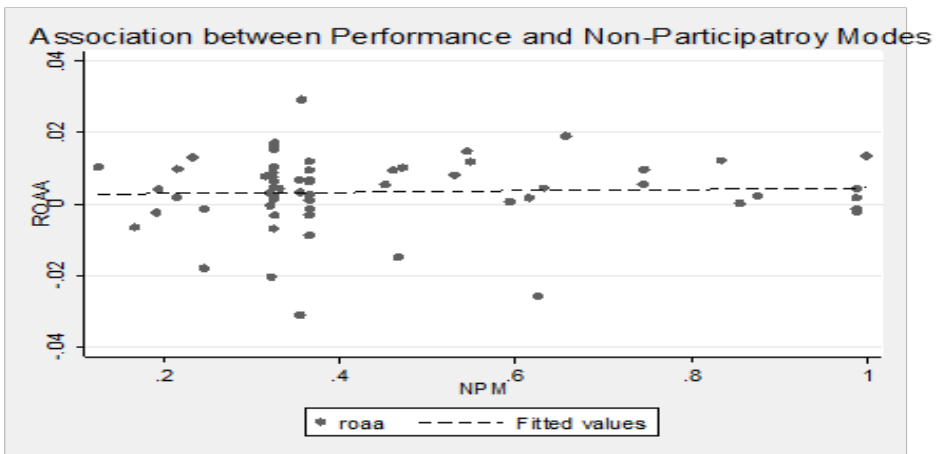


Figure 2

Association between Performance and Non-participatory Modes of Financings



Though the Hausman test (p value = 0.004) suggested that fixed effect model was more appropriate than random effect model; however, the current study applied both models for the comparison purposes. Table 5 shows the results of both Fixed Effect and Random Effect models. The Model Significance values (0.000) suggested that both models were significant. Similarly, the value of R^2 proposed that fixed effect model described 62% of variation in ROAA; whereas random effect model described almost 65% of variations in ROAA.

The fixed effect model showed that the relationship between partnership-based products (ShP) and profitability (ROAA) was positive but the association between non-partnership-based products (ShN) and profitability was negative. Consequently, ROAA increased by 2.4% if ShP increase by one unit. On the other hand, ROAA decreased by 0.1% if ShN increase by one unit. However, p -values suggested that the relationship between ShP and ROAA was significant but the association between ShN and ROAA was insignificant. The random effect model highlighted the similar results.

A possible reason of the significant positive relationship between ShP and financial performance was that investing in ShP increase customer's trust on Islamic banks resulting in gaining customers' loyalty. Accordingly, the current study confirmed the first hypothesis regarding the existence of a positive relationship between ShP and ROAA. On the other hand, this study does not support the second hypothesis regarding the existence of a positive relationship between ShN and ROAA. These findings were in consistent with the results of Javed et al. (2022) who found a significant positive relationship between financial performance and *Shariah* compliance. Furthermore, the Islamic concept of *barakah* also supported the results of this study.

Considering the control variables, the current study found a significant positive relationship between CapRto and ROAA. The identified reason of this positive relationship was that banks who had a better capital ratio were in a desirable position to invest in profitable projects than banks who had a worse capital ratio. In contrast, the study found a negative association between OprExp and ROAA as increase in expenses would simultaneously reduce the distributable profits. Random effect model also produced similar results.

Table 5
Regression Analysis Results Considering ROAA as Dependent Variable

	Robust Fixed Effect Model		Robust Random Effect Model	
	Coefficient	<i>p-Values</i>	Coefficient	<i>p-Values</i>
ShP	0.024	0.031**	0.035	0.000***
ShN	-0.001	0.658	-0.003	0.800
CapRto	0.048	0.014**	0.039	0.002***
OprExp	-0.497	0.021**	-0.449	0.002***
Lqrisk	-0.003	0.212	-0.004	0.281
CapInt	-0.027	0.806	-0.039	0.696
Constant	0.010	0.029**	0.006	0.015**
<i>p</i>		0.000***		.000***
<i>R</i> ²		0.6215		0.645

Note. Dependent Variable: ROAA.

Significant *10%. **5%,***1%

Conclusion

Islamic banking institutions were introduced as an alternative to conventional banking institutions to eliminate the interest elements, uncertainty, and speculations from financial transactions. Accordingly, Islamic banks developed several alternative financial products, which meet various financial needs of customers without violating the ruling of Islamic law.

These products can be broadly divided into two categories, namely participatory financial products and non-participatory financial products. The participatory financial products are the essence of Islamic finance as they are profit and loss-based sharing principles. On the other hand, non-participatory financial products are mostly trading and renting-based agreements. However, in this paper it was argued that while pursuing the main objective of wealth maximization, Islamic banks avoid risk and rely on trade and rental-based financial products. Arguably, these non-participatory financial products were developed in such a way that their economic substance should be the same as that of their conventional equivalent. This practice of developing identical financial products jeopardizes the reputation of Islamic banks. Thereby, the current study

explored the impact of both participatory and non-participatory financial products on financial performance as better *Shariah* compliance, which may lead to a better financial performance.

Therefore, the current study examined the unbalanced panel data extracted from the financial reports (2008-2021) of all full-fledged Islamic banks operating in Pakistan. By applying both fixed and random effects models, the study found that participatory-based financial products had significant positive impact on the financial performance; whereas non-participatory-based financial products had an insignificant negative impact on the financial performance of Islamic banks. Hence, the study suggested that Islamic banks should increase their reliance on participatory-based financial products, as it would not only improve their image of being Islamic but it would also increase their financial performance as a whole. Additionally, the current study recommended that future studies should explore the abiding relationship between investment in individual financial products and performance so that optimum level of profitability could be determined.

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