

THE IMPACT OF SHARIAH GOVERNANCE TO FINANCIAL AND NON-FINANCIAL PERFORMANCE IN ISLAMIC FINANCIAL INSTITUTIONS (IFIs): A LITERATURE SURVEY

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ABSTRACT

The main objectives of Islamic Financial Institutions (IFIs) are to achieve *Shariah* compliance and to fulfil Muslims requirement towards obedience and worship to Allah (SWT). In relation to that, the *Shariah* governance framework was introduced by Bank Negara Malaysia (BNM), who acts as the regulator, to ensure that proper *Shariah* governance is practised by IFIs. It is vital to highlight the *Shariah* governance practice in relation to IFIs' performance. This is to demonstrate the significance of its adoption for the measurement of financial and non-financial performance so that the performance criteria could be easily monitored within IFIs to ascertain the entire operations and all transactions comply with *Shariah*. The main aim of the paper is to highlight *Shariah* governance factors affecting the performance of IFIs as discussed in the literature. The literature survey discovered that *Shariah* Committee (SC), *Shariah* risk, *Shariah* audit as well as disclosure and transparency were identified as governance measures linked to IFIs' performance. However, little research exists on the role of *Shariah* review function. Despite that, the regulator has made the function compulsory for adoption within IFIs. This study aims to benefit the industry players to better understand the impact of each *Shariah* governance functions on their performance as financial industry works within defined financial and non-financial indicators.

Keywords: *Shariah* governance, Performance, Islamic financial institutions

INTRODUCTION

The emergence of Islamic Financial Institutions (IFIs) begins in 1970s in Egypt and spread around in the Middle East, North Africa, Far East, Europe, and the USA (Garas, 2012). Since then, the development has grown enormously over the last couple of years, along with the development, it is significant to strengthen the institutions through enhancing the governance system which may reflect the performance of institutions. While, Islamic banking is one of the platform for Muslims to benefit from services that relate to financial transactions, such as deposit mobilisation, getting financing or investing. In Islamic banking, these positions can only be achieved by strengthening the *Shariah* governance practice. Other factors that influence the growth of Islamic banking institutions are interest-free or *riba*-free finance, strong demand for *Shariah* compliance, legal and regulatory framework improvement and capacity of the industry to innovate and develop financial instruments to meet investors' needs (Khediri, Charfeddine, Youssef, 2015). In IFIs, transaction and business activities that are against Islamic teachings, such as *riba*, gambling, intolerable uncertainties and transactions in prohibited sectors are banned. Furthermore, Islam does not tolerate taking property of others without consent, as reflected in verse 2:188:

“Do not eat up one another’s property among yourself by false means (unjustly) nor given bribery to the judges so that you may knowingly eat up a part of the property of other sinfully”.

The implementation of *Shariah* governance in IFIs serves to provide a sound Islamic practice as religious requirement. To enhance the public confidence towards Islamic banking, *Shariah* governance ensures that the entire operation is conducted in accordance with *Shariah*. The elements of *Shariah* governance in IFIs, as stipulated in *Shariah* governance framework, should consist of *Shariah* supervision that is carried out by *Shariah* committee members by performing duties, such as advising the Board, carrying out *Shariah* audit and review as well as assisting on *Shariah* implementations in IFIs operations. The importance of *Shariah* supervision encompasses areas relating to religious, social, economic, legal, and governance (Miskam, & Nasrul, 2013).

Shariah principles within the *Shariah* governance also require high ethical and other Islamic values, such as responsibility, accountability, transparency, fairness and justice in performing duties. Under the ambit of *Shariah* governance, numerous studies were conducted to examine the relationship between *Shariah* governance practice and firm performance. Proper practice in an organisation is safeguards the interests and rights of all stakeholders, generating satisfaction and winning customers’ confidence.

This bring out the point that, the *Shariah* governance is essential to ensure proper *Shariah* practice in IFIs and hence will have impact on the firm performance. *Shariah* governance emphasises the fairness towards all stakeholders by presenting high transparency and accountability (Ahmad and Chapra, 2002). The existence of non-*Shariah* compliant elements will cause the loss of confidence and trust among stakeholders, especially the Muslim community who entrust the institution to manage their funds or investments in accordance with *Shariah* principles (Khamar Tazilah, Rapani, Abdul Halim, & Majid, 2017).

This research extensively reviews relevant literatures on *Shariah* governance and its impact on performance of IFIs assisted by a research tool, Mendeley software that filters the board-based publications on *Shariah* governance to zoom into the focus area of study, namely *Shariah* governance impact on performance. From the literature review exercise, this paper emphasises on the *Shariah* governance mechanisms that consist of *Shariah* Supervisory Board (SSB), *Shariah* risk, *Shariah* audit, *Shariah* review, as well as disclosure and transparency that will give impact on the firm performance. The literature survey focused on the role of *Shariah* governance organs and functions on IFIs’ performance. Focused governance measures were the *Shariah* Supervisory Board, *Shariah* risk, *Shariah* review, *Shariah* audit as well as disclosure and transparency that are linked to IFIs’ performance.

As the contribution to the existing area of *Shariah* governance, this paper highlights *Shariah* governance factors that impacts the financial and non-financial performance of Islamic banks. Studies on *Shariah* governance factors impacting financial and non-financial performance of Islamic banks are relatively new and under-explored. The factors identified could benefit the industry players to better understand the impact of each *Shariah* governance functions on their performance.

SHARIAH GOVERNANCE FROM THE ISLAMIC PERSPECTIVE

Shariah governance is the corporate governance system that refers to Islamic corporate governance practices implemented by IFIs. The aim of *Shariah* governance practice is ensure that the activities of IFIs complying with

Shariah. It emphasises the Islamic principles and its values in conducting the business transaction. *Shariah* governance practice highly prohibits the unlawful source, banned the *riba*, and emphasises the moral and ethical by promoting the elements of *amanah* (trust) and *adil* (fairness), and encourage the accountability and transparency.

In addition of *Shariah* requirements, *Shariah* governance are layered with the core value of faith towards the Creator (Allah SWT) as the symbol of worship, as well as Muslim's commitment in the practices of the religion. Similarly, in an organisation, proper governance system will be influenced by high moral and ethical practice as Muslims believe. Where, every action will be rewarded according to their deeds. This was narrated in verse 6: 132:

"To all are degrees (or ranks) according to their deeds"

Moreover, the concept of *tauhid* is the highest in establishment of *Shariah* governance. It highlights the understanding towards oneness of Allah (SWT) as foundation of Islam in relation to the faith of Muslim. *Tauhid* assists Muslims to belief on the existence of judge is Allah (SWT) as supreme judgement on the day of judgement. On this day, people will be counted for each of their actions and it will be decided whether they are to be rewarded or punished according to the practice (*'amal*) during lifetime as Allah (SWT) mentioned in the Quran verse 1:284:

"To Allah belongs all that is in the heavens and all that is on the earth, and whether you disclose what is in your own selves or conceal it, Allah will call you to account for it. Then He forgives whom He wills and punishes whom He wills. And Allah is able to do all things"

Thus, the concept of *tauhid* in *Shariah* governance practice has lead the people toward high ethical conduct as Islam provides the code of conduct for all mankind. This code of conduct may lead the Muslim to perform their duty in proper manner with high responsibility, honesty and transparency in all activities.

As a fore mentioned, *Shariah* governance that practicing the *Shariah* principles emphasising the *amanah* and *adil*, as well as accountability and transparency. *Amanah* is referred to the trust or, honesty. *Amanah* can be related with the characters of individual. It is one of the moral that give the values of trust to others against a person by executing a claim in the trust. Which is the responsibility of entrusted one person in executing the promise as claim without ignoring. Prophet Muhammad SAW decreed:

"One's faith is imperfect if he is dishonest" (Narrated by Ahmad)

In an organisation trust is given to perform the responsibility honestly and independently. Lack of honest and independent may triggered many problems such as deferring work and do not complete the task given, and even more complicated when associated with the conspiracy and corruption. Indeed, Islam strictly prohibits matters related to conspiracy and corruption as narrated in Quran Chapter 2 verse 18:

"And do not consume one another's wealth unjustly or send it [in bribery] to the rulers in order that [they might aid] you [to] consume a portion of the wealth of the people in sin, while you know [it is unlawful]"

However, with the existence of honest, unethical issues can be avoided such as it may prevent the conspiracy and corruption in organisation. Where, the honest person is highly encouraged and need to carrying out the duty independently. Where, performing the duty independently is required as value added in working environment. The independent person can complete the duty as best possible and able to react promptly for the task given. They also can be entrusted in decision-making process where this task must be instilled together with *amanah*. The ability to make

decisions is the most important process in the organisation. Therefore, the nature of *amanah* is emphasised, in order for the decision maker do not execute any task according to its own interest.

Adil means equally and fairly in action which also means an act that is not biased or unfavourable to one party and give something to the others in accordance with their right. In Islam *adil* is one of the principles of Islam that has been mentioned in the Quran chapter 16 verse 90:

“Indeed, Allah orders justice and good conduct and giving to relatives and forbids immorality and bad conduct and oppression. He admonishes you that perhaps you will be reminded”.

Islam upholds the fairness in every action in human life, while ignoring justice is tyranny. The justice applied in Islam proves that it is fair in meeting the social rights and not just for personal gain. In the perspective of human life, *adil* encompasses every aspect of human life. In *muamalah* *adil* is strongly emphasized so there is no persecution of any party. Therefore, as in the business transaction, the significant element of oppression such as *riba* is strictly prohibited. Where, *riba* is a depiction of oppression to a particular class up to the occurrence of inequality of economy distribution. In this respect, *adil* play a great role in fostering the well-being of human life, injustice is a denial of certain rights thereby leaving a negative impression on oneself and social.

SHARIAH GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS (IFIS)

Corporate governance in financial institutions is a comparatively significant area to be highlighted since these institutions deal with large amount of fund that is managed by different banks and belong to different account holders and investors (Bukhari, Awam, & Ahmed, 2013). The roles of corporate governance in IFIs is not only significant in fund management, but it also emphasises on the right of stakeholders and considers the obligation of Muslims towards religious requirement. *Shariah* role in IFIs is crucial, it is related to *Muamalat* and worship to Allah (SWT), that becomes the mainstream of *Shariah* governance (Setyowati, Abubakar, & Rodliah, 2017).

Shariah governance provides a structure that is represented by a *Shariah* Committee (SC) and other *Shariah* governance organs, namely Board of Directors and top management. The appointment of SC is a requirement for IFIs as stipulated in the Islamic Financial Services ACT 2013. SC exists to advise IFIs in regard to *Shariah* matter and to ensure the IFIs is in accordance of *Shariah*.

Shariah governance that embedded by *Shariah* principles has become the major element that distinguish *Shariah* governance from the conventional corporate governance. In *Shariah* governance, the *Shariah* sources are from the *Al-Quran* and *As-Sunnah*, followed by the *Ijma'* (consensus). Other *Shariah* governance characteristics are the prohibition of unlawful elements in Islam and accompanied by *aqad* (contract).

To enhance a sound and robust *Shariah* governance in IFIs, Bank Negara Malaysia (BNM) developed a *Shariah* Governance Framework (SGF) for IFIs. Since the implementation of SGF 2010, IFIs are required to adopt the framework as guidelines on *Shariah* governance. Other than SAC, the SGF is monitored by *Shariah* Board whereby the *Shariah* Board functions to control the bank transactions based on Islamic law (Ghayad, 2008). The *Shariah* Board members are entrusted towards the duty of directing, reviewing and supervising the activities of Islamic banks to ensure all transactions comply with *Shariah* principles.

In addition, the IFSA enforcement in 2013 highlighted on *Shariah* governance matters regarding Islamic financial service. The Act enacts that:

“...to provide for the regulation and supervision of Islamic financial institutions, payment systems and other relevant entities and the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with Shariah and for related, consequential or incidental matters (IFSA, 2013)”.

Shariah governance is pointed out in Part IV Division Two (2) from Section Thirty (30) until Thirty- Six (36) which highlight more specific requirements of IFSA 2013. The provision of the Act is associated with the appointment and qualification of *Shariah* committee. The current Act requires the institution to directly apply to the central bank for the establishment of the *Shariah* Committee. This allows the central bank to have direct information from the IFIs committee members, which also ensures proper oversight on activities carried out within IFIs (Miskam & Nasrul, 2013).

Thus, *Shariah* compliance is the main objective for establishing *Shariah* governance in IFIs. The existence of SGF clearly guides the IFIs on their governance by strengthening the role of the Board, the *Shariah* Committee and its management related to *Shariah* matters, which include enhancing relevant key organs that are responsible to execute the *Shariah* compliance (SGF, 2010). Meanwhile, the newly enforced IFSA 2013 provides comprehensive legal and regulation to ascertain IFIs full compliance with *Shariah*.

THE IMPACTS OF CORPORATE GOVERNANCE TO PERFORMANCE

The importance of corporate governance was addressed by various studies in this field where many studies have linked good corporate governance with better performance. It is reflected in the execution of responsibilities with utmost dedication, accountability and also the ability to make decisions wisely. Good corporate governance can ensure the organisation run effectively and properly. However, the application of corporate governance in financial and non-financial institution is different according to the nature of financial institution. In fact, the implementation of corporate governance to financial institution is more significant than non-financial institution especially can be seen through the several risk that the financial institution need to be given attention.

Hence, it is important to strengthen corporate governance in financial institutions where the impact of ineffective governance may cause the failure in financial market (Bahari, N.F & Baharudin, N.A, 2016). According to Ghaffar (2014) the corporate governance practice is evidently related to bank performance on its profitability. Moreover, lack of corporate governance structure and process lead to many financial institutions collapse, and trigger crisis (Naveen Kumar, 2013). While, according to Aljifri & Moustafa (2007), corporate governance has a significant impact on firm financial performance. Similarly, Al-Hussain (2009) found a strong relationship between corporate governance structure efficiency and bank performance.

In this respect, banks that have good corporate governance have improved performance and maintain shareholders interest (HifzaInam & AqeelMukhtar, 2014; Mollah & Zaman, 2015). According to Bijalwan & Madan (2013), a firm with outstanding and good corporate governance practice showed a significant relationship between corporate governance practice and performance. Meanwhile, Nur, Nurcahyo, Kurniasih, & Sugiharti (2013) indicated that, good corporate governance influences the corporate performance directly whereby the study had measured five basic principles, which are transparency, accountability, responsibility, independence and fairness.

In contrast, according to Shahwan (2015) on his study found that, the insignificance relationship between corporate governance practice and firm performance. However, the result of this study may be affected by the underlying independency between CG mechanisms. Similarly, Al-Tamimi (2012), in a study on the practice of corporate governance of UAE banks reported that, there is an insignificant relationship between corporate governance of UAE

banks and performance level. However, this study also stated that the banks are aware on the role of corporate governance is important and it need for improvement. According to this study, in the case of financial distress or crisis, the role of corporate governance practice is not good enough and need to be improved in it practices.

In viewing the impact of corporate governance to performance, several indicators used by researcher to measure the performance. Usually, the prior study used financial indicators to measure firm performance. Where, it was evidence that, the financial indicators have direct impact on firm performance. The profitability and efficiency is the ratios that commonly used to indicate the financial performance. For instance, Ghaffar (2014) revealed that there is a significant relationship between corporate governance practices and the profitability of banks. While, Aljifri & Moustafa (2007) found that the corporate governance mechanisms have significant impact on firm performance which are the impact on pay-out dividend ratio, debt ratio and governmental ownership.

On the other hand, non-financial indicator also applicable to be used in measuring the performance. Non-financial indicators that contrast with the financial elements can be applied to see the real performance through the practices in an organisation. For example, the performance of a firm can be seen through the employees whether they carry out their duties properly or not. In addition, it also can be seen in terms of satisfaction of consumers of the services or products that offered as well as on how far the firm concern about their employees and on how the management plays their roles in managing the firm entirely.

Thus, from the above concern, rather than financial indicators to measure the performance, non-financial factors also significant to determine the healthy firm. Non-financial factors including the employees' satisfaction, quality service, customers' satisfaction are the mechanisms that will impact the performance of firm. Where, according to the researchers, non-financial factors are for the long-term effect that impact to the long-term financial performance. That is because non-financial measures are better predictors for long-term financial performance than the current financial measures (Banker D., Rajiv, Potter G., Srinivasan. S, 2000). In addition, for business leaders, to monitor and evaluate their company efficiently (Hussain and Hoque, 2002; Kaplan and Norton, 1996).

In this perspective, Gijssel (2012) lists two benefits by using the non-financial measures. Firstly, high performance on non-financial performance measures is positively related with future financial performance. Secondly, non-financial performance measures reduce the amount of earnings management. Hakkak and Ghodsi (2015) revealed that implementation of non-financial performance measures has significant positive effect on the firms' competitive advantage and sustainability. For instance, a study conducted by Ahmed & Manab (2016) proposed a research framework to examine the influence of enterprise risk management success factors on firm financial and non-financial performance. While, Murphy, Trailer & Hill (1996) identified 71 performance parameters to measure financial and non-financial performance.

Furthermore, non-financial performance becomes the alternative indicator to focus during uncertain economy or other crisis, such as according to Gijssel, (2012), companies tend to increase their focus on non-financial performance measures during a crisis. Since the financial crisis, the company began to use more non-financial performance measures and the company was able to increase the annual bonus percentage.

Therefore, the impact of non-financial performance measures towards firm's performance has become attention for researchers. Some study used different indicators to measure firm performances, such as banking service satisfaction which is considered as the main determinant of bank performance (Al-tamimi, 2010). Another study by Al-Beshtawi, Zraaqat, & Al -Hiyasat (2014) also constructed non-financial performance as customers, employees, investors and depositors as the elements of non-financial measurement of performance.

Meanwhile, Santos & Brito (2004) classified non-financial dimension as customer satisfaction, employee satisfaction, social performance, and environmental performance are correlated with the financial performance. Hussain and Hoque, (2002) also mentioned the non-financial factors, such as customer satisfaction, product quality, productivity and business efficiency. In a study by Rajiv D. Banker, et al., (2000), they stated that non-financial measures were product quality, customer satisfaction, and market share in performance measurement and compensation systems.

However, without neglecting the role of corporate governance towards Islamic financial institutions which are known as *Shariah* governance. Its role is very important in the interest of the *ummah*. Therefore, according to the Islamic perspective, in addition to traditional measurement of performance, there are other elements that can be benchmarked against the performance of the company as well as in the implementation of *Shariah*-compliant system. The mechanisms that emphasize the performance of firm in Islamic perspective is relevant to be applied since the *Shariah*-compliant system began to gain attention, while IFIs was experiencing tremendous development.

SHARIAH GOVERNANCE MECHANISM AND FIRM PERFORMANCE

As briefed in the introduction, the main aim of this paper to examine the relationship of the *Shariah* governance mechanisms that consist of SC supervision, *Shariah* risk, *Shariah* audit, *Shariah* review, as well as disclosure and transparency that will give impact on the firm performance. Section five provides elucidation on the relationship of *Shariah* governance mechanisms to performance. Literature survey found focused on the role of *Shariah* governance organs and functions on IFIs' performance. Governance measures studied in the previous literatures are *Shariah* Committee, *Shariah* risk, *Shariah* review, *Shariah* audit and disclosure and transparency.

The Relationship between *Shariah* Committee and Firm Performance

Shariah governance in IFIs not only as a direction to implement good practices but as a responsibility to meet the needs of Muslim in choosing the product based on *Shariah*. In this regards, IFIs are responsible to ensures all activities are *Shariah*-compliant for the interest of Muslims. Failure to ensure operationalisation on *Shariah* compliance would cause loss of confidence in a majority of people on this institution, especially the Muslims community (Alnasser, 2012).

In this respect, BNM take the initiative by directing the IFIs to provide the guideline of *Shariah* governance which is SGF as required by BNM. This framework aims to ensure the Islamic banks operated in accordance of *Shariah*. In this effort, Islamic financial institutions appoint the SC from experienced scholars to assist the IFIs in implementing the *Shariah* governance system. The roles of SC have recognised by many studies which identified that SC plays a significant role towards the establishment of *Shariah* governance. According to Grassa (2013), the existence of SC in IFIs has become a significant component of *Shariah* governance. Where, the role of the SC on Islamic banks performance are including governorship of *Shariah* committee and *Shariah* Committee and profit (Ghayad, 2008). While the function of SC is to control bank transactions based on Islamic law by directing, reviewing and supervising the Islamic bank activities. SC is responsible to ensure the banks activities meet with *Shariah* requirement by referring the main source in Islam such as *Al- Quran*, *Al- Hadith*, *Ijma' Ulama'* and *Qias*. Likewise, in order to approve the financial activities of Islamic banks, SC refers to the *fatwa* and will review to ensure whether the transactions are in accordance with the *Shariah* (Bukhari, 2013) Thus, *Shariah* supervision under SC provides the solution for barriers and conflicts as well as improvements in the organisation (Garas & Pierce, 2009).

Regarding to the relationship of *Shariah* committee and performance Mollah & Zaman (2015) investigated the impact of *Shariah* supervision, including SCs supervisory or advisory role on performance. The study found that the effect of SC on accounting-based performance was positive when *Shariah* Committee have a supervisory role. While, a study

by Musibah (2014) indicated that, Return on Assets (ROA) and Return on Equity (ROE) was found to be a significant mediating factor for the relationship between capital employees efficiency (CEE), and structure capital efficiency (SCE), and corporate social responsibility (CSR) in Islamic banks. .

The Relationship between *Shariah* Audit and Firm Performance

Shariah audit is defined as an independent assessment that is periodically conducted to improve compliance level and ensure the effectiveness *Shariah* control system (Shafii, Abidin, Salleh, Jusoff, & Kassim, 2013). *Shariah* audit covers every aspects in IFIs in accordance to Islamic values where the existence of this function provide the value added towards the role of IFIs *Shariah* committee (Shafii et al., 2013). The aspects include the financial statement, organisational structure, systems and process, and a review on the *Shariah* governance process BNM (2010) will be reviewed to see whether all activities are conducted based on *Shariah* or not.

Shariah audit plays a significant role in serving the public assurance on products. To realise this role, *Shariah* audit performs periodic assessments to ensure the systematic and effectiveness of the internal control system and so as to ensure the activities comply with *Shariah*. In this context, *Shariah* auditing should not be accorded as merely sounds corporate governance practices to meet the prerequisite and condition that set by certain parties, but also need to consider on the spiritual practice that becomes responsibility according the implementation of IFIs and *Shariah* auditors (Chik, 2011).

In addition, towards the implementation of *Shariah* Audit within IFIs, *Shariah* audit function plays the significant roles to enhance the level of *Shariah* audit. As stated in SGF, where this framework clearly illustrates that the function of *Shariah* audit are important in an organisation, which will reflect the performance of firm. Particularly, this functions include oversight financial reporting, internal controls and audit, and compliance with regard to laws and regulations. Some studies argued that, the existence of audit in an organisation can improve the firm performance.

While the other study states that, the competency and work performance were positively significant with internal *Shariah* audit effectiveness (Khalid, Haron & Masron, 2017). The *Shariah* audit function in IFIs is highly required in accordance of negative impact that potentially influence the financial and non-financial performance. (Chik, 2011). Moreover, it also needed to guide the practitioners in implementing the *Shariah* compliance auditing since the current *Shariah* audit manual is considered insufficient (Kasim, Sanusi, Mutamimah, & Handoyo, 2013).

Moreover, audit always has positive impact on financial business and evaluate accounting records and the financial status of a firm. The internal audit could help the company to oversee the operation and add value to the organisation through systematic risk management. A study by Awdat (2015) states that, internal audit function is important, that give positive impact to the firm's financial performance. Alaswad & Staniši, (2016) found in their studies that, there was correlation between audit function and firm performance.

Based on the above literatures, the internal audit efficiency is important because it has an association with the financial report and an efficient financial report improves firm performance. Similarly, audit alerts the entire management which enables the organisation to ensure work is done based on guidelines and proper manners. Any inappropriate issues are brought to the management for discussion and find a way to solve it. Likewise, the role of *Shariah* audit is significant where to ensure all activities are complying with *Shariah*. Lack of *Shariah* audit function can cause loss of confidence in IFIs. Conversely, strengthen this function may help to improve the organisational performance.

The Relationship between *Shariah* Review and Firm Performance

The existence of *Shariah* review is to ensure all activities of IFIs in accordance to *Shariah* rules, regulations as reflected in fatwa, rulings and guideline issued by the *Shariah* Supervisory Board (*SSB*) (Bahari & Baharudin, 2016). *Shariah* review is one of the functions set in SGF by BNM to be performed by IFIs to ensure the compliance level on *Shariah* matters. The scope that the *Shariah* review will be performed include the planning review procedures, executing review procedures, preparation and review of working paper as well as procedures in documenting conclusions and preparation of the *Shariah* review report (Hairul et al., 2009). These procedures are to achieve the conformity that all activities carried out according to the requirement particularly on *Shariah* rules and regulation.

In SGF, the *Shariah* review function seen as a significant mechanism to seek proper governance practice in monitoring and assurance of IFIs activities. However, preparing the *Shariah* review report to be disclosed by IFIs is not mandatory. It was further found most Islamic banks in Malaysia are not including the *Shariah* review report in their annual reports, with the exceptions for Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB). In fact, a study conducted by Amalina et al. (2012) indicated that only 30 percent of banks confirmed that their review process was based on valid and reliable information given by the *Shariah* review standards developed by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). This is due to the fact that AAOIFI standards are not being made mandatorily followed in Malaysia and Indonesia. Based on this, Samah & Hassan (2014) recommended that the awareness on the importance of *Shariah* review towards the Islamic banks would realise the *Shariah* review expectation of SGF.

However, many issues arise from the *Shariah* review and previous studies on the impact of *Shariah* review on IFIs performance, most of these issues as discussed above were not been identified. Due to this, *Shariah* review mechanism are still considered as a new area of study. According to Khamar Tazilah, Ahmad Rapani, Abdul Halim, & Majid (2017) the existence of this function in the performance of IFIs was not been studied by researchers to determine the importance of *Shariah* review function.

The Relationship between *Shariah* Risk and Firm Performance

Risk management in Islamic banking is not substantially different from the conventional banking. However, the risk matter in Islamic banking is related to *Shariah* compliance and becomes the dominant risk that distinguishes IFIs from conventional financial institutions (Thijs, 2010). It is known that, the risk management roles are crucial to ascertain institutional stability. According to Khalid & Amjad (2012), risk management is important for banks performance and success. Further, risk management substantially impacts on the institutional financial and non-financial performance of. For example, the common risk in IFIs is *Shariah* non-compliance risk, Hassan, R (2016) stated that the *Shariah* non-compliance risk can have a negative impact on IFIs financial and non-financial performance.

The failure of risk management that impact on the performance of financial institutions becomes the significant area of concern for the risk management in an organisation. There are several evidences that showed the failure of risk management has a negative impact on the financial institutions.

Table 1: Evidences on failure of risk management

Events	Causes
2008- financial crisis	<ul style="list-style-type: none"> - Lack of Management / Board oversight - Weak risk culture - Risk Management function marginalized - Over-reliance on quantitative tools / methodologies - Poor liquidity management - Lack of relevant internal valuation models

2004 - National Australia Bank (2004)	- FX derivative losses of AUD 360 million
2001 - Allied Irish Bank / John Rusnak	- US subsidiary Allfirst reported FX Options trading losses of USD 750 million
1998 - LTCM, Hedge Fund	- Bond Market losses wiping out capital of USD3.9 billion - Fed and consortium of US Banks bailout

Ginena (2014) defines *Shariah* risk, as a form of operational risk, because the risk of financial losses that IFI may experience because of non-compliance with *Shariah* precepts in activities (operation), as ascertained by the SC or the pertinent authority in the relevant jurisdiction. The function of *Shariah* risk is to identify the non-*Shariah* compliance risk that may arise from the business transactions, which are to identify the possible risk, measure the level of risk, monitor to facilitate the effective risk management, and control the recurrences of non-compliance risk. According to Ginena (2014), the possible implication of *Shariah* risk are credit risk, legal and compliance risk, reputational risk, market risk. Risk cannot be ultimately avoided, but the function of *Shariah* risk management to deal and mitigate the risk is very important.

Although all the other common risk in the conventional financial institution also potentially impact on the IFIs. Islamic Financial Service Board (IFSB) identified that, against the *Shariah* non-compliance risk, not all the *Shariah* non-compliance risk impact and lead to the loss of the IFIs. But, according to the Hassan, R (2016) discussed that, the *Shariah* non-compliance risk emerges from the entire process of the Islamic finance product development, which eventually caused both financial and non-financial costs to IFIs.

On the other hand, according to IFSB working paper 2016, the Institution Offering Financial Services (IIFI) the risk of loss can be occurred as a result from avoiding the underlying contracts that are usually not compliant with the pronouncement issued by the central authority (Oz, Khokher, Ali, & Rosman, 2016). The failure to notice any rules as stipulated by an organisation put the firm into the risk. Risk of loss might be happened, as well as it will reflect the integrity level in the organisation. Thus, risk management is important in IFIs as it is related to the theory of financial intermediation (Rosman & Abdul Rahman, 2015), as well as it becomes the priority to the financial institutions (Scholtens and Wensveen, 2000). Failure to manage this risk in Islamic banks may reduce the confidence among stakeholders (Ginena, 2014). In this regards, in relation to the existence of *Shariah* governance system, the effective of this function able to mitigate the non-compliant risk and enhance the reputation of IFIs in the market.

The Relationship between Disclosure and Transparency and Firm Performance

Harmonisation of the *Shariah* governance rules is necessary to ensure high level of transparency and increase confidence and protect the interests and rights of IFIs investors and stakeholders (Bahari & Baharudin, 2016). In this regard, it becomes the responsibility of SC to ensure the disclosure and transparency level in IFIs. By enhancing corporate governance disclosure, it could mitigate the information asymmetry that exists between shareholders and managers (Darmadi, 2011). For example, stakeholders, shareholders and the public are always concerned against the correct and timely information of a company for their investment decisions (Haqqi, 2014). Moreover, Islam also recommend the disclosure practice in business deal as narrated in the Quran verse 5:99:

“Nothing is on the Messenger but communicating the Message. And Allah knows what you disclose and what you hide”.

Meanwhile, the information pertaining the financial or other activities must be disclosed in the company report. By reporting the activities in the annual report, it allows the customers to review and evaluate the level of assurance in the banking operation. It elucidates the significance of the banking sectors to provide confidence level among stakeholders towards the capability of the institution. In *Shariah* governance practice, transparency and disclosure are the most important parts, it constantly impacts on the cost of capital, reputation, investors' decision and stock prices (Haqqi, 2014).

To attain transparency, it is important for the banks to emphasise the impact of disclosure in providing valid and accurate information pertaining the financial reporting, the transaction, and the activities throughout the organisation. Disclosing all activities by providing information could give advantages to the company as well as the public that may influence the public to review the activities of company and attract the public as the potential customers.

In relation, Lahrech et al. (2014) examined the transparency level of the banks towards profit and loss sharing to investment account holders. The result indicated here is a positive relationship between the transparency and financial performance. Consistent with study by Bijalwan & Madan (2013), where the transparency and level of disclosure contributed to better corporate governance and performance. The result of this study indicated that there is a significant relationship between transparency and shareholders' rights and firm performance.

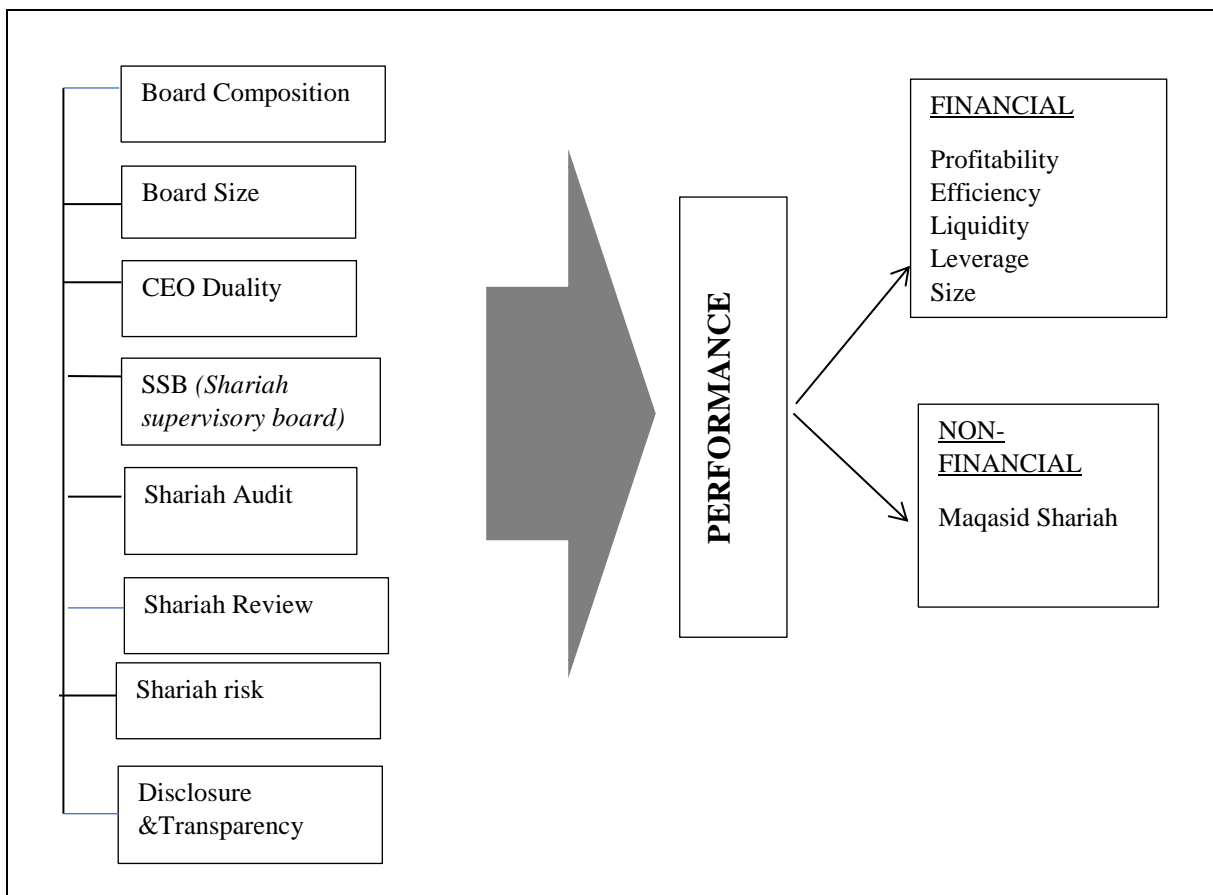


Figure 1: Theoretical Framework on *Shariah* Governance Factors Impacting Financial and Non-Finance Performance of Islamic Banks

From the literature review exercise conducted on the focused area of the impacts of *Shariah* governance factors on IFIs' performance, as discussed in the sections, sets of the relationship amongst the identified variables could be

summarised in Figure 1. Figure 1 depicts the Theoretical Framework from established theoretical and empirical gaps in the area being reviewed.

CONCLUSION

Shariah governance is essential for Islamic financial institutions to ensure the business operation is in accordance to *Shariah*. The proper *Shariah* governance practice not only provide a sound *Shariah* in an organisation, where it is evident that the *Shariah* governance practice is significant to performance. This paper provides discussion on the impact of *Shariah* governance to Islamic banks performance by emphasising five *Shariah* governance factors, namely SC, *Shariah* audit, *Shariah* risk, *Shariah* review and disclosure and transparency.

From the analysis, this paper highlights the *Shariah* governance in relation to financial and non-financial performance. Financial factors are profitability ratio ROA and ROE, while non-financial factors include customers' satisfaction, employee's satisfaction, investors and depositors, social performance, environmental performance product quality, productivity and business efficiency. The analysis also discovered the instances that financial and non-financial factors are related to performance.

Since the Islamic banking develop tremendously that contributed to the current economy, *Shariah* governance need the special attention not only to meet the needs and interests of people life, even to cultivate the well-being of the *ummah*. In sum, based on the literature analysis, it can be concluded that, *Shariah* governance mechanisms are related to performance of firm. However, the effect of *Shariah* review function is unidentifiable as this function is still under-researched, thus the impact is less known. Further research can be conducted by examine the impact of *Shariah* review on the financial and non-financial performance of IFIs.

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