

Analysing Islamic Financial Institutions Performance from Maqasid Al-Sharīah, Shariah Audit and Regulatory Shariah Compliance Perspective: Evidence from Pakistan

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Abstract: This paper attempts to contextualize the potential role of shariah audit, Maqasid al shariah, and regulatory compliance in reference to Islamic financial institutions. The motivation of this investigation is to spot and highlight the determinants that affect the Islamic bank's performance in Pakistan. The population of the study consist of managers of different Islamic financial institution in which Islamic banks, Modarba Companies and Islamic takāful companies are included operating in Pakistan. Through convenient sampling, a structured questioner was used to collect data from 316 survey respondents. The researcher used structural equation model by to analyze the data. The findings of the study shows that Sharia audit, Maqasid al-Shariah, and regulatory compliance had a significant and positive impact on IFI's performance. This research will be able to provide new insights for Islamic bankers, policymakers, and stakeholders to enhance their understandings.

Keywords: Islamic Banks performance, Shariah audit, Maqasid al-Shariah, and regulatory compliance.

1. Introduction

Islamic economic system is an important part of Islamic law that covers the religious, social, political, and moral aspects of life. Islamic finance is one of the fastest-growing industries in the past decade. Currently, the Islamic banking sector accounts for 71% of Islamic financial industry (Reuters, 2020). Islamic banks are showing stability in performance before and after the financial crises of 2008 (Olson & Zoubi, 2017). Islamic banking and finance are a unique banking phenomenon, based entirely on Islamic business/trade law (Jan & Asutay, 2019). It is

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argued that "Islamic Bank" must adopt the provisions of Sharia (Islamic Law) for all financial transactions and investments and Islamic banking is a successful example of Islamic finance and banking (Hassan & Aliyu, 2018; Olson & Zoubi, 2017; Siswanti, Salim, Sukoharsono and Aisjah, 2017).

Islamic financial services are attracting people from all over the world, especially Muslims, through the prevention of interest and applications of sharia principles. However, countries like Pakistan, peoples believe that Islamic financial institutions do not have an appropriate audit and governance system to ensure that IFIs functions comply with Islamic Sharia principles. Therefore, Islamic Financial Institutions (IFI's) need to ensure Sharia audit to achieve Maqasid al-Shari'ah; to avoid potential risks of incompatibility with Sharia laws and gain the trust of stakeholders by establishing a strong Islamic governance system. Consequently, the Sharia audit (Internal and external) could play an important role in achieving the goals (Yasoa, Abdullah, & Endut, 2018). IB's are required to improve the Islamic sharia audit and governance framework so that all transactions and products comply with Islamic Sharia (Masruki, Hanefah, & Dhar, 2020).

Researchers suggest that Islamic Financial Institutions need to use both Sharia law and basic financial knowledge to fully understand their performance (Ramdhoni, 2018). Most of the researchers focused on the financial measure to check the performance of IB's. Based on the literature, few studies discuss the qualitative and internal factors affecting IB performance. There are some issues and doubts about the IB reaction in Pakistan regarding sharia audit concern of IB for the attainment of Maqasid e Sharia and Regulatory compliance. Therefore, this study bridges this gap by discussing the most important factors affecting Pakistan's Islamic Financial Institutions.

Pakistan is a developing country with a dominant Muslim population. Islamic banks in Pakistan face many problems because their citizens are very sensitive to Islamic banks and do not believe that IB functions are operating according to the Sharia Law. This research is being conducted throughout the IB in Pakistan to provide an opportunity to Islamic banks to express their views on Sharia compliance work, the role of Sharia control under these standards, and the importance of Shariah audit in Islamic banks. So, the major objective of this study is to investigate the effect of Sharia audit, Maqasid al-Shariah, and regulatory compliance on the Islamic bank's performance. This research will be able to provide new insights for Islamic bankers, policymakers, and stakeholders to enhance their understandings.

2.0 Literature Review

Several studies are conducted to investigate different factors affecting Islamic bank's performance and most of the studies used quantitative measures. Sharia audit work of Islamic banks is still in its infancy (Khalid, Haron, & Masron, 2018). Sharia audit needs a comprehensive examination by the Shariah Committee or an elected auditor having sufficient knowledge of Shariah and its sources (Rashid, Yousaf, & Khaleequzzaman, 2017). Therefore, it is the main responsibility of IB's to ensure Sharia compliance by strengthening the effectiveness of Shari'ah governance, including internal Shari'ah audit and the internal Shari'ah review function capabilities (Ajili & Bouri, 2018)

Aziz, Rahman, and Markom (2019) stated that sharia auditing does not reject all conventional auditing techniques and mechanisms because it can be used to test the value of compatibility of IB's practices with Sharia law. Yahya (2018) also pointed out that the audit methods obtained from conventional audits in the financial sector are related to the socio-economic infrastructure and culture of Islamic society. A study conducted in 2018

concluded that shariah audit of Islamic banks would have a significant impact on the confidence of stakeholders (Arwani, 2018a), and an external audit of IBs have significantly affected their performance (M. Al Samara, Ali, & Afeef, 2019). Moreover, the frequency of audit committee meetings is positively correlated with the company's performance (Naiker & Sharma, 2009; Sultana, 2015; Zraiq & Fadzil, 2018; M. Zraiq & F. Fadzil, 2018)

Maqasid Shariah aims to protect the interests of people from harm (Bilal & Meera, 2015). It requires IBs to comply with the standard of virtue and ethical awareness advocated by Shariah, which requires a balance between personal and social rights and responsibilities supported by institutions (Abdullah & Furqani, 2012); strong practices of Maqasid Shariah significantly improve the performance of Islamic banks (Jazil, 2013; Mohammed & Taib, 2015; Mohammed, Tarique, & Islam, 2015). Prasetyowati and Handoko (2016) find that the Islamic bank's performance can be measured through Maqasid Shariah. It is also suggested that it can be used to measure sharia compliance according to the law of sharia in Islamic banks.

Sharia governance is a major determinant that affects the performance of Islamic Financial Institution. It ensures that all the activities and functions must be performed under the guidelines of sharia. The governance of Sharia law expresses all the elements related to the active role of the Shariah Committee and compliance with Sharia law and is extremely important to the Islamic banking industry (Hamza, 2013). Kinyanjui (2013) argued that a sharia-compliant legal system is necessary for low market penetration. The managers of IBs showed the difficulties regarding sharia-compliant policies and there is a need to expand sharia-compliant financial services for Islamic banks penetration. Islamic Banks must ensure that they act in accordance with Islamic rules and guidelines. The risk of non-compliance with Sharia law will negatively affect the performance of IB's. In addition, the inconsistency of Sharia law also affects the public Confidence in Islamic Financial Institution. Corporate governance of Sharia-compliant companies should be the number one concern to ensure the implementation of sharia governance (Ibrahim, 2007).

2.1 Hypothesis Development

The performance of Islamic Financial Institution based on Islamic principles is not only affected by internal quantitative factors (such as financial indicators), but also by internal qualitative factors (such as sharia audit, Maqasid al shariah, and regulatory compliance factors). The literature shows that internal and external sharia audit can significantly improve the performance of IFI's (Abu Hussain & Al-Ajmi, 2012). In addition, Islamic shariah is an important determinant of the financial performance of banks (Rahman Faried, Tareq Mohammad, Yunanda Rochania, & Mahdzir, 2017) and showed a significant effect of Sharia audit on IFIs performance (M. Al Samara et al., 2019). Based on previous research, the following hypotheses are proposed:

H1: Shariah Audit has a significant and positive impact on IFI's performance.

H2: Maqasid al Shariah has a significant and positive impact on IFI's performance

H3: Regulatory Compliance has a significant and positive impact on IFI's performance.

3. Methodology

A cross-sectional survey was conducted using questionnaires to examine bankers' opinions on sharia audit, Maqasid al shariah, and regulatory Shariah compliance. The population of the study consists of bankers working in Islamic Financial Institution operating in Pakistan. The convenient sampling was used to collect data from the managerial staff of IFIs selected part of Pakistan. A questionnaire was used to collect data from 316 survey

respondents. The administration of the questionnaire on IF's managers was conducted by the researchers themselves, and with permission, they visited different branches of each IFI's participating in the research. IFI's managers volunteered to participate in the survey. The returned questionnaires were carefully reviewed to ensure the accuracy and completeness of the information. The researchers used Smart-PLS SEM software to analyze the data. Different statistical techniques were applied for data analysis including descriptive statistics, reliability analysis, and correlation, and structural equation modeling.

4.0 Result and discussion

4.1: Summary of Demographics of the respondents

Table 2 indicates that majority of respondents are male and married within the age group of 26 to 30 years. Similarly, qualification, and work experience of the respondents is placed in Table 2 that is self-explanatory.

Table 1: Demographics of the respondents

Demographics	Classification	Frequency	Percentage
Gender	Male	233	73.7
	Female	83	26.3
Marital Status	Single	127	31.5
	Married	189	68.5
Age	Less than 25 year	60	19
	26-30 year	112	35
	31-40 year	84	26
	41-50 year	44	14
Working Experience	1-3 year	99	31
	4-6 year	139	44
	7-10 year	53	17
	Above	25	08

4.2 Reliability of the Instrument:

Internal consistency and reliability of selected constructs/variables are analyzed through Cronbach’s Alpha. The results of Cronbach's alpha indicate that variables/dimensions are consistent and reliable as the values of Cronbach’s Alpha and AVE are greater than the threshold.

Table 2: Reliability analysis

Name of Variables	Cronbach's Alpha	rho_A	Composite Reliability	(AVE)
IFI Performance	0.776	0.785	0.831	0.535
Maqasid-Shariah	0.849	0.862	0.88	0.552
Regulatory Shariah Compliance	0.894	0.947	0.912	0.635
Shariah Audit	0.805	0.829	0.855	0.564

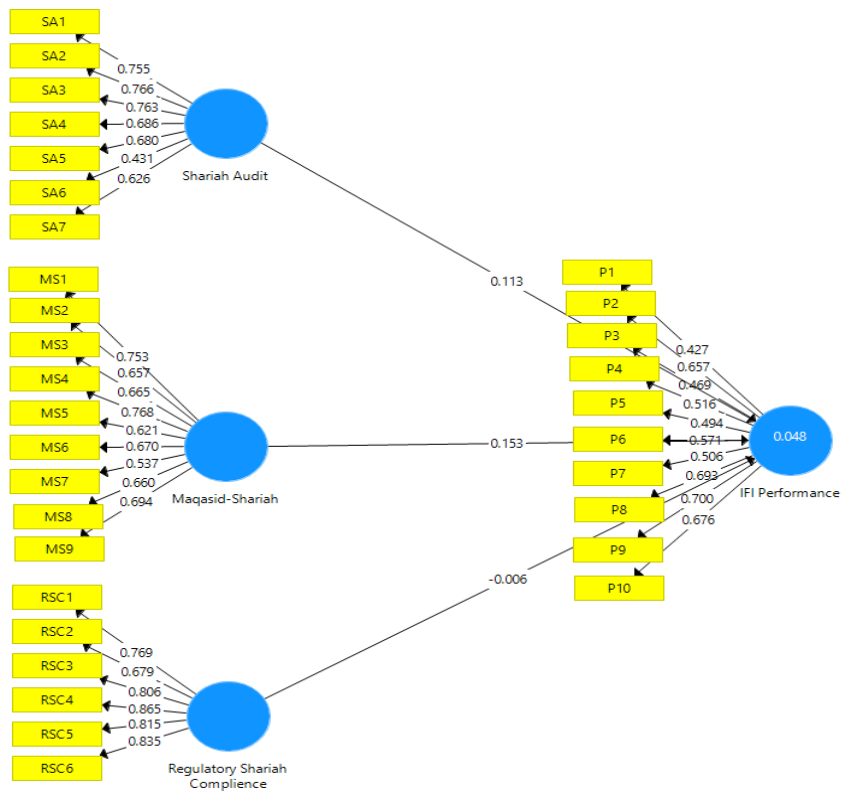


Figure 1: Reliability analysis

4.3 Correlation

Table 4 shows the correlation analysis between the variables that is used to check the association between them. The findings clearly show that there is a positive and significant correlation between the variables. More specifically, results indicate that there is a significant and positive correlation between sharia audit and performance of Islamic banks as value is .486** at p-value 0.000. Maqasid al shariah and performance of Islamic banks are significantly and positively correlated with each other as the value is 0.549** at p-value 0.000. Moreover, regulatory compliance is a positive and significant relationship between the performances of Islamic banks.

Table 4: Correlation Analysis

123 4			
Shariah Audit	1		
Maqasid al Shariah	.552**	1	
Regulatory S Compliance	.523**	.655**	1
Performance of IFI	.486 **	.549**	.492**

** Sig. level 0.01

4.4 Structural Equational Model

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (O/STDEV)	P Values	Hypothesis
MS -> IFI Performance	0.11	0.119	0.029	3.842	0.000	Supported
RSC-> IFI Performance	0.228	0.227	0.043	5.248	0.000	Supported
SA -> IFI Performance	0.479	0.483	0.043	11.062	0.000	Supported

Table 5 shows the result of structural Equational model. All the variables are a significant and positive relationship with Islamic financial institutional performance. The overall results indicate that due to strong sharia audit, Maqasid al-Shariah and strong regulatory compliance improve the performance of IFI's.

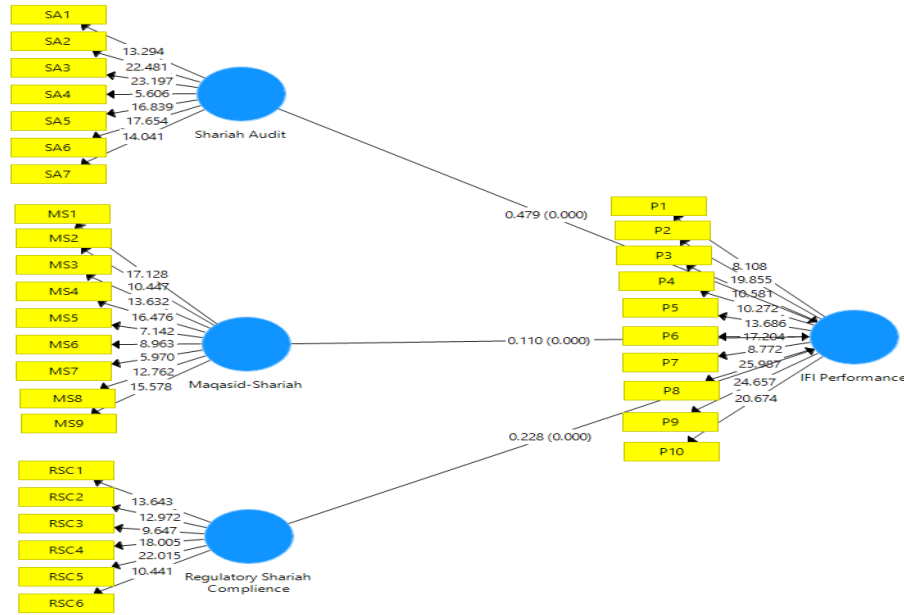


Figure 2: Structural Equational Modeling

5.0 Summary of Results

The findings of the study indicate that sharia audit has a significant and positive effect on IFI's performance. Findings also indicate that sharia audit is very necessary for sharia compliance which ultimately ensures that every function performed by an Islamic financial institutions was under the principle of sharia. Literature support the findings of the current study as one of the researcher's findings indicate that the Shariah audit (internal and external) significantly affect the performance of Islamic financial institutions. Moreover, the findings indicate that due to strong sharia audit practices the customers show confidence in Islamic banks (Arwani, 2018b). Another study conducted on a similar topic indicates that sharia audit significantly influences the customer perception toward Islamic financial institutions which ultimately increase the profitability of IBs (M. F. Al Samara, Al Ali, & Afeef, 2019).

The findings of the study indicate that Maqasid al Shariah has a significant and positive impact on IB's performance. The study suggested that strong practices of Maqasid al Shariah increase the profitability of the IFIs and attract new customers. Similar studies confirm the findings of the current study. As, one of the researchers conclude that the Malaysian IB encourages and advocates obtaining Maqasid al Shariah through appropriate performance measures (Mohamad, 2016). The findings of the study suggested that regulatory Shariah compliance positively and significantly affects the Islamic bank's performance. The findings suggest that strict compliance of regulation leads to sharia compliance which is a positive sign for IFI's. The governance structure, bank regulations, and active supervision positively associated with Islamic banks. Previous studies confirm the findings of the current study as one of the researcher found a positive association between regularity compliance and IFIs performance which enhance the practices of Sharia compliance in Bangladesh (Ullah, 2014). Some of the studies in the literature contradict the findings of the current study as one researcher found that strict regulatory and governance structures negatively affected banking employees' efficiency (Barth, 2013).

5.1 Implication of the study

Practically, this work will help IFI's to attract more customers by reducing the confidence gap between IFI's and its customers. As shown in the results of this research, Islamic banks should follow sharia laws, implement strict regulatory compliance, and aware of their customers that its banks operate following Sharia law. Based on the results of this research, they can convince customers that their bank only handles halal products permitted by Islam. This research will be able to provide new insights for Islamic bankers, and policymakers, helping them to improve the sharia compliance to increase IBS performance and business opportunities. Theoretically, the findings of this study strengthen the findings of previous research by researching observed variables in the Pakistani IFI's context. The sample size of the study is limited. This research is conducted only in Pakistani Islamic financial institutions. So, future researchers should conduct in other developing countries. Future researchers should include IFI's customers to collect data by adding different variables like service quality and customer satisfaction etc.

6.0 References

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