

CHAPTER 1

INTRODUCTION

1.1 Background of Islamic Finance

Islamic finance has contributed to the Islamic economic system that safeguards the interests of stakeholders, impacts economic development, and forms community relations. This contribution can be seen through its growth at 10 % to 12 % yearly and recorded USD 2.2 trillion in total for more than 60 countries (Market Research Malaysia, 2020). The emergence of IFIs began in 1970 in Egypt and spread around the Middle East, North Africa, Far East, Europe, and the USA (Garas, 2012).

The development of the Islamic financial system in Malaysia started with the establishment of pilgrimage fund (Tabung Haji) in 1963 as the first Islamic savings institution. The first full-fledged Islamic bank in Malaysia is Bank Islam Malaysia Berhad (BIMB) was established in 1983 (Laldin, 2008). BIMB offers banking services, and the products are based on Shariah principles (Kunhibava, 2012).

The second Islamic bank in Malaysia, Bank Muamalat Malaysia Berhad (BMMB), was founded on October 1st, 1999 (Bank Muamalat, 2022). However, on May 5, 1993, Bank Kerjasama Rakyat Malaysia (Bank Rakyat) began implementing the Islamic Banking System in its four branches by offering the scheme that refer to the Islamic banking and financial system run by a cooperative bank without the use of riba (Asni, 2019). The conversion of the conventional banking system to the Islamic banking system has taken place gradually since the adoption of the Islamic banking scheme

(Borhan, 2001). following that, 40 Bank Rakyat locations were fully functioning for Islamic banking at the end of 1995 (Asni, 2019).

The fourth Islamic bank in Malaysia, MBSB Bank Berhad, was founded on November 6, 2017. Currently, Malaysia has sixteen Islamic banks consisting of full-fledged and subsidiary, and local and foreign ownership (BNM, 2020). Aligned with the development and the Muslim's demand on the Shariah compliant product and services, the first Islamic banking established in accordance of Islamic Banking Act 1983 emphasised the requirement of the Islamic bank operation must be avoided from the elements that do not approved by Islam (Hassan, 2008).

Currently, there are legal framework for IFIs to promote institutional integrity and portray a Shariah-compliant image on their products and services. A comprehensive legal framework is required to support the growth and development of IFIs (Hassan, 2016). Therefore, the Central Bank of Malaysia (Bank Negara Malaysia or BNM) issued the Shariah Governance Framework (SGF) 2010 to strengthen the Shariah compliance system, providing comprehensive Shariah principles to the public and financial markets through the integrity of Islamic financial services (BNM, 2010).

Following the implementation of SGF, the Malaysian legal system has enacted a law for Islamic financial services institutions called IFSA, which came into effect on 30 June 2013. The act regulated to empower Islamic financial systems in Malaysia in relation to the Shariah compliance system, including the banking system, the takaful, the financial market and the payment system, and other financial intermediaries. In addition, in 2019, BNM issued the Shariah Governance Policy Document (SGPD) 2019 to supersede the SGF issued in 2010. This new policy document, which directly came into effect in 2020, strengthened the oversight commitment of the Board of Directors (BOD), the Shariah Committee (SC), and other organs involved in Shariah governance

implementation (BNM, 2019). Although SGPD 2019 has replaced the SGF 2010, both principles of documents remain the same, with SGPD 2019 placing a strong emphasis on all elements of Shariah governance (Naysary et. al, 2020).

IFSA 2013 regulates the specific requirement of SC, highlighting the criteria and enhancing the roles and position of SC as an integral part of the company (Miskam & Nasrul, 2013). This law has increased the SC responsibility to the same level as the Board of Directors (BOD) and senior management (Muhamad Sori et al., 2015). In addition, the Act enhances the Shariah governance by incorporating the requirements of Shariah compliance and enforcing penalties for non-compliance (Hassan, 2016).

In relation to the Shariah governance as crucial component in IFIs, Apart from emphasising Islamic principles and the success of Shariah governance in promoting social welfare, disclosure and transparency are essential for the public to review Shariah status and corporate activities. The Shariah disclosure highlighted in the SGF could boost public confidence towards the Islamic banks regarding the Shariah-compliant and describe the company's commitment to the society. It allows the public and stakeholders to reach the information regarding the banks' activities and the status of Shariah-compliant. In addition, the disclosure is frequently related to the company's financial report and corporate report. These documents are considered valid and accurate communication tools between the banks and the public or stakeholders, recommended in the business deal and any transaction as mentioned in the Holy Quran, of which Allah SWT states:

"Nothing is on the Messenger but communicating the Message. And Allah knows what you disclosed and what you hide" (Al-Qur'an, Al-Maidah 5: 99)¹

¹ Al-Qur'an. Al-Maidah 5: 99. (All Quran translations in this writing are based on Saheeh International 2001-2012. The Meaning of the Quran in English. Jeddah: Al-Muntata Al-Islami. King Fahd National Library Cataloging. Translation from other sources will be cited accordingly)

Disclosure guides an organisation to operate transparently. Providing valid, accurate, and sufficient information without any suspicion and deception is significant in an organisation. It identifies accountability as part of the commitment and recognises the integrity and fairness among the stakeholders and the direction to achieve a higher performance in the business environment.

A disclosure requires an organisation to provide transparent information by revealing the bank's activities and Shariah transaction status, corporate background, social activities, and financial status. The disclosure of relevant information to stakeholders allows the investor and the public to access a particular company's information for decision-making purposes. In addition, the information provided allows the public to compare the best channel for their business. Thus, reporting on the financial status and other corporate information to the public could influence the firm's performance. In addition, corporate governance reporting can identify stakeholders, especially regulators, and help reduce the information asymmetry between internal and external and between institutional shareholders and minority shareholders (Haat et al., 2008). Therefore, it is consistent with the demand for corporate disclosure that arises according to the information asymmetry and agency conflict between the management and the investors.

In line with the development and achievement of the Islamic finance industry, Malaysia has not ruled out accountability, which has become a concern resulting from large companies' collapse. The accountability in IFIs becomes significant because this industry carries out various activities and engages in a considerable amount of money in daily transactions. At the micro-level, a bank provides financial facilities to the community through banking services. The bank's primary function includes serving as

a tool for collecting and managing the money from the depositors and providing financial facilities to the community.

Islamic banks highlight disclosure and transparency, which requires an extensive disclosure practice to protect all stakeholders and the public. The most crucial disclosure information on any organisation is on the performance. In an organisation, performances are frequently emphasised, mainly on financial performance, and financial performance becomes the leading indicator of the success of the business. A strong financial performance depends on how a company is conducted, considers the ethical values, the company's ability to maintain in the marketplace, good services provided, and the most significant elements of an organisation's governance structure. It has been debated that from the Islamic perspective, governance can eliminate the ethical issues that can critically cause the failure of an organisation (Ghafran & Yasmin, 2020). In addition, Brammer et al. (2007) suggest that religious belief can shape individuals' attitudes towards governance.

1.2 Statement of the Problem

Shariah governance emphasises accountability, disclosure and transparency, and fairness that can form a good governance practice. Undoubtedly, weak, and controversial corporate governance practices, such as transparency and accountability issues, lead to financial and non-financial scandals that are also pointed as a factor that affects the corporate sector (Chang & Leng, 2004; Salem et al., 2019;). For instance, the Lehman Brothers were the most significant collapse in history in 2008 when the issue of corporate governance and accountability was identified as a critical factor in the failure.

The implementation of Shariah governance by Islamic banks is crucial; it is to grow the establishment of the Islamic banking system, enhance the existence of Islamic banks, and maintain the Islamic banking image in public (Siswanti et al., 2017). Similarly, Chapra and Ahmed (2002) opine that corporate governance practices in Islamic financial institutions could increase public confidence, mainly Islamic Bank's customers. The needs for Shariah governance is critical in IFIs to ensure the credibility of this industry amongst the stakeholders and public (Muneeza & Hassan, 2014; Zain & Abdullah, 2019), and such governance seems to be able to prevent governance issues, such as financial scandals and other corporate scandals related to a poor governance practice.

In addition, the reporting on the Shariah governance is critical for both Islamic banks and all stakeholders regarding the Shariah-compliant (Alam et. al., 2021). Shariah non-compliance risk that leads to the Shariah non-compliant status, such as from prohibited elements or illegal contracts, will affect the status of income of a firm. It may also result in a loss of confidence and trust among stakeholders, particularly Muslim consumers, in the institution's ability to manage their finances or investments in accordance with Shariah principles (Khamar Tazilah et al., 2017). Moreover, the implication of Shariah non-compliance is against the commands of Allah SWT, a barrier to Allah SWT's blessing, and threatens the reputation of a business. According to Malaysian law, shariah non-compliance is included under IFSA 2013. Section 28 (5) of the Act provides for imprisonment for a term not exceeding eight years or a fine not exceeding twenty-five million Ringgit, or both (IFSA, 2013).

Despite a tremendous growth, weak Shariah governance seems to be complicated in instilling a strong trust in the management and the BOD. It resulted to the scepticism in the Islamic financial system in managing the trust of the stakeholders (Abdul Aziz,

2013). In this regard, Shariah governance disclosure seems like an integral element as a communication tool to reveal the Shariah governance's implementation and so that all the stakeholders can access information. Many studies have examined the relationship between adherence to Shariah governance disclosure and performance (Alam et al., 2021; Khanifah et al., 2020; Masruki et al., 2018). However, most of the studies determined the items of Shariah governance by looking at the SC as an indicator for Shariah governance. Prior studies also used the guidelines, such as AAIOFI, IFSB, and several studies based on SGF. Since SGF and SGPD stand by the same principle SGF 2010 is still applicable to be applied in this study. However, whether the SGF 2010 and SGPD 2019 have impacted the banks' performance is inconclusive and debatable.

Hence, this study adopted the guidelines based on the SGF 2010 and SGPD 2019 to develop the Shariah governance disclosure item. In addition, prior studies were widely conducted on the SC as an indicator for Shariah governance disclosure. In order to address the gap of the previous study on Shariah governance that lacks comprehensive examinations on Shariah supervision, Shariah audit and Shariah risk disclosure were conducted in a single study. The disclosure studies also tend to focus on accountability, CSR, sustainability, and environmental disclosure.

It is also argued that the information on corporate governance is vital to be disclosed by the firm, while discharging corporate disclosure, and its impact on performance has become debated among academicians and practitioners (Darmadi, 2011a). To respond to the challenges on Islamic banks' disclosure elements, the content of the annual report regarding the Shariah governance as requirement practices and the achievement of Maqasid Shariah is essential as the corporate concern to the social and public attraction. The reporting in Malaysian companies is still moderate and needs improvements on their reporting countries (Md Surani & Noradiva, 2019). In addition,

enhancing reporting will earn stakeholders and community trust, improve public confidence, improve the relationship with the investors, and indirectly lower the average cost of capital (Gunawan & Lina, 2015; Hawashe, 2019). The annual report is considered the critical document that consists of financial and non-financial reports as a medium of communication with their stakeholders by providing the information regarding the company (Darmadi, 2013b; Scaltrito, 2015).

Concerning Maqasid Shariah studies, others have measured the disclosure that complies with the Shariah-based on Maqasid Shariah and links it to the performance (Ahmad & Ishak, 2020; Lesmana & Haron, 2019). These elements are related to human sustainability, which emphasise the welfare of the society and environment, also known as social responsibility, where the corporate social responsibility practices are part of Maqasid Shariah. Maqasid Shariah includes the circulation of wealth in the society through investments sustainability and fair and equitable wealth distribution leading to economic prosperity. It will benefit the community by providing the basic needs for the needy and emphasising the right and interest of community, as well as transparency in financial services in order to resolve disputes and the recognition of private and public property ownership (Hurayra, 2015). However, there are concerns over the Islamic banks of not being entirely complying with the implementation of Maqasid Shariah (Mohammed et al., 2015). Thus, the Maqasid Shariah disclosure could provide evidence to the public to show that the Islamic banks consistently support the Muslim and community for the interest of the *ummah*.

The elements of Maqasid Shariah are widely discussed and studied by many researchers and there are numerous studies conducted on Islamic banks and the Maqasid performance, however, the findings are inconclusive. It is found that the topic of Maqasid Shariah is still lacking (Ahmad & Ishak, 2020). In addition, there is a lack of

empirical and theoretical literature dealing between Maqasid Shariah and performance (Bedoui & Mansour, 2014). Maqasid Shariah, from an organisational perspective, has been discussed in a limited scope. Most studies related to Maqasid Shariah only focus on Islamic banking transactions, systems, and products offered, such as the Shariah contracts executed in Islamic banking, and measuring its achievement through Zakat, Sadaqah, and contributions in education and environment. In contrast, this study identified the Maqasid Shariah's elements in a broader scope through disclosure; it tests whether the Maqasid Shariah's achievements by Islamic banks can influence and improve financial performance.

Therefore, this study integrated the prior studies on Maqasid Shariah and CSR. Similarly, Said et al. (2018) and Bedouin and Mansour (2015) interpret CSR from an Islamic perspective that explains the Maqasid Shariah's elements. Accordingly, the findings of the study can harmonise, integrate, and interpret the CSR with Maqasid Shariah achievement to meet Shariah goals. By linking CSR with Maqasid Shariah, its achievement can be realised in a broader perspective, and its impact is more significant on the community and ummah. In addition, The Shariah objective incorporating larger social responsibility in the Islamic economics and financial system is justified based on the necessity to address potential issues relating to the environment, human rights, and dignity as well as economic, justice, development, and social welfare (Tarique et al., 2017).

Mergaliyev et al. (2019) developed a comprehensive evaluation framework in a Maqasid Shariah to measure Islamic banks' performance. Likewise, Asutay and Harningtyas (2015), Iryani et al., (2019), Mohammed et al., (2015), Rusydiana and Al-Parisi, and Al-Mubarak and Osmani (2010) also used the Maqasid Shariah to measure the level of performance of Islamic Banks in several countries. In contrast, this study,

on the Maqasid Shariah disclosure, was designed to investigate the association between Maqasid Shariah and the performance of Islamic banks. Therefore, this study applied the content analysis method to reveal the level of disclosure of Islamic banks concerning the Maqasid Shariah achievement.

In addition, this study combined two disclosures, namely, Shariah governance and Maqasid Shariah, where the prior study was conducted only on Shariah governance, while Maqasid Shariah was examined in a separate study. Combining Shariah governance and Maqasid Shariah shows a unique combination since the Shariah governance objective is towards the achievements of Maqasid Shariah. Moreover, unlike previous studies, in this study, the Shariah governance and Maqasid Shariah disclosure are presented as the independent variables by developing the disclosure item to investigate the relationship between Shariah governance and Maqasid Shariah disclosure and Islamic banks' performance in Malaysia.

Furthermore, the decision-making on Shariah matters is constrained by a Shariah board that sanctions or rejects any proposals in the light of Islamic law. However, the BOD is responsible for the appointment of the SC; the management of business operations also rests in the board's hands (Ghayad, 2008). The BOD may lead to a higher monitoring that may maximise the company's value. Still, in relation to the board, the company's performance depends on the corporate governance indicators' attributes (Bukhair & Rahman, 2015). In a corporate organisation, the role of the BOD is pertinent. The BOD is responsible for setting and approving the overall policy and strategy and monitoring the progress toward corporate objectives (Safieddine, 2009).

Many studies have looked at the BOD as an essential element associated with the performance, especially its role as a mediator (Darmadi, 2011). Therefore, this study examined the impact of the BOD on performance. Further, this study tested the

mediation effect by testing the board's function in mediating the relationship between Shariah governance disclosure and the performance of Islamic banks and investigated whether the Board mediates the relationship between Maqasid Shariah and Islamic Bank's performance.

In this study, the board consists of BOD size, BOD independence, BOD meeting and Muslim in BOD (Ghaffar, 2014; Shatnawi, 2020). The relationship between the BOD and the performance of Islamic banks has been discussed in numerous studies, however, the findings are inconclusive. The BOD is responsible for setting and approving the overall policy and strategy and monitoring progress toward corporate objectives (Chapra & Ahmad cited in Safieddine, 2009). In Islamic banks, the BOD is responsible for the decision-making, while the roles of Shariah governance practice is to ensure that all the activities comply with Shariah.

A firm's financial performance can be measured based on profitability, return on assets (ROA), return on equity (ROE), and Debt-to-Equity ratio (DER). These financial measures have a significant impact on exercising corporate performance in leading the company to achieve its goals. Therefore, this study aimed to analyse the impact of Shariah governance disclosure and Maqasid Shariah disclosure on the performance of Islamic Banks in Malaysia. This study is also critical in demonstrating the significance of the BOD as a mediator to financial performance. Based on the issues raised above, the research questions for the study were formulated and presented in the section that follows.

1.3 Research Questions and Research Objectives

The present research was conducted based on the research questions and objectives of the study.

1.3.1 Research Questions

1. What is the relationship between Shariah Governance (SC, Shariah audit and Shariah risk) disclosure and Islamic banks' performance?
2. What is the relationship between Maqasid Shariah disclosure and the performance of Islamic banks in Malaysia?
3. Does the BOD (BOD size, BOD independence, BOD meeting, Muslim in the BOD) mediate the relationship between Shariah governance and Maqasid Shariah with the financial performance?

1.3.2 Research Objectives

1. To investigate the impact of Shariah governance (SC, Shariah audit, and Shariah risk) on Islamic banks' performance.
2. To examine the impact of Maqasid Shariah on Islamic banks' performance.
3. a. To assess the mediation effect of BOD on the relationship between Shariah governance and the Islamic bank's performance.
b. To assess the mediation effect of BOD on the relationship between Maqasid Shariah and the Islamic bank's performance.

1.4 The Significance of the Study

Numerous prior studies have empirically and conceptually discussed the Shariah governance, Maqasid Shariah, the BOD function, and the performance. However, those studies mainly examined the Shariah governance and Maqasid Shariah in a single study. Thus, this condition inspired the current study to investigate whether the BOD plays a mediating function in the relationship between the Shariah governance disclosure and Maqasid Shariah disclosure on the performance of Islamic banks.

The primary objective of this study highlights the disclosure and transparency of the Islamic Banks on the Shariah governance and Maqasid Shariah. The disclosure of the Shariah governance information is essential for the shareholders or other stakeholders to access accurate information and decision-making. Companies may disclose the social information in their corporate reports to strengthen their transparency policy, enhance their reputation, and meet the needs and interests of the community (Hassan & Harahap, 2010). In addition, the disclosure on the Maqasid Shariah as additional information seems to be consistent with the legitimacy theory, which emphasises the aim of disclosure to legitimise the firm's behaviour by providing information intended to affect the stakeholders and society's perception (Hooghiemstra, 2000).

Based on the current literature, there are many studies on Shariah governance in a different study setting. In contrast, this study could be significant with the multi-theoretical framework. This research is an extension to the existing studies, and therefore, it contributes in the form of a new empirical study on Shariah governance and an extension to the development of the theory from the Islamic perspective. Meanwhile, the combination of Shariah governance and Maqasid Shariah disclosure and the BOD has been identified on each variable's different characteristics with a different theoretical explanation. Therefore, these theories could be evident, and they contribute to future studies based on this empirical study concerning the board's role that mediates the effect of Shariah governance on the Islamic banks' performance.

This study used updated data on Shariah governance, Maqasid Shariah, and the BOD as a mediator function on Islamic banks' performance, especially on the Shariah governance, by combining the SGF 2010 and SGPD 2019. For academic purposes, this study guides Shariah governance in Islamic organisations regarding the

implementation, practices, and impact on firms' performance. Moreover, this study provides the current guidelines for developing the Shariah governance items that are mainly based on the SGF 2010 and SGPD 2019.

This study highlights financial performance as being crucial for a company and other interested parties, such as shareholders, managers, suppliers, customers, and tax authorities as potential taxpayers. The financial performance becomes attention to measure the stability of a firm to gain profits and interest from the company. In addition, financial performance can increase confidence within the interested party, such as the tax authorities having the opportunity to collect taxes from a company that will contribute to the country's economy. From a firm's perspective, a strong financial performance is a significant factor in maximising profits. In addition, from a Muslim's perspective, the income from a business will contribute to economic development, such as paying taxes or Zakat to assist the needy. Thus, through this study, the industry can consider the Shariah governance and Maqasid Shariah elements that might influence the firm's performance.

This study is valuable because it may enhance the Shariah governance to complement the current practice of the industry. Apart from that, it is also vital for the public and private institutions to promote the Islamic financial system as a business entity from an Islamic perspective through Shariah governance and emphasise Maqasid Shariah as the highest recognition in the Islamic institution and the society. In addition, the results of this study may assist managers in understanding the need to improve Shariah governance and emphasising the importance of Maqasid Shariah and the quality of disclosure level in Islamic banks' corporate reports. In addition, the findings of the study are also significant in improving the responsibilities and functions of the BODs in mediating the roles of Shariah governance to the performance.

1.5 Scope of the Study

This study investigated the effects of Shariah governance mechanisms (SC, Shariah audit and Shariah risk), Maqasid Shariah as independent variables, and financial performance (ROA, ROE, DER) as dependent variables. This study also examined the function of BOD characteristics (BOD size, BOD independence, BOD meeting and Muslim in BOD) in mediating the relationship between independent and dependent variables.

As the study focuses on disclosure, secondary data gathered from Islamic Banks' annual reports were examined. All the information and the data in this study were obtained from similar sources. The reporting appears as an essential mechanism to provide information to the stakeholders such as the public. The disclosure of information in the annual report becomes the standard communication tool between the organisation and the public or other stakeholders who expected information regarding the Shariah governance and other Shariah matters.

Other than Shariah governance disclosure, the Maqasid Shariah represents the voluntary mechanisms of Islamic banks. The Maqasid Shariah refers to social welfare at the necessary level of human life, including preserving the faith and other human welfare. The Maqasid Shariah elements in this study consist of the items related to the services provided by Islamic banking, internal and external welfare, such as employees and society, and environment preservation. In general, it consists of the elements of CSR of Islamic banks in preserving the welfare of society. This study measured the disclosure level regarding the Maqasid Shariah, which might influence the performance of Islamic banks.

In addition, this study emphasises several theories related to this study. It began with the Intellectual Capital Model (ICM) as an underpinning theory. Then, the other

theories, including the stewardship theory, stakeholder theory, and legitimacy theory, were utilised to explain the nature of the study. The agency theory mainly explains the Shariah governance as a typical corporate governance theory, stewardship theory, and stakeholder theory. Meanwhile, the Maqasid Shariah has been explained by the stakeholder and legitimacy theories. The legitimacy theory explains both Shariah governance and Maqasid Shariah in terms of disclosure.

1.6 Structure of the Thesis

This thesis is organized into five chapters. The following chapter, which is Chapter Two explains the disclosure, transparency, and accountability in the financial industry and Islamic perspectives. This chapter introduces the Shariah governance practices in Malaysia, including the policy, guidelines, and framework. In addition, this chapter highlights the Maqasid Shariah, its application and achievements in Islamic banking perspectives. Also, highlights the gaps in the existing literature and guides the present study. Finally, this chapter developed the research framework and developed the hypothesis based on the prior to achieve the quantitative research objectives.

Chapter Three describes the research methods employed in this study to achieve the identified objectives. This chapter addressed the research paradigms, research strategies, goodness of measures, pilot test and data analysis tools.

Chapter Four provides the study results, including the descriptive analysis. This chapter also provides the result of the study based on SmartPLS data analysis. The result in this chapter has been discussed based on the research objectives of the study.

Chapter Five is conclusion chapter highlighted the theoretical and practical implications, limitations, and ends with the recommendations for future research.