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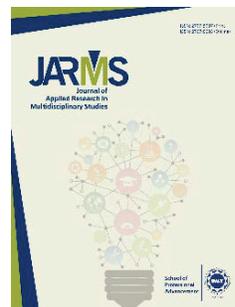
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Title: **Examining Islamic banks performance through CSR, Shariah Audit and Regulatory Compliance: An empirical Assessment**

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Examining the Performance of Islamic Banks in View of Corporate Social Responsibility (CSR), Shariah Audit, and Regulatory Compliance: An Empirical Assessment

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Abstract

The current research attempted to investigate the role of *Shariah* Audit, corporate social responsibility (CSR), and regulatory compliance on Islamic banks performance. The current research investigated the employees of Islamic banks in Pakistan who comprised the sample population. Using a structured questionnaire, the data was collected from 316 individuals selected through convenience sampling. The data was analyzed using SPSS software. Various statistical approaches including descriptive statistics, reliability analysis, correlation, and regression analysis were used for analysis. The current research indicated that corporate social responsibility, *Shariah* audits, and *Shariah* compliance carried a significant impact on the performance of Islamic banks. The introduction of external religious auditors in order to ensure *Shariah* compliance is advocated, which may provide the much-needed incentive to enhance governance and boost market with stakeholder trust. This study contributes to the development of policies pertaining to a better comprehension of the spread of CSR practices and the veracity of CSR reporting by Islamic banks in developing countries. This research comprises a significant addition to the academic literature on selected variables from the perspective of a developing country where CSR efforts are backed by the Islamic banking system. Additionally, the assessment of the validity of CSR disclosures clarifies the social responsibilities of business organizations towards their stakeholders and society. This inquiry was conducted to identify and draw attention to the factors that influence the performance of Islamic banks in Pakistan. It would

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provide Islamic bankers, policymakers, and other stakeholders with fresh insights that would strengthen their understanding of the topic.

Keywords: Corporate Social Responsibility (CSR), Islamic banks performance, *Shariah* audit, *Shariah* compliance, regulatory compliance

Introduction

Islamic law, which includes the Islamic economic system, addresses the issues of religion, society, politics, and daily morals. It handles these topics via the lens of Islamic economics. Over the course of the last decade, Islamic finance has established itself as one of the industries with the most rapid pace of increase. At present, the Islamic banking sector constitutes almost 71% of the entirety of the Islamic financial industry as a whole. The banks of this sector were extremely resilient in the years preceding up to and during the 2008 global financial crisis (Rehman et al., [2022](#)). Islamic banking and finance is a phenomenon unto itself since it is based only on Islamic principles of commerce. This is what separates it from the rest of the financial sectors (Mirzaei et al., [2022](#)). For a bank to be considered "Islamic," the general consensus is that it must treat all of its customers and business partners in accordance with the tenets of Sharia (Islamic Law) (Alam et al., [2023](#); Jan et al., [2021](#); Khatib et al., [2022](#); Mergaliyev et al., [2021](#)).

The elimination of interest and the implementation of Shariah rules are the two primary points of Islamic financial services, which attract customers from all over the world including Muslims in particular. Many countries and their citizens including Pakistan, worry that Islamic banks' activities aren't in line with the Islamic Shariah principles, since there isn't a strong enough auditing and governance system in place. Accordingly, Islamic Banks (IBs) need to guarantee Sharia audit in order to achieve Maqasid al-Shari'ah. This is necessary to prevent possible risks of incompatibility with Shariah rules and to acquire the trust of stakeholders by developing a robust Islamic governance framework. Resultantly, the Shariah audit (both internal and external) carries the potential to play a significant part in order to accomplish the aims (Yasoa et al., 2018). IBs are obligated to strengthen the Islamic Shariah auditing and governance structure to ensure that all business dealings and products adhere to the Islamic principles.

Corporate social responsibility (CSR) has emerged as an important part of Islamic banks' day-to-day activities and other monetary organizations in

the Islamic world. Businesses and institutions from all over the globe are presently exploring the notion of corporate social responsibility (CSR) to understand its contribution to a company's bottom line by satisfying important constituencies (Abdelmoety et al., [2022](#)). This is because corporations do not operate in an isolation within society. The main issue lies in it. Therefore, businesses must contribute to the development and prosperity of the communities in which they operate (Octrina & Mariam, [2021](#)).

According to the findings of certain researchers, Islamic banks need to use Shariah law in addition to fundamental financial knowledge to completely understand their performance (Ramdhoni, [2018](#)). The majority of the academics concentrated on monetary metrics as a means to evaluate the success of IBs. According to the available research, only a few studies addressed the qualitative and internal aspects that influence IB's success. The IB's response in Pakistan to its Sharia auditing concern about achieving Maqasid-e-Sharia and regulatory compliance raises a few issues and concerns that need to be resolved. In light of this, the purpose of the current research was to fill this void by analyzing the most significant elements influencing Pakistan's Islamic banking business (Said et al., [2021](#)).

Pakistan is a Muslim-majority nation that is now in the process to become a developed nation. The people of Pakistan are very sensitive to Islamic banks and according to them, the duties of Islamic banks are not carried out in accordance with the Sharia law. Resultantly, they confront a number of challenges (Zafar & Sulaiman, [2020](#)). This survey was conducted throughout Pakistan's IBs to provide Islamic financial institutions a voice on Shariah audit, the role of Shariah control within industry standards, and the importance of Shariah compliance. For that reason, the study's major objective was to investigate how Sharia audit, CSR, and regulatory compliance affect the efficiency of Islamic financial institutions. The current research would provide novel understandings that may aid Islamic bankers, policymakers, and anyone interested in the issue.

Literature Review

A considerable research was conducted to study the elements that may impact the performance of an Islamic bank and the majority of these studies employed quantitative metrics. Sharia auditing is a relatively new area of focus for Islamic banks (Khalid et al., [2018](#)). There must be either a

comprehensive review by the Shariah Committee or a review by an elected auditor with enough knowledge of Shariah and its sources for an audit to be conducted in accordance with Shariah (Rashid et al., [2017](#)). Thus, IBs bear a disproportionate amount of burden to ensure Sharia conformity by increasing the efficacy of Sharia governance (Alshater et al., [2022](#)).

Aziz et al. ([2019](#)) stated that Sharia auditing does not totally reject all current auditing methods and procedures. The value of an institution's adherence to Sharia law may be tested via sharia auditing. This is because auditing, according to Sharia law is a realistic option. According to Yahya ([2018](#)), standard auditing procedures in the financial sector have links with Islamic culture and society. Yahya formed these inferences after realizing that the techniques used were adapted from those used in traditional audits in the banking sector. A research project, carried out in 2018 concluded that a shariah audit of Islamic banks would have a substantial influence on the trust of stakeholders (Arwani, [2018](#)). Additionally, an external audit of IBs considerably altered how well they function (Al Samara et al., [2019](#)). Moreover, there was a favorable correlation between the success of the firm and the number of times the audit committee met (Tabash et al., [2022](#)).

To conclude the CSR of Islamic banks, Farook et al. ([2011](#)) performed a study. The research indicated a correlation between corporate social responsibility initiatives and the success of Islamic banks in Malaysia. The results of yet another research showed that CSR has a significant beneficial effect on Islamic banks' performance as a whole (Mosaid & Boutti, [2012](#)). Kariuki ([2014](#)) concluded that CSR positively affects the performance of large and medium banks; however, it has no effect on the return on assets (ROA) of small banks.

An important issue that affects the success of Islamic banks is the implementation of Sharia-compliant governance. In doing so, it ensures that every business is conducted in conformity with sharia law's tenets. Sharia law's administration is highly valued in the Islamic banking industry since it represents all the factors related to Shariah Committee's participation and the bank's adherence to Islamic law (Hamza, [2013](#)). A legal system, consistent with sharia is necessary for marginal market share (Said et al., [2021](#)). They defended this point. The managers of Islamic banks demonstrated the challenges associated with sharia-compliant policies which is necessary to increase the availability of sharia-compliant financial services to increase the penetration of Islamic banks. Islamic financial

institutions are obligated to conduct their business in a manner that is consistent with Islamic regulations and principles. IBs may expect their performance to suffer as a direct result of the possibility that they would violate Sharia law. Additionally, the incoherence of Sharia law is a factor that undermines public confidence in Islamic financial institutions. In order to guarantee the successful application of sharia governance, the corporate governance of Sharia-compliant enterprises should be the primary focus of attention (Ibrahim, [2007](#)).

Carroll ([1979](#)) was called the father of CSR. By taking the Bowen's definition as the basic idea, many researchers defined CSR and its dimensions. In his paper, *Business in Contemporary Societies: Framework & Issues*, Carroll ([1999](#)) defined CSR in a variety of dimensions and then analyzed them. Carroll ([1999](#)) further enhanced the meaning and dimensions of CSR. Davis and R. Blomstrom the term CSR as the responsibility of the strategy developer to take or develop such strategy that will not only meet their own goals but also ensure the protection and improvement of the society. J. McGuire stated that the firm has not only economic and legal obligations; however, it also carries a social responsibility on them. C. Networks also explored CSR as the exclusion of company behavior to the level of society's norms, values, and expectations. Carroll's ([1979](#)) work expanded the CSR to economic, legal, ethical, and philanthropic expectations of the society.

CSR in Pakistan is in the developing stage and even the enterprises don't fully understand the idea of corporate social responsibility. Very little work has been conducted in Pakistan on CSR activities, that is, Corporate Social Responsibility, Theory and Practices in Pakistan, Syed Kamran Hameed, 2010, and Afshan Ahmed, Iftikhar Ahmed, 2011, SDPI, Pakistan. The banking sector is not taking initiative in this perspective (Ahmed & Ahmad, [2011](#)). The current research was conducted to cover this gap theoretically and practically by examining the determinant of corporate social responsibility and to determine the effect of these responsibilities on the performance of the Islamic banking sector of Pakistan. Pakistan is based on Islamic perspective, therefore, religious responsibility was also added in the current research as the Islamic banks are based on Shariah compliance features. The features followed that whether it is fulfilling its religious responsibility or not, within the limits and teaching of Shariah.

The idea of corporate social responsibility (CSR) rapidly developed into an integral component of the day-to-day operations of Islamic financial institutions, especially in the banking sector of the economy. Businesses and institutions from all over the globe are presently exploring the notion of corporate social responsibility (CSR) to understand how it may contribute to a company's bottom line by satisfying important stakeholders (Abdelmoety et al., [2022](#)). This is because businesses exist not in isolation; however, as part of a community. This is the root cause of the problem. Resultantly, businesses must make positive contributions to the development and flourishing of the communities in which they perform their trade (Octrina & Mariam, [2021](#)).

Internal qualitative elements, in addition to internal quantitative ones (such as financial indicators) may affect the success of Islamic banks that are founded on Islamic principles (such as sharia audit, CSR, and regulatory compliance factors). According to the research, internal and external sharia audits have the potential to considerably enhance the overall performance of IB. (Abu Hussain & Al-Ajmi, [2012](#)). Additionally, the results of the study indicated that sharia audit showed a substantial influence on the overall performance of Islamic banks (IBs), which proves that Islamic sharia is an essential component in the financial performance of banks (Rahman et al., [2017](#)).

Methodology

A questionnaire was used to explore the bankers' perspectives on sharia auditing, corporate social responsibility, and regulatory compliance in a cross-sectional fashion. The participants in the current study comprised bankers who work for conventional and Islamic banks in Pakistan. The data was collected by the researcher using a method known as convenience sampling from the management and staff of a specific area in Pakistan. A questionnaire was used to collect information from 316 people who participated in the study. Participation from these institutions in the decision-making process surrounding the expansion of Islamic banking in Pakistan made it prudent to hire Islamic bankers. The questionnaire was provided to bank personnel by the researchers, who, with the bank's permission, traveled to several branches of each financial institution that participated in the study to collect responses. The survey was undertaken by Islamic bankers who volunteered their time. All of the completed surveys went through a stringent quality assurance process to ensure that the

information was correct and exhaustive. The researchers used SPSS to analyze the data. In order to conduct an analysis of the data, several statistical methods, such as descriptive statistics, analyses of reliability and correlation, and regression analyses, were used.

Results

Demographic Analysis

Table 1 shows that the vast majority of respondents are middle-aged married men who fall between the ages of 26 and 30. These individuals have a median age of 30 years old. Table 2 presents the respondent's credentials and prior work experience in a way that is similar to that described in the preceding paragraph. Table 2 also has its own explanation. Additionally, Meezan Bank accounts for 70% of the answers.

Table 1
Demographic Characteristics

Classification	Frequency	%
Gender		
Male	233	73.7
Female	83	26.3
Marital Status		
Single	127	31.5
Married	189	68.5
Respondents Age		
>25 years	59	19
26-30	109	34
31-40	91	31
41-50	50	16
Respondents Experience		
1-3 year	99	31
4-6 year	139	44
7-10 year	53	17
Above	25	08

Reliability Analysis

An inquiry of the internal consistency and reliability of several different constructs and variables may be carried out with the assistance of Cronbach's Alpha. According to the data, the CA values of all the variables were higher than the threshold, which was 0.70. This indicates that the instrument was dependable for conducting future research.

Table 2

Item-Total Statistics

Scales	Scale Mean if Item Deleted	Scale Variance if Item Deleted	Corrected Item-Total Correlation	Cronbach's Alpha if Item Deleted
Shariah Audit	7.8084	3.546	.734	.709
Shariah Compliance	7.4953	1.815	.657	.769
CSR	7.2029	2.207	.532	.777
IB Performance	7.7933	3.020	.634	.749

Correlation

Table 3 displays the analysis of the correlation performed to examine the relationship between the variables. The results demonstrate a positive and statistically significant relationship between the variables. Specifically, a value of .486** with a p-value of 0.000 suggests a favorable link between sharia audit and Islamic bank performance. The value of the correlation between CSR and the performance of Islamic banks is 0.549**, with a significance level of 0.000. Additionally, there is a favorable and statistically significant correlation between Islamic bank performance and adherence to regulatory requirements.

Table 3

Correlation

Variables	1	2	3	4
1. Shariah Audit	1			
2. CSR	.552**	1		
3. Shariah Compliance	.523**	.655**	1	
4. Performance of IFI	.486**	.549**	.492**	1

Note. ** Significance level 0.01.

Regression Analysis

In regression analysis, the independent variables and the dependent variables are analyzed to determine whether or not there is a link between them. This test is also used to determine whether or not the model is appropriate for use and how accurate its predictions are.

Table 4

Model Summary

Model	<i>R</i>	<i>R</i> ²	Adjusted <i>R</i> ²	Std. error
1	.750	.662	.650	.43563

The value of the R-square, which could be seen in Table 5, explains the predictive capacity of the model. Based on the findings, the R square value was calculated to be .750. This indicates that the independent variable was responsible for explaining 75.0% of the outcome variables.

Table 5

Coefficients for Performance of IB

Model	Unstandardized Coefficients		Standardized Coefficients	<i>t</i>	<i>p</i>
	<i>B</i>	Std. Error	β		
(Constant)	2.151	.127		17.001	.000
Shariah Audit	.143	.031	.198	3.374	.000
CSR	.139	.041	.170	2.954	.000
Shariah Compliance	.115	.047	.162	2.474	.014

A regression analysis was conducted in order to evaluate the hypothesis that Shariah audit, CSR, and Shariah compliance have a significant and favorable effect on the profitability of Islamic banks. Shariah Audit, that is, $\beta = .143$ and *p* value 0.000 was shown to have a substantial and favorable influence on IB performance. Additionally, the results showed that CSR has a considerable influence, both positively and significantly, on IB performance ($\beta = .139$ and *p* value 0.000). Conclusively, the research showed that Shariah Compliance has a considerable influence, both

positively and significantly, on IB performance ($\beta = 0.115$ and p value 0.014).

Discussion and Conclusion

The findings of the current research indicated that the shariah audit significantly impacted IB's performance in a positive way. The results also indicated that sharia audit is an essential component of sharia compliance. Sharia compliance assures that the activities of an Islamic bank are in accordance with the sharia principles. One of the conclusions of the current study indicated that the Shariah audit, both internal and external, carried a substantial effect on the performance of Islamic banks. Moreover, the findings of the current study were supported by previous researches on the topic. Additionally, the data suggested that the clients have faith in Islamic banks owing to the robust sharia audit standards that were implemented by such institutions (Arwani, [2018](#)). It is imperative to keep in mind that Shariah compliance functions on three distinct levels, that is, the level of product development and execution, the level of governance, and the conceptual level. Auditing, based on Sharia law is an important component of the Shariah administration system. It provides an unbiased assessment of the degree to which Islamic business organizations (IBIs) abide by Shariah's directing principles and laws. Both the management of the Shariah non-compliance risk and the construction of a competent internal Shariah control system is made easier with its assistance (Khatib et al., [2022](#)).

The standard of the Shariah audit impacts the quality of the decisions reached by the Shariah boards, which in turn has repercussions for the entire Shariah compliance environment of the organization. Audits based on Shariah law act as both the ears and eyes of the Shariah boards (Islam et al., [2021](#)). Due to the significance of Shariah audit quality to ensure a sustainable and sound Shariah compliance mechanism in the institution, the current paper laid out a framework to ascertain the meanings of Shariah audit quality in the first place. Secondly, it determined the factors that affect Shariah audit quality in the Islamic banking institutions of Pakistan. This is because the current paper provides a framework to ascertain the meanings of Shariah audit quality.

These results are given greater credence by the managers of the banks, who indicated in their reports that the community and society are the most significant stakeholders, respected by their organizations. The managers of

the banks gave these findings more credibility. It illustrates that Islamic banks have the objective to focus on the generation of value for the community and society as a whole, which is one of the fundamental goals of organizations that are established on the principles of Shariah (Al-Haija et al., [2021](#)). Customers and the physical environment that surrounds the business are two groups of individuals that do not get the same amount of consideration. This may be attributed to the fact that customers are the source of money and revenue, which is also a fundamental goal that any commercial firm should attempt to achieve (Bhuiyan et al., [2021](#)). The improvement of the economic, social, and communal well-being of communities and groups should be the major focus of Islamic financial institutions. This emphasis is thus completely in line with the ethos of Islamic organizations, which are underpinned by the guidelines and precepts of Shariah. It is important to highlight that none of the banks make the welfare of their employees or the creation of value for them a top priority, despite the fact that employees are one of the most crucial internal stakeholders (Zafar & Sulaiman, [2020](#)). It is crucial for banks to have employees and customers that are dedicated, focused, and loyal, and the power that banks possess rests in their organizational strength (Elsafty & Tahon, [2020](#)).

The study's findings supported the hypothesis that Islamic banks' success would be enhanced with a greater emphasis on regulatory compliance. The data suggested that IBs should see strict adherence to regulation as a positive trend since it is more likely to result in sharia compliance. Sharia compliance in Bangladesh is strengthened by previous research which showed a positive association between regularity compliance and IBs performance. These results validate the conclusions of the current study, which were found to be supported by those previous studies (Ullah, [2014](#)). Additionally, several researches reached the conclusion that stringent shariah governance processes result in improved performance of financial organizations (Jan et al., [2021](#); Mergaliyev et al., [2021](#)). The results of the current study showed conflict with the findings of other studies that were conducted in past, since one researcher discovered that rigorous regulatory and governance systems had a detrimental impact on the efficiency of banking personnel (Barth, [2013](#)).

Implications and Limitations of the Study

In a more specific way, the current research work would assist IBs to increase the number of clients they serve by narrowing the trust gap that exists between IB and those customers. According to the findings of the current study, Islamic financial institutions need to operate in accordance with Sharia law, ensure rigorous regulatory compliance, and make their consumers aware that their banks engage in business following the Sharia law. They may persuade clients that their bank exclusively deals with halal items, goods that are approved by Islam, according to the findings of this investigation. In a theoretical sense, the results of the current study add weight to the findings of earlier research, since it investigates observable factors within the context of the Pakistani banking industry. It is limited to Islamic financial institutions located in Pakistan. Therefore, subsequent scholars need to undertake their work in other emerging nations. In the future, researchers need to include IB's clients in the data collection process by including a variety of criteria, such as service quality and customer happiness, etc. This research contributes to the creation of policies that are related to a better knowledge of the proliferation of CSR practices and the authenticity of CSR reporting by Islamic banking sectors in the developing nations. By using CSR activities as a signal of more openness and honesty in operations and financial reporting, future academics may get a glimpse of the actual reputational effect that CSR efforts have on customers and investors. This could be possible because CSR activities are becoming increasingly popular. The current study makes a substantial contribution to the existing academic literature on Corporate Social Responsibility (CSR), Shariah Audit, and Shariah compliance. It examines these topics from the viewpoint of a developing country in which CSR initiatives are supported by the Islamic banking system. The evaluation of the authenticity of CSR disclosures also helps to clarify the social duties that business organizations have towards their stakeholders and society as a whole.

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