**CORPORATE AND SHARI’AH GOVERNANCE AS A COLLABORATIVE GOVERNANCE MECHANISM IN INFLUENCING PERFORMANCE**

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**Abstract**

In Malaysia, the Shari’ah Governance Framework (SGF) was first issued to be adopted by Islamic financial institutions (IFIs) in June 2011. Meanwhile, corporate governance has been established in Malaysia in advance since 1999. Hence, this study intends to examine the effect of corporate and Shari’ah governance as a collaborative governance mechanism (CGM and SGM respectively) on the financial performance (FP) of Islamic banks in Malaysia. This study employs quantitative research techniques via secondary data collection methods, which covers annual reports and financial database. The data on CGM and SGM were taken from annual reports of thirteen Islamic banks in Malaysia. FP was taken from the Bankscope database. The data analysis has been done via Smart PLS SEM. The results indicate that CGM and SGM have a significant influence on FP of Islamic banks in Malaysia. The findings of this study indicates that the importance of Islamic rules and regulations, moral values and ethics in enhancing financial performance of the Islamic banks. This research has documented evidence that Shari’ah governance mechanism (SGM) is an essential predictor in explaining financial performance of Islamic banks in Malaysia. This can be perhaps because of Shari’ah board members understand the ultimate objective of Islamic institutions in helping shareholders and other shareholders who are society as a whole to ensure the proper distribution of wealth and resources.

**Introduction**

Corporate governance is essential to ensure the smooth running of any business, and it has been seen as a mechanism to improve accountability and performance. However, there is a critical debate on the governance and performance based on the increasing number of corporate/bank closures and difficulties. The people comprising the management of the institution are the key players that bear the ultimate responsibility and accountability to run the business properly. This has been proven from cases around the world involving senior persons in the business operations who were not acting in the best interests of shareholders and other stakeholders.

In 1999, the Malaysian Finance Committee Report defined corporate governance as “*the process and structure used to direct and manage the business and affairs of the institution toward enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholders’ value, whilst taking into account the interests of other stakeholders*”. Moreover, the Organisation for Economic Co-operation and Development (OECD) in the Principles of Corporate Governance (2000, revised April 2004) defines corporate governance as the *“…set of relationship[s] between a (company’s) management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of (the company) are set, and the means of attaining those objectives and monitoring performance are determined.*” It is emphasized that corporate governance involves a set of relationships between an institution’s management, its board, shareholders and other stakeholders.

In fact, the code also further explains that corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Therefore, from the definition itself, corporate governance can be illustrated as a mechanism for managing and monitoring a corporation to achieve its objectives, and, at the same time, to ensure that the interests and welfare of the shareholders and stakeholders are protected. Indeed, Bank (2009) also highlights that good governance is an effective mechanism for protecting stakeholders, whilst poor governance puts all parties at risk. By having the best practices of governance in place, the interests of shareholders and other stakeholders are guaranteed by the proper running of the business, which is handled by the appropriate and responsible individuals.

In the financial services sector, the principal-agent relationship carries the same definition as is applied in the corporate sector. However, the additional requirements of governance for Islamic banks need to be understood by the persons responsible when making decisions for Islamic banks. As highlighted by Chapra (2004), there are three groups of internal key components in Islamic banks involving decision-making – the board of directors, the Shari’ah and key Shari’ah compliance functions, and the majority shareholders. They are in the position to make sound decisions and realign the direction of the business for the sake of shareholders and other stakeholders in Islamic banks in achieving good performance of the Islamic banks.

This study evaluates how the monitoring and control mechanism of corporate and Shari’ah governance can better contribute to financial performance. This study also examines the adequacy of corporate and Shari’ah governance monitoring and control mechanisms that are expected to reduce or minimize agency and accountability problems in Islamic banks. This study provides empirical evidence on whether good governance leads to a good performance by taking into consideration the implementation of the Shari’ah governance framework with the effective date of June 2011 in Malaysia. This, to a certain extent will improve the governance requirements of the unique and opaque nature of Islamic banks that requires an understanding of the broader issues of responsibility and accountability from the corporate and Shari’ah governance perspective.

**Literature Review**

**Corporate Governance**

The International Financial Services Board (IFSB) (2006) defines corporate governance “as a set of relationships between a company’s management, its board of directors (BOD), its shareholders, and other stakeholders that provide the structure through which the objectives of the company are set; and the means of attaining those objectives and monitoring performance are determined.” This definition has been adopted from OECD (2000 and revised 2004).

In the context of Islamic banks, good corporate governance should encompass “a set of organizational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders; provision of proper incentives for the organs of governance such as the BOD, Shari’ah board, and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging Islamic banks to use resources more efficiently; and compliance with Islamic Shari’ah rules and principles” (IFSB, 2006).

Based on the description as discussed, corporate governance cannot be seen solely as a set of relationships amongst directors, shareholders and other stakeholders in an institution. An institution should set up its strategic objectives and ensure that the objectives can be achieved, whilst, at the same time, the monitoring mechanism must be in place. Hence, corporate governance in the context of Islamic banks can be defined as, firstly, a set of relationships among the key players and stakeholders. Secondly, these banks should have clearer strategic objectives of their existence. Thirdly, they should also have a proper monitoring mechanism in terms of the checks and balances of the business operations and activities.

Corporate meltdown has created much interest in the role of the board of directors in monitoring and controlling corporate performance. Since the introduction of codes, guidelines, rules, and regulations, it has been proven that the board is a unique and opaque element for ensuring corporate governance is effectively and efficiently implemented in the business institutions. This would absolutely guarantee that institutions are well administered, monitored and controlled by a credible, reputable and competent person. Boards are expected to manage and provide direction of the business and making communication effective (Bakalikwira, Bananuka, Kaawaase, Musimenta and Mukyala, 2017).

**Shari’ah Governance**

At present, in Malaysia, the Central Bank, i.e., Bank Negara Malaysia (BNM), has developed the Shari’ah governance framework for Islamic banks, effective beginning 1st January 2011 with the ultimate objective being to enhance the role of the board, the Shari’ah Committee and the management in relation to Shari’ah matters. Indeed, the Shari’ah Governance Framework was the first guideline on Shari’ah governance matters to be issued and applied in Islamic financial institutions in Malaysia.

The definition of Shari’ah governance in the Shari’ah Governance Framework for Islamic Financial Institutions guideline has been adopted from the definition in the Islamic Financial Services Board (IFSB) (2009). The IFSB (2009) defines the Shari’ah governance system as “a set of institutional and organizational arrangements through which Islamic banks ensure that there is effective independent oversight of Shari’ah compliance over the issuance of relevant Shari’ah pronouncements, dissemination of information and an internal Shari’ah compliance review.” Besides the corporate governance requirements as prescribed by other codes at the international level and locally, Islamic banks are also required to comply with the Shari’ah governance requirements to ensure Shari’ah compliance.

The agency problems in Islamic financial institutions are unique to other financial institutions, and different ways of examining and solving the issues are needed. As highlighted by Bukhari (2013); Darmadi (2013); Safieddine (2009); Grais and Pellegrini (2006); Archer et al. (1998), and Sarker (1999), the need to comply with Shari’ah rules and regulations makes a huge difference between Islamic finance and other modes of financing.

Shari’ah governance sets out the expectations of the bank concerning an IFI’s Shari’ah governance structure, processes and arrangements to ensure that all its operations and business activities are in accordance with Shari’ah. Shariah governance also provides comprehensive guidance to the board, Shari’ah Committee and management of the IFI in discharging its duties in matters relating to Shari’ah. The Shari’ah governance mechanisms outlined four important supportive functions of Shari’ah review, Shari’ah audit, Shari’ah risk management and Shari’ah research (Bank Negara Malaysia, 2011). In theory, robust Shari’ah governance mechanisms would enhance the credibility of Islamic finance operations and boost general public trust and the confidence of the financial markets.

Before the implementation of the Shari’ah governance framework in 2011 in Malaysia, the Accounting and Auditing Standards for Islamic Financial Institutions (AAOIFI, 2008) governance standard for Islamic banks (GSIB No.1 and No.2) defines a Shari’ah supervisory board as an independent body of specialized jurists in Fiqh al-Mu’amalat (Islamic commercial jurisprudence). However, the Shari’ah supervisory board may include a member other than those specialized in Fiqh al-Mu’amalat but who should be an expert in the field of Islamic financial institutions and with knowledge of Fiqh al-Mu’amalat. The AAOIFI (1999 and 2005) standard also specified a minimum number of three Shari’ah advisors on the board for particular Islamic banks. In addition, the IFSB (2005 and 2006) has stated that an appropriate mechanism must be created to ensure Shari’ah compliance in Islamic bank business operations, processes, and activities. Thus, an adequate system may include the Shari’ah board.

**Performance**

Islamic banks are accountable not only to the shareholders, depositors and other stakeholders, i.e., depositors and investment accountholders, but also ultimately to Allah s.w.t. There have been numerous studies on Islamic banks and their performance, but, through the review of the literature, not many studies have been conducted that assess the impact of Shari’ah governance mechanism on Islamic banks’ performance. Majority of the studies on Islamic banks have been on corporate governance, such as Adam and Mehran (2012), As-Saidi and Al-Shammari (2012), Zagarchev and Goa (2015), Pathan and Faff (2013), and Wasiuzzaman and Gunasegavan (2013).

There have been limited studies that use Shari’ah governance in Islamic banks as a variable for interpreting the performance of Islamic banks except for the study of Mollah and Zaman (2015). Other studies, such as Hassan (2011), Garas (2012), Choudhury (2013), Wan Abdullah, Percy and Stewart (2013), Mohammed and Muhammed (2017), Mohamad, Muhamad Sori and Shah (2015), and Shaharuddin (2011) focus on the Shari’ah governance practices.

Hasan (2011) aimed at understanding current Shari’ah governance practices in Malaysia, the GCC countries (Kuwait, Bahrain, United Arab Emirates, Qatar and Saudi Arabia) and the UK by identifying a regulatory framework (Shari’ah board structure, composition, role, function, independence, competence, disclosure and transparency) to create awareness of some of the crucial issues pertinent to Shari’ah governance of Islamic banks and to promote greater understanding of Shari’ah governance practices. However, no ranking or benchmarking has been done on the basis of the influence of corporate and Shari’ah governance concerning performance.

### Hypotheses Development

The board of directors are the top executives or key players of a corporation and assigned with the responsibility of formulating the policies and strategies and supervising the operations of the corporation. The BOD of every Islamic bank can be considered as the ultimate internal policymaker that is responsible for the establishment of the governance policy framework in their institution (IFSB, 2006).

As per the general requirements, as stated in the Shari’ah governance framework (SGF) issued by BNM in 2011, the BOD, Shari’ah Boards and Shari’ah Committee have important roles in implementing the strategic objectives of the Islamic banks to achieve better performance. The BOD has been recognized as having ultimate accountability and responsibility by the authority, BNM, to ensure the effective functioning of the overall governance framework (corporate and Shari’ah governance) in accordance with the size, complexity, and nature of the business.

The most crucial works are on the approval and the implementation of all the policies relating to Shari’ah matters. The BOD is also expected to appoint a competent and qualified Shari’ah Committee in the Islamic banks. Furthermore, the effective communications concerning the dissemination of Shari’ah matters must be smooth and proper to ensure that all Islamic bank staff is fully aware of the Shari’ah requirements at all times.

Non-executive directors (NED) are not employees of the company or affiliated with it in any other way, whilst executive directors are full-time employees of the company who manage the day-to-day operations of the business. Therefore, the existence of NED in the corporation may help corporations to prevent agency problems by monitoring and controlling the opportunistic behaviours of management in pursuing their interest.

At the international level and from the corporation perspective, the Cadbury Committee (1992) recommends that there should be at least three non-executive directors on the board of quoted companies. Board independence is associated with the entry of outsiders onto the board and the Cadbury Committee stated the rationale for having an outside presence on the board as firstly, outside directors broaden the strategic view of boards and they widen a company’s vision. Secondly, outside board members ensure that boards always have their sights on the interests of the companies. They are well placed to resolve conflicts. Thirdly, the outside directors bring awareness of the external world and ever-changing nature of public expectations to board discussions. Finally, outside directors have a clear role in appointing and monitoring the executive team. Nalukenge, Tauringana and Ntayi (2017) also highlight the pivotal of their role and expertise.

As supported by other previous research works, their presence would enhance the quality of the director’s decision-making in the corporation and serve as a monitoring and control mechanism for improving performance (Jensen and Meckling, 1976; Pearce and Zahra, 1992; Haniffa and Hudaib, 2006; Bakalikwara 2017). In the banking industry, the majority of studies suggest that increases in the proportion of outside directors on the board increase the firm’s performance (Andres and Vallelado, 2008) and that they can be more effective in monitoring managers (Adams and Mehran, 2003).

Moreover, Pandya (2011) finds and highlights in his study for the banking sector in India that they, i.e., NEDs, would be able to offer *‘objectivity to board decisions’, provide ‘general interest of the bank’, and assure ‘compliance with sound corporate governance practices.’* Hence, the ideal number of independent non-executive directors would assist in enhancing performance, strengthening the monitoring mechanisms and helping in promoting good corporate governance. Moreover, the IFSB (2006) outlines the importance of an independent non-executive director as the chairperson of the Governance Committee and members (Part 1: Para 16). They are particularly relevant to Islamic banks in cultivating a good corporate governance culture by providing different skills, such as legal expertise and business proficiency.

In line with the complexities and heavily regulated nature of the banking industry, banks need people who are knowledgeable and skilful. The BOD is also expected to have a reasonable understanding of the principles of Shari’ah and its broad application in Islamic finance for Islamic banks (paragraph 4.1, SGF). Furthermore, the IFSB (2009) provides a detailed discussion on the competency of the person in monitoring and controlling Islamic banks. Part II of the IFSB (2009) mentions that the BOD and senior management of the IIFS need to comply with certain minimum criteria to maintain the public’s confidence.

By having proper ‘competency’ criteria, the public would feel secure in dealing with people who are competent, honest, and financially sound and treat them fairly. The competency and credibility of key players in the Islamic banks provide the assurance that the Islamic bank’s operations are being monitored and controlled by qualified and trusted people. Competent directors may give a broader understanding in protecting the shareholders and other stakeholders due to the unique character of Islamic banks (Magalhães and Al-Saad, 2013).

To ensure successful decision-making in meetings, one of the requirements concerns the frequency of the meetings as well as the quality of achieving a consensus in the meeting. Researchers in the banking industry, such as Andres and Vallelado (2008), and Adam and Mehran (2003), conclude that by having more frequent board meetings, banks would enhance the quality of decision-making and improve performance as the complex nature of the banking industry requires more detailed analysis for every issue arising in the business.

H1: Corporate governance mechanism has a positive effect on the financial performance of Islamic banks.

H1a: Corporate governance mechanism has a positive effect on the ROE of Islamic banks.

H1b: Corporate governance mechanism has a positive effect on the ROA of Islamic banks.

H1c: Corporate governance mechanism has a positive effect on the CTI of Islamic banks.

The Shari’ah governance framework (2011) required the number of Shari’ah Committee members must not be less than five with the majority possessing strong knowledge of Shari’ah and backed by the appropriate qualifications. Firstly, must be Muslim; secondly, at least hold a Bachelor’s degree in Shari’ah (which includes the study of Usul Fiqh or Fiqh Muamalat) from a recognized university; thirdly, be able to demonstrate strong proficiency and knowledge in written and verbal Arabic, and have good understanding in Bahasa Malaysia and the English language. In addition, the Shari’ah Committee may also comprise experts with a finance and law background, and that a diversity of qualifications, experience, and knowledge is preferable. Paragraph 2.7 of the Shari’ah Governance Framework clearly mentions the ultimate responsibility and accountability of the Shari’ah Committee for all decisions, views, and opinions related to Shari’ah matters.

The Shari’ah Board/Committee must also ensure that meetings are held at least once in every two months (Appendix 5, SGF), the argument is that the more people handling the key Shari’ah compliance functions in the Islamic banks, the better the banks would perform. The key Shari’ah compliance functions cover Shari’ah Review, Shari’ah Audit, Shari’ah Risk Management and Shari’ah Research.

The Shari’ah Review work should cover from product structuring to product offering and its function refers to the ‘regular assessment on Shari’ah compliance in the activities and operations of the IFI by qualified Shari’ah officer(s), with the objective of ensuring that the activities and operations carried out by the IFI do not contravene Shari’ah (Paragraph 7.3, SGF).

The Shari’ah Audit work covers the audit of the financial statements of the IFI, compliance audit on organizational structure, people, process and information technology application systems, and the review of the adequacy of the Shari’ah governance process. The Shari’ah Audit function refers to the ‘periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI’s business operations, with the main objective of ensuring a sound and effective internal control system for Shari’ah compliance’ (Para 7.8, SGF).

The Shari’ah Risk Management refers to ‘a function to systematically identify, measure, monitor and control Shari’ah non-compliance risks to mitigate any possible non-compliance events’ (Para 7.15, SGF). The Shari’ah Research function refers ‘to the conduct of performing in-depth research and studies on Shari’ah issues, including providing day-to-day Shari’ah advice and consultancy to relevant parties, including those involved in the product development process(es)’ (Para 7.21, SGF).

Darmadi (2013) and Safieddine (2009) state that a Shari’ah Supervisory Board is essential to ensure that the activities of Islamic banks are in line with Shari’ah law. They serve as an internal control mechanism (Mollah and Zaman, 2015), Haniffa and Hudaib, 2007; Nienhaus, 2007; Magalhães and Al-Saad, 2013). They describe this mechanism for reviewing and supervising the activities of an Islamic bank. Apparently, they serve as an independent body within an Islamic bank. In sum, they should not be influenced by the management of banks or shareholders.

By having Shari’ah board in Islamic banks they would contribute to increasing the confidence of the Islamic investors and society, as posited by Farook, Hassan and Lanis (2011), Al-Tamimi (2012), and Abu-Tapanjeh (2009). Ultimately, Islamic banks would be known as efficient, stable, and trustworthy providers of financial services to the public (Bhatti and Bhatti, 2010). Based on the above explanation, the following hypotheses have been developed.

H2: Shari’ah governance mechanism has a positive effect on the financial performance of Islamic banks.

H2a: Shari’ah governance mechanism has a positive effect on the ROE of Islamic banks.

H2b: Shari’ah governance mechanism has a positive effect on the ROA of Islamic banks.

H2c: Shari’ah governance mechanism has a positive effect on the CTI of Islamic banks.

As discussed above, the hypotheses are formulated for examining the influence of corporate and Shari’ah governance mechanisms on the Islamic economic and financial performance (ROE, ROA, and CTI) of Islamic banks in Malaysia.

**Research Methodology**

This study covers an examination of the monitoring and control mechanisms of Corporate and Shari’ah governance amongst all Islamic financial institutions in Malaysia (excluding Takaful and re-takaful). Altogether there are 16 Islamic banks in Malaysia (BNM’s website assessed on 7th December 2013); however, only 13 were taken as a sample for this study as the remaining three (3) of them were not able to offer the detailed information needed.

### Conceptual Definitions and Variables Measurement

The conceptual definitions from previous studies have been adopted to match accordingly to the current study. Tables 1 and 2 illustrate the conceptual definition, code, and the operationalization of the research variables used in this study.

Table 1 Conceptual Definition and Operationalization of Exogenous Variables

|  |  |  |  |
| --- | --- | --- | --- |
| Summary of Variables, Definition, and Operationalization | | | |
| **CORPORATE AND SHARI’AH GOVERNANCE MECHANISM** | | | |
| **Variable** | **Code** | **Definition** | **Operationalization** |
| Board Size | BS | The total number of directors sitting on the board.  (Mollah and Zaman, 2015; Wasiuzzaman and Gunasegaran, 2013; Pathan and Faff, 2013; Andres and Vallelado, 2008; Adam and Mehran, 2005; Adam and Mehran, 2003; Belkhir, 2009; Mahmood and Abbas, 2011; Iqbal and Zaheer, 2012; Al-Shammari and Al-Sultan, 2009; Kyeboah and Biekpe, 2006) | Actual values. |
| Board Composition- Independent Non-Executive Director | NED | The proportion of independent NED to total number of directors.  (Mollah and Zaman, 2015; Pathan and Faff, 2013; Andres and Vallelado, 2008; Haniffa and Hudaib, 2006; Adam and Mehran, 2003; Pandya, 2011; Al-Saidi and Al-Sammari, 2013; Jensen and Meckling, 1976; Pearce and Zehra, 1992) | The number of independent non-executive directors/Total number of directors on the board. |
| Board Competency | BC | The qualification of the boards.  (Bank Negara Malaysia; Magalhaes and Al-Saad, 2013) | The number of directors with a qualification from finance, accounting, legal, business management, information technology, investment management/ Total number of directors on the board. |
| Number of board meetings | BM | As a proxy for the functioning of boards.  (Andress and Vallelado, 2008; Adam and Mehran, 2003) | Actual values -  The number of board meetings held during the year. |
| Shari’ah Board Size | SBS | The total number of Shari’ah board members in the respective Islamic banks.  (Mollah and Zaman, 2015; Rammal, 2010; Sheikh Hassan, 2012; Darmadi, 2013; Safieddine, 2009; Haniffa and Hudaib, 2007; Nienhaus, 2007; Magalhaes and Al-Saad, 2013) | Actual values -  The number of Shari’ah board members |
| Shari’ah Board Meetings | SBM | As a proxy for the functioning of Shari’ah boards.  (Andress and Vallelado, 2008; Adam and Mehran, 2003) | Actual values -  The number of Shari’ah board meetings held during the year. |

**Operationalizing Financial Performance**

Table 2 explains the code, definition and formula ratio of endogenous variables for this study. Ratio analysis is a crucial method to examine the financial performance of any corporation. By combining with the trend analysis, it provides a health indicator for banks and for predicting their future performance. Other studies such as Kamukama, Ahiauzu and Ntayi (2010) and Nkundabanyanga, Ntayi, Ahiauzu and Sejjaaka (2014) use questionnaire with a five-point Likert-type scale ranging from 5 (strongly agree) to 1 (strongly disagree) in measuring financial performance. Prior distribution, the questionnaire validated by experts.

Table 2 Code, Conceptual Definition and Operationalization of

Endogenous Variables

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **FINANCIAL PERFORMANCE** | | | | |
| **No** | **Financial Ratios** | **Code** | **Conceptual Definition** | **Formula Ratio and Its Indicators** |
| 1. | RETURN ON ASSETS | ROA | Profit earned per RM of total assets.  (Belkhir, 2009; Pandya, 2011; Athanasoglou et al., 2008; Sufian and Hasbulah, 2009; Sufian, 2010; Samad and Hassan, 1999; Rosly and Bakar, 2003; Coleman et al., 2007; Hassan & Bashir, 2005; Alsultan et al., 2005; Iqbal, 2001; Bontis, 2000; Clarke, 2011) | Profit before interest and Tax /Total Assets  This measures the ability of the bank to utilize its assets to generate profits, i.e., indicates bank efficiency in converting assets into net earnings. |
| 2. | RETURN ON EQUITY | ROE | Profit earned per RM of total equity.  (Samad and Hassan, 1999; Mahmood and Abbas, 2011; Pandya, 2011; Chiang, 2005; Alsultan et al., 2005; Nahar, 2004; Iqbal, 2001; Clarke, 2011) | Profit before Interest and Tax/Total Equity  This measures how effectively a banks’ management is in utilizing its shareholders’ funds. |
| 3. | COST TO INCOME | CTI | Income generated per dollar cost.  (Samad, 2004; Iqbal, 2001; Norhayati and Haron, 1998; Bankscope’s definition, 2015) | Total Expenses/Total Income  It measures the overheads or costs of running the bank as a percentage of income generated before provisions. |

**Data Analysis**

In general, PLS-SEM data analysis was run through two stages (Hair et al., 2017). Firstly, on the evaluation of the measurement model (MM), which was the relationship between the indicators and the constructs. Secondly, the evaluation of the structural model (SM), which was the relationship among the constructs that showed the influence of the exogenous variables (SGM) on the endogenous variables (IEP).

According to Gholami, Ainin, Ramayah and Molla (2013), Gotz, Liehr-Gobbers and Krafft (2010), and Petter et al., (2007), the assessment of the formative constructs is conducted via testing the significance of the item (weights) and the multicollinearity (VIF) between indicators via bootstrapping procedure. The general rule for FMM, according to Hair et al. (2017), is “*first, the indicator’s weight must be more than 0.5, if not we can always check the outer loading, which must be more than 0.5; then the item can be retained in the research model”*.

Table 3 shows the significance levels (outer weights) of BC (-0.314), BS (-0.331) and BM (0.377) values are all below 0.5. A negative correlation was not taken into consideration, such as the value for BC -0.314 (-0.241) as Hulland (1999) mentioned that indicators for the formative index can have positive (+), negative (-) or zero (0) correlation (outer weights and outer loadings).

The no significant indicator weights (relative importance) for the formative constructs should not be automatically interpreted as an indicator of poor measurement quality (Hair et al., 2017). Also, consideration shall be given especially for its construct via the value of the outer loading (absolute importance).Thus, when an indicator’s outer weight is not significant (for formative constructs) but its outer loading is high (i.e., above 0.50) then the indicator should be interpreted in the statistical terminology as *‘absolutely important but not as relatively important’.* The outer loadings for BM (0.583), it outer loadings are more than 0.5; thus BM is *‘absolutely important but not as relatively important’*. Therefore, BM can be retained in the measurements.

Table 3 Significance and Relevance of the Formative Indicators

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Formative Constructs** | Formative Indicators | Outer Weights  (Outer Loadings) | t-values | Significance Level | p-values |
| **CGM** | BC | **-0.314 (-0.241)** | 1.310 | NS | 0.192 |
| BM | **0.377** (0.583) | 2.580 | \*\*\* | 0.011 |
| BS | **0.331 (0.374)** | 1.724 | \* | 0.086 |
| NED | 0.648 (0.896) | 2.837 | \*\*\* | 0.005 |
| **SGM** | SBM | 0.528 (0.705) | 2.774 | \*\*\* | 0.006 |
| SBS | 0.731 (0.859) | 1.557 | NS | 0.121 |

Note: NS = Not Significant.

1. Bootstrapping confidence intervals for 10% probability of error (α = 0.10).

The t-value was greater than 1.645 (\*p <.10)

The t-value was greater than1.946 (\*\*p <.05)

The t-value was greater than 2.57 (\*\*\*p<.01)

1. Indicators for formative index can have positive (+), negative (-) or zero (0) correlation (outer weights and outer loadings) (Hulland, 1999).

Variance Inflation Factor (VIF) is the second assessment was the collinearity issue for the measurement model. The VIF as described by Chin (1988) as the degree to which the standard error is increased due to the presence of collinearity. The value must be at 10 or below to ensure that collinearity does not exist. Table 4 shows all the formative items with the VIF all below 10. Thus, there were no collinearity issues for the formative measurement model (FMM) for this particular study.

Table 4 Collinearity Issues

|  |  |  |
| --- | --- | --- |
| **Item** | VIF (<10.00)  (Chin,1988) | Collinearity Exist |
| **BC** | 1.460 | Not exist |
| **BM** | 1.113 | Not exist |
| **BS** | 1.598 | Not exist |
| **NED** | 1.354 | Not exist |
| **SBM** | 1.062 | Not exist |
| **SBS** | 1.062 | Not exist |

In conclusion, the formative measurement model in this study was considered to fulfill the major requirements of the PLS-SEM analysis in that it had met all the requirements for free/less collinearity and all the indicators were significant and relevant to be retained for further testing in the structural model. All the indicators can be used for predicting the concept/theory for this particular study. Therefore, further analysis can be conducted to ensure the structural measurement results.

**Findings and Discussion**

The structural model comprised the hypothesized relationships between the exogenous (CGM and SGM) and endogenous variable (FP) in this study. This shows how well the theoretical model predicts the hypothesized paths. The key criteria for examining the hypothesized relationships are the R² values and the significance of the path coefficients. The R² value is a measure of the model’s predictive accuracy and is calculated as the squared correlation between a specific endogenous construct’s actual and predicted values. High R² values indicate that the values of the construct can be well predicted via the PLS path model.

There is no fixed rule of thumb for acceptable R² values as this depends on the model complexity and the research discipline (Hair et al., 2017). The higher the R² values, the better the construct is explained by the latent variables in the structural model that point at it via structural model path relationships. Hence, the coefficient represents the exogenous latent variables combined effects on the endogenous latent variables. This study took a critical rule given by Hair et al. (2011), i.e., R² of 0.75 as substantial, 0.50 as moderate, and 0.25 as weak.

Table 5 The Results of R²

|  |  |  |  |
| --- | --- | --- | --- |
| **Endogenous Latent Variable** | **Exogenous Variable** | **R² Value** | **Results** |
| ROE | CGM  SGM | 0.488 | Weak |
| ROA | CGM  SGM | 0.313 | Weak |
| CTI | CGM  SGM | 0.439 | Weak |

**Note:**

CGM – Corporate Governance Mechanisms

SGM – Shari’ah Governance Mechanisms

ROE – Return on Equity

ROA – Return on Assets

CTI – Cost to Income

**Decision rule for R² (Hair et al., 2011 and Henseler et al., 2009):**

0.75 = Substantial

0.50 = Moderate

0.25 = Weak

The R² values, as shown in Table 5 of ROE, ROA and CTI were rather weak predictors (0.488, 0.313 and 0.439, respectively). ROE achieved the R² of 0.488 or 48.8%. This variance was quite a weak predictor even though it was nearly 50% as near to the moderate predictor as categorised by Hair et al. (2011). ROA achieved 0.313 or 31.3%; the value also suggests a weak variance in the ROA as financial performance measures. CTI also achieved a weak variance of 0.439 or 43.9%.

Thus, ROE (R² = 0.488) had a reasonable moderate predictive model in the structural model path relationships, followed by CTI (R² = 0.439) and the weakest predictive structural model path relationship, ROA (R² = 0.313).

The path coefficients, which have been defined by Falk & Miller (1992), as quoted in Berghman (2006), can be interpreted as the standardized beta coefficients that measure the strength of a relationship between a dependent variable and an independent variable, while holding constant the effects of all other independent variables (Allision, 1999 in Berghman, 2006). The path coefficients measure the strength of a relationship between a dependent variable and an independent variable.

Table 6 Path Coefficients and Hypothesis Testing

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Hypo-**  **Thesis** | **Relationship** | **Path Coefficient** | **t-value** | **p-value** | **Significance Levels** | **Significant** |
| **H1** | Corporate governance mechanism (CGM) has a positive effect on the financial performance of Islamic banks. | | | | | Yes |
| **H1a** | CGM 🡪 ROE | 0.556 | 2.582 | 0.011\*\*\* | S | Yes |
| **H1b** | CGM 🡪 ROA | 0.463 | 1.940 | 0.054\* | S | Yes |
| **H1c** | CGM 🡪 CTI | -0.641 | 2.536 | 0.012\*\* | S | Yes |
|  |  |  |  |  |  |  |
| **H2** | Shari’ah governance mechanism (SGM) has a positive effect on the financial performance of Islamic banks. | | | | | Yes |
| **H2a** | SGM 🡪 ROE | 0.469 | 2.748 | 0.007\*\*\* | S | Yes |
| **H2b** | SGM 🡪 ROA | 0.293 | 1.988 | 0.048\*\* | S | Yes |
| **H2c** | SGM 🡪 CTI | -0.141 | 1.043 | 0.298 | NS | No |

Note:

NS = Not Significant;

S = Significant

The t-value was greater than 1.645 (\*p <.10)

The t-value was greater than1.946 (\*\*p <.05)

The t-value was greater than 2.57 (\*\*\*p<.01)

Table 6 shows the significance of the relationship as a t-value statistic of 1.645 or more is considered to have a significant influence with a one-tailed test. The results indicate that:

1. Corporate governance mechanism (CGM) has a positive effect on return on equity (ROE) (2.582) in a one-tailed test (T Statistic > 1.645).
2. Corporate governance mechanism (CGM) has a positive effect on return on assets (ROA) (1.94) in a one-tailed test (T Statistic > 1.645).
3. Corporate governance mechanism (CGM) has a positive effect on cost to income (CTI) (2.536) in a one-tailed test (T Statistic > 1.645).
4. Shari’ah governance mechanism (SGM) has a positive effect on return on equity (ROE) (2.748) in a one-tailed test (T Statistic > 1.645).
5. Shari’ah governance mechanism (SGM) has a positive effect on return on assets (ROA) (1.988) in a one-tailed test (T Statistic > 1.645).
6. Shari’ah governance mechanism (SGM) has a positive effect on cost to income (CTI) (1.043) in a one-tailed test (T Statistic > 1.645).

The statistical findings for the evaluation of the influence of Shari’ah governance mechanisms on financial performance, indicate that from three variables, i.e., ROE, ROA and CTI, two results out of three (ROE and ROA) show significant findings. Hence, it can be concluded that Shari’ah governance mechanisms significantly influence the financial performance of Islamic banks.

Table 7 Summary Results of Research

|  |  |  |
| --- | --- | --- |
| **Hypotheses** | **Results** | **Supported/Not Supported** |
| H1: Corporate governance mechanism (CGM) has a positive effect on the financial performance (FP) of Islamic banks. | √ | Supported |
| H2: Shari’ah governance mechanism (SGM) has a positive effect on the financial performance (FP) of Islamic banks. | √ | Supported |

Table 7 shows the decisions to support or not to support the relationships. CGM is represented as the control and monitoring mechanisms of corporate governance, i.e., board size, board competency, non-executive directors and board meetings. Meanwhile, SGM is represented by the Shari’ah board size and meeting. Theoretically, a good board would lead to good Islamic banks’ performance.

Meanwhile, FP can be measured by financial ratio. The financial ratio analysis is widely recognized and entrenched as a valid instrument for examining the performance of economic entities, as highlighted by Hassan and Bashir (2002), Li et al. (2012), and Ariff, Badar, Shamser and Hassan (2011), especially in comparison analysis.

H1a outlined that CGM has a positive effect on the ROE of Islamic banks (t-value = 2.582). Hence, we accept H1a. H1b proposed that corporate governance mechanism (CGM) has a significant influence on return on assets (ROA) (t = 1.940) in a one-tailed test (t > 1.645). Hence, H1b is supported. This result shows that CGM has a significant influence on the ROA. CGM has a significant influence on CTI (t = 2.536) in a one-tailed test (t > 1.645). Hence, H1c is supported. Overall, CGM has a positive effect on the financial performance of Islamic banks in Malaysia.

This finding (H1) is aligned with what has been outlined by the majority of the rules and regulations in that by having an ideal board structure, Islamic banks would perform better in the financial performance. Prior studies, such as Rashid et al. (2013) have ascertained that business operations, processes and activities are under the direction of their board and top management. These findings are consistent with previous studies (Al-Saidi and Al-Shammari, 2013; Adam and Mehran, 2012; Zagorchev and Gao, 2015; Belkhir, 2009; Andress and Vallelado, 2008; Cole, 2008; Haniffa and Hudaib, 2006; Belkhir, 2009; Mahmood and Abbas, 2011; Pearce and Zahra, 1992; Jensen, 1986).

Abdullah (2004) has highlighted that the board of directors plays a crucial role in the business operations, the process and the activities in a company. It oversees top management and is entrusted with the responsibility of monitoring and supervising the company’s resources and operations. Therefore, the board is collectively seen as a team of individuals with the fiduciary responsibilities of leading and directing a firm, with the primary objective of protecting the firm’s shareholders’ interests. Also, as emphasized by Pandya (2011), the key aspects of good corporate governance cover the accountability of managers and the boards to shareholders and corporate responsibility towards stakeholders. Hermalin and Weisbach (2003) describe BOD as the heart of governance.

The MCCG (2000, revised 2007, 2012 and 2017) provide guidelines to the boards to improve their accountability to shareholders and supervision of the management team. An effective board structure is a primary determinant/signal of strong board monitoring and control, and corporate governance as a whole. Moreover, boards that can provide independent monitoring and control of management are better able to protect shareholders against opportunistic top management behaviour. Hence, CGM, represented by board size, the proportion of non-executive directors, board competency and board meetings are crucial in predicting financial performance, i.e., ROE, ROA, and CTI.

H2a and H2b are also supported on the basis that SGM shows to be a significant predictor for ROE and ROA for Islamic banks in Malaysia (t-value = 2.748 and 1.988, respectively); thus, H2a and H2b are supported. Nevertheless, SGM has no effect on CTI as the t-value is 1.043 in a one-tailed test (t > 1.645). Hence, H1c is not supported. As a whole, we accept H2a and H2b but reject H2c. In sum, H2 can be accepted as SGM has a positive effect on the two out of three indicators of financial performance.

CGM and SGM have been described as the key factors for the monitoring and control of Islamic banks. Hence, this finding should be interpreted that as the board of directors and Shari’ah boards that administer, monitor, direct and control, the Islamic banks should always behave according to the Shari’ah compliance and Islamic values to ensure better performance.

In the context of SGFW (2011), the finding of this study indicates that the right step taken by the regulators to enhance the SGM quality of Islamic banks may be seen as a step in the right direction. The evidence that SGM has a positive effect on IEP indicates the need for Islamic banks to provide an ideal attribute of Shari’ah boards in discharging duties and accountability for Shari’ah matters.

The study is in line with the suggestion made by Hasan (2012), that by having better key players in Shari’ah governance mechanisms, better performance is expected from Islamic banks. These results confirm that the greater the extent of the control and monitoring mechanisms from the Shari’ah compliance perspective, the greater it will enhance FP. Previous studies such as Hashim et al., 2015; Garas, 2012; Mollah and Zaman, 2015; Muhamad Sari, 2015; Choudhury, 2015; Magalhaes and Al-Saad, 2013; Rashid et al., 2013; Hamza, 2013; Andres and Vallelado, 2008; Adam and Mehran, 2003; Haniffa and Hudaib, 2007; Nienhaus, 2007; Farook et al., 2011; Al-Tamimi, 2012; Abu-Tapanjeh, 2009; Safieddine, 2009; Darmadi, 2013 emphasize the essential roles of the SSB in supporting Islamic banks’ performance.

Ideally, as mentioned by Tariqullah (2006), the members of Shari’ah committees should be knowledgeable in economic, legal and accounting issues in relation to Shari’ah matters. They should be a pious person and should be able to give good advice. Clearly, an efficient board is a strong base for governance and is valuable not only for its shareholders and stakeholders, but also for the development of an Islamic economic system. Moreover, the sound governance of banks is a necessary condition to safeguard both the health of financial intermediaries and the economic development of a country.

**Conclusion**

This indicates that when there are proper monitoring and control mechanisms for corporate and Shari’ah governance, financial performance is significantly better. Thus, the results of this study appear to be expected because every code of governance guideline clearly states that governance provides a guarantee for good performance. As such, ideally, every Islamic bank should structure a good corporate and Shari’ah governance system in their business operations. Future studies can focus more sample from other countries. A perception based study like use of a questionnaire or interviews can also be conducted in this research area within and other national settings.

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