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The Influence of National and Individual Islamic Governance on Islamic Banks' Social Performance

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Abstract

Purpose - This study investigates the relationship between Islamic governance and social performance of Islamic banks, pioneering a new aspect in terms of impact of national shariah board on social performance of Islamic banks. The essential body in the Islamic banks in charge of Islamic governance is the *Shariah Supervisory Board (SSB)*. Therefore, in this study the authors explore how the characteristics of *Shariah* board and Islamic governance mechanisms influence social performance of Islamic banks.

Design/methodology/approach – Panel data methods are applied to the annual data of 43 banks from 14 countries over the period 2012-2018 to explore the impact of Islamic governance on Islamic banks' social performance. We have used all available bank annual reports in the given period. Social performance is measured by *maqasid al-Shariah* (in term of the goals of Islamic moral economy) index using a comprehensive evaluation framework. Islamic governance is represented by improved Islamic Governance Score (IG-Score) index, which measures the quality of Islamic governance in Islamic banks. In our research we also introduce frequency of SSB meetings in IG-Score.

Findings - The findings suggest a strong link between Islamic governance and social performance of Islamic banks, illustrating the importance of *Shariah* board in achieving *maqasid*. On the other hand, the research discovered that National Shariah Boards are inefficient and existence of NSB can jeopardize the social performance of Islamic banks. The results of this research imply valuable recommendations for Islamic banks that are keen to improve their social performance.

Originality/value – Besides investigating impact of SSB governance on social performance of islamic banks by using improved IG score index, this is the first study that investigates impact of national Shariah boards on social performance of islamic banks.

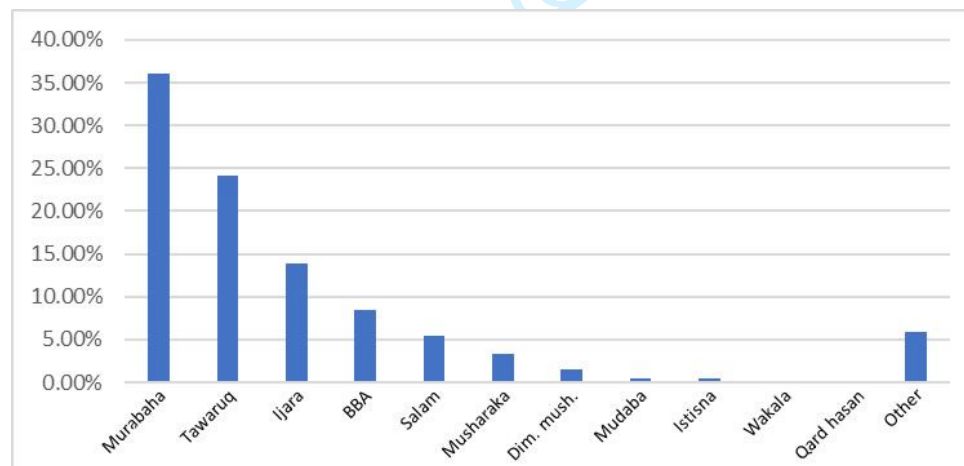
Keywords: Islamic banks, Islamic governance, *Shariah* board, social performance, *maqasid al-Shariah*

Introduction

Social performance is at the hearth of Islamic Moral Economy (IME), since operations of Islamic banks according to IME should not only formally be under Islamic teachings but these institutions should also promote human wellbeing (Asutay, 2012). Therefore, Islamic banks should have dual objectives – financial and social (Haniffa and Hudaib, 2007). Avdukic et al. (2021) note that Islamic Moral Economy provides framework for assessment of Islamic banking and finance in practice.

Existing literature suggest that, in practice, Islamic banks seem to be more concerned with the legal and mechanical aspects of *Shariah* observance than with promoting Islamic ethical values (Nienhaus, 2011). The prevailing general view is that Islamic banking has de facto failed to meet social and ethical goals (Ahmed, 2011). From a theoretical point of view, Musa (2011) noted that “the current literature on Islamic finance and Islamic business ethics lacks an assessment of the extent to which Islamic financial institutions enforce the ideal ethical norms of Islam”. Authors such as Kuran (2004), Pollard and Summers (2007), Asutay (2012), as well as Belal *et al.*, (2015), recognized that there are differences between Islamic banks in their compliance to Islamic teachings, especially if we consider IME requirements regarding social responsibility. They found that Islamic banks developed a debt-oriented culture similar to conventional banks, keeping in mind that debt-based instruments such as *murabaha*, *al-bay' bithaman ajil*, and similar are the most popular financing products of Islamic banks, with a share of more than 70% in their balance sheet in some cases. This indicates the preference of the neoclassical profit-maximization approach by Islamic banks instead of the approach suggested by IME.

Figure 1. Structure of Islamic banks' financing in practice



Source: Adewale & Archer (2019)

Apart from apparent “anomalies” from the balance sheet, empirical research confirmed these suspicions regarding failing to meet the goals of IME, since Asutay and Harningtyas (2015), Rusydiana and Firmansyah (2018), as well as Antonio *et al.*, (2012), indicated a lack of social responsibility, the frequent absence of the expected positive effects of Islamic financial intermediaries on society. Such positive effects are often highlighted in theory as an argument in favour of Islamic financial institutions. Besides weak social performance, authors such as

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3 Asutay and Harningtyas, 2015; Ngaliim *et al.*, 2015; Mohamed, 2018; Hasan and Ali, 2018;
4 Mergaliyev *et al.*, (2019) and Meskovic *et al.*, (2021) confirmed significant differences in social
5 performance among Islamic banks.
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8 Since IME draws its principles from *Qur'an* and *Sunnah*, it has become common practice for
9 Islamic financial institutions to appoint a *Shariah* committee, which will oversee the banks'
10 operations and ensure they are compatible with Islamic principles. This gives clients the
11 security of having their money handled following Islamic teachings. Junaidi (2022) in his
12 research noted that both the government and the SSB need to enhance the control and promote
13 Islamic values, which should lead to higher client's commitment to Islamic banking products.
14 Overall, all other, including traditional, Islamic institutions can learn from Islamic banks when
15 it comes to applying governance mechanisms to improve benefits to society. This also includes
16 zakat institutions, as noted by Widiastuti *et al.* (2021).
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21 Islamic finance is grounded in the principles of Islamic law (Shariah) and the Maqasid al-
22 Shariah (the underlying objectives of Shariah), which together provide a framework for ethical
23 and moral financial practices. The Maqasid al-Shariah provides a holistic approach to Islamic
24 finance by emphasizing the importance of considering the impact of financial practices on
25 individuals, society, and the environment. (Auda, 2022). It is based on the idea that the ultimate
26 goal of Islamic law is to promote the well-being and prosperity of individuals and society as a
27 whole. Maqasid al-Shariah provides a valuable tool for addressing social problems in Islamic
28 countries in a way that is consistent with the values and objectives of Islamic law, while also
29 being responsive to the changing needs of society. Budi (2021) notes that from an Islamic
30 perspective, Islamic corporate governance is a responsibility and obligation not only at the
31 company level but also at the individual level. The foundation of Islamic banks is rooted in
32 Islamic law, and Islamic banks adhere to the principle that contracts, which are exploitative
33 based on interest, uncertainty, or contain risk or speculation, cannot be executed. In this study,
34 we consider Islamic governance at the national level as well. Some authors have previously
35 recognized importance of the Shariah supervisory board for social performance of Islamic
36 banks. However, the field has not been researched enough to include impact of National Shariah
37 boards which some countries have introduced. Also this study takes into account improved
38 index of Shariah governance in Islamic banks internally.
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45 Elamer, Ntim, & Abdou (2020) in their research took into account national governance quality
46 measure based on the index consisted of "conventional" governance dimensions, while our
47 research takes into account Islamic governance at the national level, embodied in the National
48 Sharia Board. No country has gone further than Malaysia when it comes to setting standards
49 for Islamic financial institutions, including corporate governance. Bank Negara Malaysia
50 (BNM) has long tradition of providing the minimum standards and specific requirements for
51 Islamic banks and Takaful operators. Meskovic *et al.* (2021) noted that Malaysia is among the
52 countries with highest Islamic banking social performance, although authors did not explore
53 the reasons for such performance. BNM has issued a Shariah Governance Policy Document
54 (2019) which includes robust responsibilities of Shariah Supervisory Boards (SSB) on the
55 individual (bank) level. Hasan *et al.* (2020) noted that Shariah governance processes among the
56 Islamic funds in Malaysia are well-managed, and praised the current regulations issued by the
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regulators. Authors such as Muhamat and McIver (2019) confirmed this on the sample of Malaysian takaful operators, while Noordin and Kassim (2019) confirmed that Shariah governance quality in Malaysian Islamic banks influences disclosure. Shahr et al. (2020) came to similar conclusions, with note that there is a difference in the risk reporting between small and large Islamic financial institutions.

Keeping in mind that SSB is the crucial body ensuring *Shariah* compliance of Islamic banking operations, this paper addresses the following research questions:

What is the impact of *Shariah* board characteristics on social performance of Islamic banks?

What is the impact of existence of National Shariah board on social performance of Islamic banks in the country?

The purpose of the study is to gain new knowledge that can help us elevate social performance of Islamic banks. The motivation for this study is the fact that the answer to these questions can support Islamic banks and the regulators in achieving a higher level of social performance. We use improved Islamic Governance Score by employing panel data methods including FEM, REM and PCSE.

In previous literature, several authors such as Mergaliyev *et al.* (2021), Iryani *et al.* (2019), Lesmana and Haron (2019), Mukhibad (2019), Rahman and Haron (2019), Sencal and Asutay (2020) and others confirmed that characteristics or quality of internal *Shariah* governance system has significant effect to social performance of Islamic banks. However, this study has been conducted on a global scale with a much larger sample. Furthermore, according to our best knowledge, there has been no research on the impact of national *Shariah* governance on social performance of Islamic banks as of today.

This study contributes with additional insights regarding the role of Shariah governance in achieving higher social performance of Islamic banks, and explores the importance of national Shariah boards.

The study is important because it gives us new insights into impact and relevance of Islamic governance quality at the individual and national level on ability of Islamic banks to achieve higher ethical objectives of Islamic moral economy.

The rest of the paper is organised as follows: Section 2 presents the theoretical framework, Section 3 discusses relevant literature and hypotheses development, Section 4 presents the study sample and methodology, Section 5 reports the results, while section 6 discusses them. Section 6 provides theoretical and practical implications, while Section 7 concludes and offers recommendations.

Literature review and theoretical framework

This study uses systems-oriented theories (Farook *et al.*, 2011), including political economy, stakeholder theory, and legitimacy theory. Theory of Islamic political/moral economy is

structured from the axioms found in the ontological and epistemological resources of Islam (*Qur'an* and *Sunnah*). Compared to mainstream Islamic finance, IME promotes value-oriented financing characterized by embeddedness; in other words, dependence on the environment and the system within which different social activities take place and on which they depend. The opposite of this integration is the lack of integration of financial and real sectors, as we have in the modern capitalist economy. Two main theories explaining organisations' social responsibility and their social impact are stakeholder theory (Deegan and Unerman, 2011) and legitimacy theory (Deegan, 2002). Although these two theories also overlap in some aspects (Gray *et al.*, 1995), stakeholder theory implies a more precise approach as it separates different stakeholders into groups, while legitimacy theory looks at society. Legitimacy theory could be considered a particular case of stakeholder theory, where all stakeholders are treated equally, which Fernando and Lawrence (2014) called "ethical perspective". Al-shamali, Sharif, and Irani (2013) noted that social function of Islamic banks refers to bank responsibility for the wellbeing of all stakeholders. The managerial perspective implies that organisations (in this case, Islamic banks) will consider only economically powerful stakeholders. However, both approaches are still beneficial for a company (Fernando and Lawrence, 2014). Legitimacy theory involves an invisible "social contract" between company and society (Deegan, 2006), whose purpose is to ensure that organisation is perceived as functioning within the norms of the society in which they operate. Organisations that fail in this matter will not survive in the long term, so they will participate in socially responsible activities to maintain, gain or regain their legitimacy, positively impacting their social performance.

A stakeholder that is critical for any Islamic bank's legitimacy is *Shariah* board or *Shariah* committee. The *Shariah* board is a unique governance structure in an Islamic financial system, entrusted with directing, reviewing, and overseeing the activities of Islamic financial institutions to ensure compliance with *Shariah*. Corporate governance in Islamic financial institutions requires the existence of a *Shariah* committee to ensure that the institution's operations are in line with the principles of Islamic business law (Cadbury, 2002). The International Council of the Fiqh Academy defined the *Shariah* committee by Decision No. 177 (19/3) regarding its role in regulating the operations of Islamic banks as a group of specialists in Islamic jurisprudence, especially civil jurisprudence (*fiqh al-mu'amalat*), whose number will not be less than three and were selected from among those with the ability and knowledge given the practical reality, whose job is to pronounce judgments and revise everything that needs to be revised, to confirm and ensure that all transactions conducted by Islamic financial institutions comply with *Shariah* guidelines and for decisions to be made public and Islamic financial institutions must support SSB decision. Although they considered "conventional" governance variables such as board independence, directors and institutional ownership and overall governance quality, Naveed and Abidin (2020) found that governance quality is helpful in reducing the total and downside risk exposure of Islamic mutual funds.

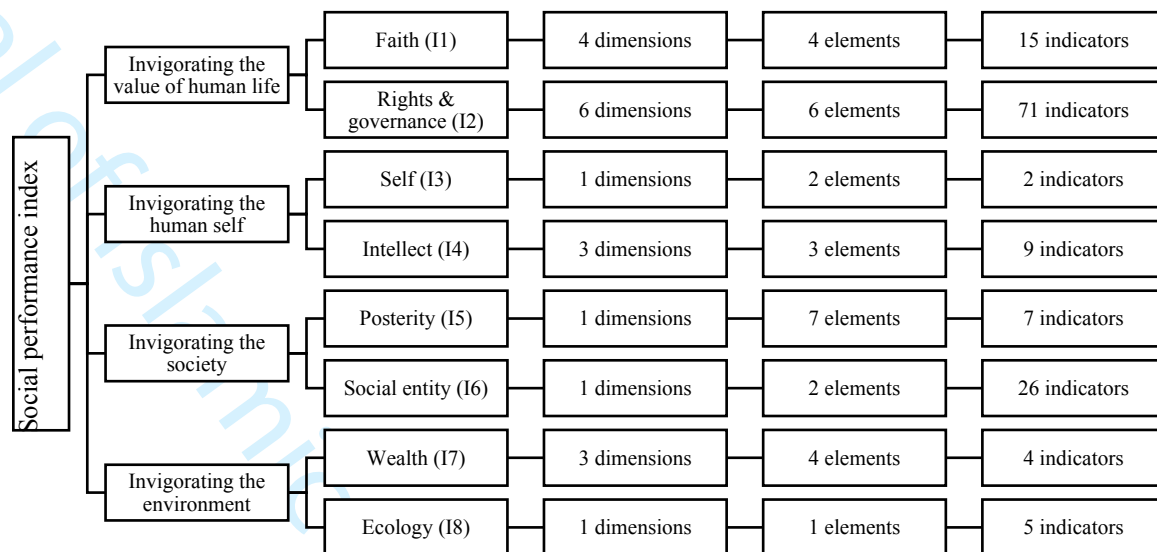
Islamic financial products and instruments must be legitimate and by *Shariah* principles. Thus, the primary goal of a *Shariah* committee is to ensure compliance with the principles and values of IME, thereby legitimising the bank as Islamic. Alam *et al.* (2021) thoroughly explored expected duties, roles and functions of *Shariah* board in Bangladesh by using interview method. This includes opinions on *Shariah* issues taking into account modern banking circumstances as

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3 well, developing appropriate Shariah governance policies and implement them, approve new
4 products but also review them, i.e. overall ensuring Shariah compliance. On the other hand, Jan,
5 Lai & Tahir (2021) proposed a more general role for Islamic corporate governance covering
6 the Shariah dimension and conventional context of corporate governance to examine its nexus
7 with sustainability performance.
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11 In addition to existence itself, specific characteristics of a *Shariah* board, such as independence
12 or authority of the board members, can affect the legitimacy (Alsartawi, 2019). In this process,
13 Islamic financial institutions require the existence of these specialised committees with experts
14 on *Shariah* issues, especially *fiqh al-muamalat*, which would support banks to determine the
15 legitimacy of Islamic financial products and the overall business of such institutions (Ainley *et*
16 *al.*, 2007). Various aspects are involved in this process, including transparency, accountability,
17 reporting structure, and independence of Shariah committee (Wilson, 2009). Kaaroud *et al.*
18 (2020) noted that audit report lag in Islamic financial institutions can be decreased with
19 appropriate governance mechanisms. Sencal and Asutay (2020) attempted to constitute an
20 Islamic corporate governance framework as a theoretical construct, exploring the Shariah
21 Annual Reports of Islamic banks in second stage of their study. All these aspects are essential
22 for achieving the legitimacy of an Islamic bank.
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27 Since social responsibility is embedded in the core business of Islamic banking, *Shariah* board
28 should look at technical issues regarding Islamic modes of financing and collecting deposits,
29 and consider the broader ethical perspective of IME. Therefore, in this study we use *maqasid*
30 *al-Shariah* index based on IME to measure Islamic banks' social performance. In constructing
31 the social performance index, we use Najjar's approach to *maqasid*, which considers four goals
32 and eight dimensions. Such index was initially introduced by Mohammed *et al.*, (2008) and
33 further refined by Bedoui and Mansour (2014), Asutay and Herningtyas (2015), and Mergaliyev
34 *et al.*, (2019). The methodology includes a dichotomous approach of Haniffa and Hudaib
35 (2007), which means that the observed item received a rating of "1", if it is found in the annual
36 report, or "0", otherwise. Furthermore, some sub-indices are extracted from the banks' financial
37 statements, hence quantitative rather than qualitative data.
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42 **Figure 2. Social performance index based on a *maqasid al-Shariah* evaluation framework**
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Source: Adapted from (Mergaliyev et al., 2019; Mohammed et al., 2008; Bedoui and Mansour, 2014; Asutay and Harningtyas, 2015)

Research of influence of Islamic corporate governance (*i.e.*, *Shariah* board characteristics) has gone into two main directions – some authors have examined its impact on financial performance while most articles have investigated the impact of *Shariah* board on corporate social responsibility (CSR) disclosure of Islamic banks. However, most studies investigating the impact on social performance have been conducted on fewer observations than this study.

When it comes to social performance, authors use different terms such as social performance; ethical performance; environmental, social, and governance (ESG) performance; *maqasid* performance; *etc.* (Meskovic *et al.*, 2021). As most authors agree that social performance of Islamic banks is not on a satisfactory level, research is now shifting towards causes of such a low performance and Islamic corporate governance is recognized as one of the major determinants.

Islamic governance in this study is measured by IG-Score developed by Farook *et al.*, (2011). In a pioneering work, Farook *et al.*, (2011) develop IG-Score by combining a number of variables:

- Existence of SSB,
- The number of SSB board members,
- The existence of SSB members with cross-memberships,
- The existence of SSB members with doctoral qualifications, and
- Existence of reputable scholars presiding on SSB board.
- In our research we include additional variable which considers frequency of SSB meetings held during the year, according to Alsartawi (2019) and Mukhibad (2019)

They hypothesized a positive association between IG-Score and the level of CSR disclosure presented by Islamic banks in their annual reports. They tested this hypothesis on 47 banks and their results revealed that IG-Score is highly significant, indicating that *Shariah* board

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3 characteristics are important determinants of CSR disclosures in Islamic banks. Following
4 Farook *et al.*, (2011), Rahman and Bukair (2013) investigated characteristics of *Shariah* board
5 on CSR disclosure of 53 Islamic banks in the year 2008. Their findings indicated that the
6 combination of *Shariah* board characteristics has a significant positive influence on CSR
7 disclosure, illustrating the importance of *Shariah* board for CSR in Islamic banks.
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10 When it comes to social performance, Board of directors (BoD) has important role. There is no
11 doubt that characteristics and even personal beliefs of BoD members can impact the institutions
12 CSR strategy and social performance. Exploring *Shariah* governance's influence on 10 Islamic
13 banks' CSR during 2011-2018, Ridwan and Mayapada (2020) concluded that the board of
14 directors' effectiveness plays a vital role in enforcing CSR disclosure. Their results showed that
15 audit committees and *Shariah* supervisory boards have no significant effect on CSR disclosure
16 in Islamic banks. Therefore, the conclusion regarding Islamic corporate governance was that
17 *Shariah* board still focuses on the *Shariah* principles regarding the products and operations.
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20 Together with governance, social performance of Islamic banks is the main idea in this study.
21 According to our best knowledge, the most extensive overall study of determinants of Islamic
22 banks' social performance so far was conducted by Mergaliyev *et al.*, (2019). This research
23 explored various internal and external determinants that affect social performance of Islamic
24 banks. A panel analysis of several key factors such as political and socioeconomic environment,
25 ownership structures, and factors related to corporate and *Shariah* governance was used to
26 identify the main determinants of *maqasid* disclosure success. The authors found that the share
27 of the Muslim population, the duality of CEO, and *Shariah* governance positively affect Islamic
28 banks' social performance.
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31 One additional constituent of IG score which we use in this study is frequency (number) of SSB
32 meetings. Alsartawi (2019) explored whether the independence and frequency of *Shariah* board
33 meetings influenced the performance of 48 Islamic banks over the period 2013-2017. This
34 research showed a negative impact of *Shariah* board composition on financial performance
35 regarding return on assets. The author concluded that this may be due to the passive role of the
36 *Shariah* board, whose members act more as advisors and less as supervisors, allowing managers
37 to supersede their decisions. Moreover, Nugraheni (2018) investigated the effect of SSB
38 characteristics on the level of social performance in Islamic banks in Indonesia during 2010-
39 2014. The research revealed that, on the one hand, size and reputation of SSB members
40 significantly affect social performance. On the other hand, frequency of meetings, educational
41 qualification, and cross membership of SSB does not significantly affect social performance.
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44 As an important body which is highly positioned on organizational chart of any Islamic bank,
45 SSB can influence performance of these institutions. Some authors such as Almutairi and
46 Quttainah (2017) explored the impact of *Shariah* board and its attributes on Islamic banks'
47 performance. Their findings suggested that increasing the size of corporate boards and SSBs
48 should improve monitoring and advisory functions, management behaviour, and organizational
49 performance of Islamic banks. Similarly, Khalil and Taktak (2020) examined the relationship
50 between *Shariah* board characteristics and financial soundness (Z-score) of 67 Islamic banks
51 over 2005-2014. The authors did not investigate social performance of Islamic banks but as
52 they found a negative relation between *Shariah* board size, this could indicate the existence of
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3 trade-off between social and financial performance. However, the only significant result they
4 got is that size of Shariah board negatively impacts financial soundness. Generally, the
5 reputation of *Shariah* scholars is important as Khan (2010) noted that one of the explanations
6 for the poor “Islamic” of Islamic banks is that Islamic financial institutions choose those
7 scholars who are more cooperative, *i.e.*, eager to certify *Shariah* transactions while being paid
8 relatively large sums of money per year. In that regard, the engagement of a national *Shariah*
9 board could be one way to fight this phenomenon.
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13 Sencal and Asutay (2020) analyzed disclosure in Shariah annual reports of Islamic banks
14 through AAOIFI standards and the Islamic moral economy. Their findings suggest that AAOIFI
15 guidelines impact the level of Shariah disclosure of Islamic banks. Furthermore, the popularity
16 of Shariah scholars is found to be significant. On the national level, adoption of AAOIFI, quality
17 of regulation and duration of Shariah compliance have some explanatory power.
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21 Further, each component of IG-Score should positively affect social performance of Islamic
22 banks. With a greater number of *Shariah* scholars in the committee, the *Shariah* board should
23 be more effective in ensuring *Shariah* compliance and the commitment of Islamic banks
24 towards their social function (Nugraheni, 2018). The number of SSB meetings held during the
25 year should be disclosed in an Islamic bank’s annual report (Hameed *et al.*, 2004), and SSB’s
26 contribution towards social function of Islamic bank should grow with the number of meetings
27 held. Besides, educational qualifications, *i.e.*, presence of SSB members with a doctorate,
28 should help the bank achieve higher social performance (Farook, *et al.*, 2011). In the same vein,
29 the reputation and cross-membership of SSB members should help share experience between
30 Islamic financial institutions, including activities regarding social responsibility.
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37 **Research hypotheses**

38 Considering the aforementioned, we hypothesize that:
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40 **H₁: Quality of Islamic governance in Islamic banks, represented by IG-Score, has a**
41 **positive effect on social performance of Islamic banks.**
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44 Namely, recognizing that *Shariah*-incompliance is a risk that can hit Islamic financial
45 institutions’ asset values severely with possible loss of investments, funds and potential
46 incomes (Grassa, 2015) some countries have decided to introduce national *Shariah* boards.
47 Muneeza and Hassan (2014) called *Shariah* corporate governance “the Islamic version of
48 corporate governance”. Thus, considering the systemic importance of banks in a financial
49 system, we can claim that the approach with the introduction of national *Shariah* boards has
50 similar intentions as overall banking regulation. It aims to protect the institutions, deponents,
51 shareholders, and the general public and financial system. Ahmed (2011) recommended active
52 regulatory participation in *Shariah* governance to maintain stability. Therefore, as Grassa
53 (2015) noted, some countries have developed comprehensive regulatory frameworks governing
54 *Shariah* practices at both national and institutional levels, while some have adopted a regulatory
55 framework for *Shariah* supervision only at institutional level.
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Although some countries formally introduced *Shariah* board at national level, such *Shariah* board has a very passive and usually only advisory role. Therefore, national *Shariah* board (NSB) has different roles in different countries. In some countries, such as the United Arab Emirates, Qatar, Bangladesh, and Jordan, NSB exists but its role is limited to commenting on some issues or giving *fatwas* regarding the central bank's products (Grassa, 2015). Therefore, such NSB does not have any authority at the institutional level, as Grassa (2015) stated, so we cannot claim that such *Shariah* board impacts individual Islamic banks and their operations. Thus, we must distinguish between NSB with an active supervisory and advisory role and NSB without an active role in individual Islamic banks' operations, as shown in Table 1.

Table 1. National *Shariah* governance system across different countries

NSB with an active role	NSB without active role	No NSB
Malaysia, Indonesia, Pakistan, Sudan, Bahrain*	United Arab Emirates, Qatar, Bangladesh, Jordan, Kuwait	Kingdom of Saudi Arabia, United Kingdom, Bosnia and Herzegovina, Sri Lanka

* Since 2017

Source: Authors

Some countries have positioned NSB at the central bank or the securities commission (Malaysia, Indonesia, Pakistan, Sudan, and Bahrain). At the same time, Kuwait, Jordan, Qatar, and the United Arab Emirates have given jurisdiction to the ministry of *awqaf* and religious affairs or the ministry of justice and Islamic affairs (Grassa, 2015).

Therefore, we hypothesize that:

H₂: The existence of a National Shariah Board with an active role towards individual Islamic banks has a positive effect on social performance of Islamic banks in the country.

Data and methodology

This study uses a balanced panel of annual data for 43 banks from 14 countries, covering 2012 to 2018. Based on the publication "Top Islamic Financial Institutions", published by the respected magazine "The Banker", in 2013 there were 185 commercial banks that provided Islamic banking services. Of that number, 70 are conventional banks that have so-called Islamic windows were not observed either, because in principle they are not Islamic banks (only in the range of their products, among other things, they offer Islamic products). Thus, the population is represented by 115 Islamic commercial banks. Of these 115 banks, 43 of them regularly published annual reports in the observed period. The main criterion for composing the sample is the availability of the data, since after 2018 some of the banks in the sample stopped publishing annual reports, thus our sample would not be balanced. Initially, 115 Islamic banks from The Banker Among the selected countries, there is one country from Africa (Sudan), two countries from Europe (Bosnia and Herzegovina and the United Kingdom), five countries from Asia (Bangladesh, Indonesia, Malaysia, Pakistan, and Sri Lanka), and six countries from the Middle East (Bahrain, Jordan, Kingdom of Saudi Arabia, Kuwait, Qatar, and the United Arab Emirates).

Explaining the impact of the differences in *Shariah* governance between individual banks and countries on social performance of Islamic banks is the motivation for this research.

Consequently, this paper aims to investigate the relation between Islamic governance score (IG-Score) at the individual bank level and the existence of *Shariah* supervisory board at the national level in the country, on the one hand, and social performance of Islamic banks, on the other hand. To test the above-mentioned hypotheses, social performance is measured by *maqasid al-Shariah* index, an index based on the foundational axioms of IME, which was previously developed by Asutay and Harningtyas (2015) and further enhanced by Mergaliyev *et al.*, (2019).

The degree of development of Islamic governance in the individual banks is measured via IG-Score. It is an index developed by Farook *et al.*, (2011), which sums the value of the dichotomous characteristics of *Shariah* board, i.e., existence of the SSB itself, the number of SSB board members (1 if more than three members, otherwise 0), the existence of SSB members with cross-memberships (1 if there are scholars with cross memberships), the existence of SSB members with doctoral qualifications, and the existence of reputable scholars presiding on SSB board (Farook *et al.*, 2011). Since we consider that number of *Shariah* board meetings during the year impacts the quality of *Shariah* governance (Alsartawi, 2019; Mukhibad, 2019) we also add a number of meetings held during the year in this sum for IG-Score, therefore further enhancing the index. All variables are presented in Table 2.

Table 2. Variables included in the model

Variable	Variable definition	Source
SPI	Social performance index of Islamic banks	Indicators based on the information from the Islamic banks' annual reports
IG-Score	The quality of <i>Shariah</i> governance in the bank	Annual reports
NSB	Existence of a NSB with an active role in the country (dummy)	National legislation and Refinitiv database
SIZE	The size of Islamic bank's assets (log)	Annual reports of the banks
LEV	The leverage ratio of an Islamic bank (log)	Annual reports of the banks
AGE	The age of an Islamic bank	Annual reports of the banks
GDP	GDP of the country (log)	World Bank database

Source: Authors

The following regression model is used to analyse and test the hypotheses under the stated objectives:

$$SPI_{i,t} = \alpha + \beta_1 IGScore_{i,t} + \beta_2 NSB_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 LEV_{i,t} + \beta_5 AGE_{i,t} + \beta_6 GDP_{i,t} + \varepsilon_{i,t} \quad (1)$$

In operationalising the research, a social performance index (SPI) based on *maqāsid al-Shariah* has been constructed for measuring the social performance of Islamic banks. In the calculation of the social performance index (*maqāsid*) content analysis of available publishable text was used through dichotomous approach as suggested by Mohammed *et al.*, (2008), Haniffa and Hudaib (2007), as well as Hameed *et al.*, (2004) to mitigate any possible bias.

In conducting the content analysis for generating disclosure-related data for index, the value of "qualitative" components implies the arithmetic mean of the values of individual indicators within these components, which take the value 1, if complete information for a particular

indicator exists in the Islamic bank's annual report, or 0 if the information is not existing in the annual report (Haniffa and Hudaib, 2007; Belal *et al.*, 2014, Mergaliyev *et al.*, 2019). In the same way, the values of "quantitative" components from annual reports of Islamic banks are calculated using the arithmetic mean within these components of *maqāsid* index such as ROA for instance. Daud (2019) noted that islamic governance can have significant impact on the quality of reporting of (any) Islamic organisation, suggesting several approaches to reinforce reporting through governance frameworks.

The data used to construct some of the sub-indices, in particular categories I3, I5, and I7, are extracted from the financial statements of the banks. Furthermore, the indicators of categories I5 and I7 are scaled to take a value between from 0 to 1. This is done using the linear scaling transformation (LST) method of Singh *et al.*, (2009), which compresses the indicator original values to lie between 0 and 1. In any particular year, the lowest value of the indicator takes a value of 0 and the highest value takes a value of 1.

Data analysis method

In hypotheses testing we use several estimators generally available when it comes to panel data methods, with the main three are pooled ordinary least square (OLS), fixed effects model (FEM), including "within" estimation and least-squares dummy variables (LSDV), and random effects model (REM). Accordingly, this paper applies these methods to estimate model (1). Furthermore, we apply panel corrected standard errors (PCSE) estimation to estimate the model (2) to correct for some issues existing in the previous model (1) and test for robustness.

General panel data methods including FEM and REM (and other employed in Table 6) do not account for the simultaneous presence of cross-sectional dependence and serial correlation (Hoechle, 2007; Reed and Ye, 2011; Sarafidis & Wansbeek, 2012), which our model suffers from. In fact, diagnostic tests of model (1) show the existence of autocorrelation (using Wooldridge test); heteroskedasticity (using Breusch-Pagan /Cook-Weisberg and Modified Wald tests); and cross-sectional dependence (using Pesaran's test). One potential estimator that overcomes the simultaneous presence of serial and cross-sectional correlation is Park's feasible GLS (FGLS) (Parks, 1967) but it suffers from standard errors downward bias (Beck and Katz, 1995). Therefore, a more effective and efficient estimator called panel corrected standard errors (PCSE) of Beck and Katz (1995) is used in the current paper. FGLS assumes $N > T$, which is the case of our sample, even more, the suitability of PCSE to samples such as ours is confirmed by a number of papers (Blackwell 2005; Plümper *et al.* 2005; Hoechle, 2007; Reed and Ye, 2011). Therefore, main panel data analysis method in the paper is PCSE – panel corrected standard errors estimator.

Results

As we already stated, the main purpose of this study is to investigate the relationship between Islamic governance and social performance of Islamic banks. We take into account the standard Islamic governance measures on individual-bank level and improve this measure, but we are

also pioneering a new aspect in terms of impact of national shariah board on social performance of Islamic banks. Essentially, we explore how the characteristics of Shariah board and Islamic governance mechanisms on bank and national level influence social performance of Islamic banks. This section will provide the results of our research.

Table 3 summarizes descriptive statistics for the variables in the model (1) and reports an average value of SPI of 0.3539 (or 35.39%). SPI is the overall Islamic banks' social performance, constructed for 2012-2018. The score can be considered low compared to the theoretical expectations and the index's maximum value, which is 1 (or 100%).

Since it considers the number of meetings held during the year, IG-Score does not have a theoretical maximum; however, the largest value of IG-Score is 12 while the smallest is 2. NSB is a dummy variable taking a value of 1, if the country (in the observed year) has an active NSB; otherwise, this variable takes a value of 0.

Table 3. Descriptive statistics for the variables included in the model

Variable	Obs.	Mean	Std. dev.	Min.	Max.
SPI	301	0.3539	0.1143	0.1124	0.6818
IG-Score	301	4.7009	1.9279	2	12
NSB	301	0.3820	0.4867	0	1
SIZE	301	8.4518	1.6213	1.9643	11.3405
LEV	301	2.0693	0.4723	0.8070	3.1101
AGE	301	23.3720	13.5615	3	64
GDP	301	25.8759	1.1902	23.5681	28.6867

Source: Authors

Regarding control variables, SIZE shows a bank's asset size (logarithm) in the corresponding year in USD (mil.), while LEV (leverage) represents the ratio of debt and capital. AGE shows how old the bank is in a corresponding year, while GDP is the GDP (logarithm) of the country in an observed year. The correlation matrix of the variables in the model is presented in Table 4.

Table 4. Correlations between the variables

	SPI	IG-Score	NSB	SIZE	LEV	AGE	GDP
SPI	1.0000						
IG-Score	0.2961*	1.0000					
NSB	0.3178*	-0.0839	1.0000				
SIZE	0.0146	0.1523*	-0.1753*	1.0000			
LEV	0.4587*	0.1633*	0.4069*	-0.0742	1.0000		
AGE	0.0784	0.1884*	0.0148	0.2027*	-0.0855	1.0000	
GDP	0.1750	0.0010	0.7988	0.0004	0.1390		1.0000
	0.0600	-0.0390	0.2190*	0.3087*	0.2746*	-0.1236*	
	0.2995	0.5001	0.0001	0.0000	0.0000	0.0320	

Source: Authors

Gujarati (2003) noted that if there is a correlation between the independent variables larger than ± 0.8 , then we can conclude that severe multicollinearity problems exist. As shown in Table 5, such a level of correlation does not exist in the model, and the results of the variance inflation factor (VIF) test confirm that model (1) does not suffer from the multicollinearity problem. For

that reason, according to Gujarati (2003) and Hair et al. (1995), values of VIF below 10 are acceptable and indicate no multicollinearity problem. Moreover, our model (1) also satisfies the strict criterion of other authors who set the threshold at 5 (Becker *et al.*, 2015).

Table 5. VIFs

	VIF	1/VIF
LEV	1.35	0.7384
GDP	1.34	0.7446
NSB	1.32	0.7554
SIZE	1.31	0.7608
AGE	1.14	0.8784
IGS	1.13	0.8830
Mean VIF	1.27	

Source: Authors

We start by estimating model (1) using Pooled OLS, LSDV, and “within” as fixed effects (FEM) and random effects (REM) estimators (generalized least square - GLS). Breusch-Pagan/Cook-Weisberg test, as well as Modified Wald test, indicate the presence of heteroskedasticity. Therefore, the standard Hausman test cannot be used to select between FEM and REM. So the Sargan-Hansen test with robust FEM and REM (p-value=0.0001) is applied, which shows that FEM is preferred.

FEM is also a theoretically preferred model (Allison, 2009). Furthermore, FEM is a superior method when there is an unobservable omitted variables bias (Halaby, 2004; Allison, 2009). Considering the nature of quality of Islamic governance, which is the main focus of this paper, model does not cover neither all potential macro factors (variables) such as regulation and competition, nor all bank specific factors such as shareholders, management, intellectual capital, human resources, and management principles.

Table 6. OLS, LSDV, FE, FE robust and RE model results

Variable	OLS	LSDV	FE	FE robust	RE
IG-Score	0.0139*** (0.00307)	0.0312*** (0.00767)	0.0312*** (0.00767)	0.0312** (0.0147)	0.0268*** (0.00596)
NSB	0.0519*** (0.0131)	-0.0260* (0.0138)	-0.0260* (0.0138)	-0.0260*** (0.00963)	0.000803 (0.0139)
SIZE	0.00472 (0.00393)	0.00190 (0.00242)	0.00190 (0.00242)	0.00190 (0.00232)	0.00225 (0.00260)
LEV	0.0883*** (0.0137)	0.0166 (0.0110)	0.0166 (0.0110)	0.0166 (0.0143)	0.0311*** (0.0116)
AGE	0.000311 (0.000437)	0.0166*** (0.00221)	0.0166*** (0.00221)	0.0166*** (0.00452)	0.00431*** (0.000876)
GDP	-0.00918* (0.00541)	-0.189*** (0.0488)	-0.189*** (0.0488)	-0.189* (0.102)	0.0178 (0.0123)
CONS	0.277** (0.129)	4.758*** (1.278)	4.662*** (1.220)	4.662* (2.497)	-0.418 (0.312)
N	301	301	301	301	301
Adj. R ²	0.291	0.908	0.268	0.372	

Note: * significant at 10%, ** significant at 5% and *** significant at 1%

Source: Authors

The results of OLS, LSDV, FE, FE robust, and RE show that variable IG-Score (i.e., the quality of *Shariah* governance in an Islamic bank, represented by IG-Score) and NSB (i.e., the existence of NSB with an active role) are consistently significant on standard significance levels (except for NSB in RE estimator). Surprisingly, NSB has a negative sign in LSDV and FE/FE robust. Leverage (LEV) is significant (on different significance levels) in OLS and RE. Bank AGE plays a role as the variable is significant in all estimators except OLS. GDP is also significant in all estimators except RE, but with a negative sign.

PCSE assumes there are autocorrelation and heteroskedasticity between panels when it calculates the standard errors, the variance and covariance (Beck and Katz, 1995) and therefore, in order to account for autocorrelation, Prais-Winsten transformation - AR(1) (Beck and Katz, 1995) is used to estimate model (2). The results are reported in Table 7.

Table 7. PCSE model (2) results

Variable	PCSE
IGS	0.0289*** (0.00836)
NSB	-0.0222 (0.0136)
SIZE	0.00255* (0.00139)
LEV	0.0160** (0.00701)
AGE	-0.000885 (0.00110)
GDP	-0.173*** (0.0418)
CONS	4.754*** (1.146)
N	301
Adj. R ²	0.372

Note: * significant at 10%, ** significant at 5% and *** significant at 1%

Source: Authors

Table 7 shows that the quality of *Shariah* governance in the Islamic banks has a significant positive impact on social performance of these banks, at 1% significance level. In contrast, the existence of NSB and the bank's age do not significantly impact SPI in this model. Bank size is significant at the 10% level, while leverage shows significance at the 5% error level. The significance of leverage implies that the Islamic banks which use available resources more efficiently are also more efficient when implementing principles of IME.

Discussion

Since our results confirm the first hypothesis, we can conclude that the quality of *Shariah* governance in Islamic banks plays a crucial role in explaining social performance of these banks. Several researchers in the field of Islamic economics and banking also found a positive impact of *Shariah* board characteristics, i.e., the degree of development of Islamic governance structures or the quality of Islamic governance, on social performance of Islamic banks, such as Mergaliyev *et al.*, (2021), Iryani *et al.*, (2019), Lesman and Charon (2019), Mukhibad (2019), as well as Rahman and Charon (2019). Consequently, on very practical level, improvement of

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3 internal Shari'ah governance structures would enhance maqāsid orientation and the
4 performance of IBs for the benefits of wider stakeholders within society.
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6 This is a proof of the importance of *Shariah* governance for the identity and business of Islamic
7 banks and the achievement of *maqasid al-Shariah*, in term of the goals of IME, in practice.
8 Moreover, Fersi and Boujelbéne (2016) on the example of Islamic microfinance institutions
9 confirmed the importance of Sharia governance for social performance of this kind of Islamic
10 financial institutions. Nugraheni (2018) found that certain characteristics of *Shariah* committee,
11 such as size (number of members) and reputation, have a statistically significant effect on social
12 performance of the Islamic banks in Indonesia, while the number of meetings, education, and
13 cross-membership do not. Also, according to Shafii and Salleh (2010), internal *Shariah* audit
14 has a special place in ensuring the quality of *Shariah* governance. This is also in line with the
15 proposals of Shafii et al. (2015) the combination of internal and external *Shariah* revision gives
16 the best effects.
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21 The second hypothesis, which considers the impact of NSB on social performance of Islamic
22 banks, is not only unconfirmed but the variable NSB is significant with a negative sign in the
23 model (1). Based on the results of this study, we can conclude that NSB is not efficient
24 mechanism when it comes to social performance of Islamic banks and its role in implementing
25 *maqasid*.
26
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28 *Shariah* governance is one of the main features of IBs, ensuring that their products and
29 operations are *Shariah* compliant, particularly on NSB level. Despite that Farook et al. (2011)
30 proposed that *Shariah* governance should be a factor for social disclosures, however, the NSB
31 does not have positive impact the maqāsid performance of IBs. Perhaps this is not surprising as
32 social and moral expectations never come from the centres of power hence it applied for *Shariah*
33 boards. Essentially, this result is similar to result of Khalil (2021) who found that Sharia board
34 reduces financial soundness of Islamic banks.
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38 Despite those studies on *Shariah* governance emphasises *Shariah* compliancy in the overall
39 functions of the Islamic banks, while *Shariah* denotes some rules, regulations, guidelines,
40 objectives and directions to enhance accurate functions and activities, which are solely based
41 on *Shariah* principles (Alam *et al.*, 2021). This is important for Islamic banks to implement
42 *Shariah* principles, confirm *Shariah* compliance and monitor the functions of the banks on
43 micro-level. However, when it comes on the macro-level, NSB failed. Besides, it is needed for
44 a well, efficient, effective, profitable business and higher performance and, finally, to eliminate
45 the confusion among the management, executives, conventional bankers and banks.
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50 In other words, the executive management of *Shariah* boards needs to endorse *Tawhidi*
51 approach (complementarity and unitarity or God's unity and sovereignty) which implies that
52 the nature of knowledge and its articulation should lead into equality of all stakeholders without
53 anyone's dominance over the other. This identifies that Shari'ah governance as operational tool
54 of IME within IBs essentialise de-centring of capital and bringing capital to the same level with
55 other stakeholders through the *ihsani* process for enhancing *maqasid* performance.
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58 In a nutshell, for Islamic banks to achieve the goals of IME in practice, they should have an
59 appropriate level of quality of Islamic governance in the banks themselves. The results therefore
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3 suggest that Islamic banks seeking to improve their social performance should pay special
4 attention to the appointment of members of Shariah committee, which is consistent with Farook
5 *et al.*, (2011), Rahman and Bukair (2013), Mergaliyev *et al.*, (2019) and partially with
6 Nugraheni (2018). Alam (2021) in his paper has proposed centralized Shariah governance
7 framework for Islamic banks in Bangladesh which includes institutional SSB and centralized
8 National Shariah supervisory board as well.
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11 12 **Implications of the study**

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14 Positive social impact is among the main objectives of Islamic banks. This social impact
15 became one of the main issues for researchers in this field and policymakers, as research shows
16 that Islamic banks do not have a significant positive social impact in practice (compared to
17 theoretical expectations). It can be concluded that these institutions failed in meeting their
18 (Islamic) obligations towards society overall. This directs us to search for different (internal
19 and external) ways of improving the social performance of these institutions including those
20 that can be tackled by different regulatory or policy measures. Among potential determinants,
21 characteristics of the Shariah board as an Islamic governance mechanism is among the most
22 promising factors.
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27 The results of our research show that the quality of internal shariah governance mechanisms
28 positively impacts the social performance of Islamic banks. Surprisingly, the external shariah
29 governance mechanism in the form of the National / Centralised Shariah Board has a negative
30 impact on social performance, according to our results. This suggests that policymakers should
31 strengthen Shariah Supervisory Board as an Islamic governance mechanism on individual
32 banks instead of introducing Centralised Shariah Boards on the national level. This quality of
33 Islamic governance on the level of individual Islamic banks can be improved on different ways,
34 with Shariah Annual Report being the critical communication instrument as noted by Sencal
35 and Asutay (2020).
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40 In our research, all observed banks had an internal Shariah Supervisory Board, while banks in
41 some countries also had a centralised Shariah board as an additional Shariah supervisory body.
42 It could be the case that introduction of an external Shariah Board made internal one less
43 efficient by making its members less engaged into Shariah and maqasid issues in the bank. If
44 there are boards on different levels overlapping in their responsibility, members of the internal
45 one will tend to transfer their responsibility towards members of the Centralised Shariah board.
46 This way, the board which is less "demanding" (and less efficient) takes precedence, thus
47 weakening Shariah governance and harming social performance.
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51 Contribution to knowledge is reflected in findings that Islamic governance quality has positive
52 impact on ability of Islamic banks to achieve higher social performance, while it gives
53 directions for further research into why national shariah boards fail in such a mission. When it
54 comes to practice, this research gives important inputs for policymakers and Islamic banking
55 decision makers on how to improve social performance of Islamic banks.
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59 The research results can impact the quality of life in the society if the policy makers take into
60 account the poor impact of National SSB's and take measures to improve them. Also, board of
61 directors of Islamic banks can learn from this study about the importance of Islamic governance

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3 for achieving higher social performance of their banks, thus the banks themselves being more
4 legitimate as Islamic. This is especially important in muslim countries, since Junaidi (2021) in
5 his research found that extrinsic religiosity has crucial role on consumers' awareness and
6 consumer attitudes in Indonesia.
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9 **Conclusions and future research**

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11 This study investigated the impact of *Shariah* governance quality on social performance of
12 Islamic banks because making an impact on society is one of the primary purposes of Islamic
13 banks. SSBs should take care that Islamic banks not only use models that are technically
14 *Shariah*-compliant but they should also take care of *maqasid al-Shariah*, i.e., aims and
15 objectives of *Shariah* and the "spirit" of the principles of Islamic banking. In hypotheses testing,
16 the level of social performance is measured by an index based on the theory of IME, where the
17 values of its indicators are derived from the annual reports of Islamic banks, based on both
18 qualitative and quantitative data. This index follows the goals of IME (or *maqasid*) following
19 the work of classical authors in Islamic law.
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24 Results of the study show that the quality of *Shariah* governance in the Islamic banks has a
25 significant positive impact on social performance of these banks, at 1% significance level. In
26 contrast, the existence of NSB and the bank's age do not significantly impact SPI in this model.
27 Bank size is significant at the 10% level, while leverage shows significance at the 5% error
28 level.
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32 According to the results of this research, to meet social impact objectives Islamic banks should
33 focus on improving internal *Shariah* governance mechanisms. Today, it is common practice for
34 Islamic financial institutions to appoint a *Shariah* board, which will oversee all agreements and
35 ensure that they are compatible with Islamic economic principles. The confirmed hypothesis in
36 the research refers to the positive impact of the quality of Islamic governance in the bank on its
37 social performance.
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41 Some countries, particularly those in Southeast Asia, have established special central *Shariah*
42 committees for all banks in the banking system due to doubts about the quality of *Shariah*
43 governance at the level of individual banks. However, results of our research show that it has a
44 negative impact on social performance of Islamic banks, thus the effectiveness of such
45 supervisory mechanisms can be questionable.
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48 The most significant limitation of this research lies in using SPI based on information from the
49 annual reports, as the index is based only on information published in the reports. Although
50 most large banks publish annual reports, the fact is that some banks do not publish. This does
51 not mean, however, that their social contribution is non-existent. Furthermore, sometimes there
52 are significant differences in the quality of published reports.
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55 Due to the fact that this research focuses on Islamic-governance-related factors that affect social
56 performance of Islamic banks, there is room for further research about other internal and
57 external determinants of Islamic banks' social performance (e.g., corporate culture,
58 management style, ownership, regulatory aspects, economic environment, etc.).
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Appendix: List of Indicators of Maqasid Performance of IBFIs based on Najjar's Maqasid Framework

No	Key Objectives	Consequences	No	Dimension	Elements	Source:	Indicator/Disclosure Aspect
A	Safeguarding the value of human life	1. Faith	1	PLS products	Functional Distribution	Mohammed, Dzuljastri & Fauziah [37]	Mudharabah and Musharakah Modes/Total Investment Modes
			2	Elimination of negative elements that breed injustices	Interest free Product	Mohammed, Dzuljastri & Fauziah [37]	Interest free income/total revenue
			3	1.Underlying Philosophy and Values	Vision and Mission Statement Disclosure	Haniffa & Hudaib [5]	i. Commitments in operating within Shari'ah principles/ideals
						Haniffa & Hudaib [5]	ii. Commitments in providing returns within Shari'ah principles
						Haniffa & Hudaib [5]	iii. Focus on maximising stakeholders returns or values
						Haniffa & Hudaib [5]	iv. Directions in serving the needs of Muslim community
						Haniffa & Hudaib [5]	v. Commitments to engage only in permissible investment activities
						Haniffa & Hudaib [5]	vi. Commitments to engage only in permissible financing activities
						Haniffa & Hudaib [5]	vii. Commitments to fulfil contracts via 'contract (uqud) statement'
						Haniffa & Hudaib [5]	viii. Appreciation to shareholders and customers
		4	2 & 3. Interest-free and Islamically Acceptable Deals - Shari'ah Section in AR	Shari'ah Report on financial transactions	Haniffa & Hudaib [5]	Disclosure of any unlawful transactions	
					Haniffa & Hudaib [5]	Description of unlawful transactions	
					Haniffa & Hudaib [5]	Disclosure of how gains from such activities have been handled	
					Belal et at. (2014)	Disclosure of reasons for undertaking unlawful transactions	
					Belal et at. (2014)	Opinion of SSB regarding necessity of undertaking unlawful transactions	
		2. Rights & Stakeholding	5	2 & 3. Interest-free and Islamically Acceptable Deals - Product Aspects	Employees	Haniffa & Hudaib [5]	i. Employees appreciation
						Haniffa & Hudaib [5]	ii. Number of employees
						Haniffa & Hudaib [5]	iii. Equal opportunities policy
						Haniffa & Hudaib [5]	iv. Employees welfare
						Haniffa & Hudaib [5]	vi. Training: Other
Haniffa & Hudaib [5]	vii. Training: Student/recruitment scheme						
Haniffa & Hudaib [5]	ix. Reward for employees						
6	Corporate Governance Indicator (Fairness and Transparency) - general aspects		1 IFSB Guiding Principles for Corporate Governance	Belal, Abdelslam & Nizamee [11]	Strategic role and function of the Board of Directors		
				Belal, Abdelslam & Nizamee [11]	Strategic role and function of Executive Management		
				Belal, Abdelslam & Nizamee [11]	Strategic role and function of Internal auditors		
		Belal, Abdelslam & Nizamee [11]		Strategic role and function of external auditors			
Belal, Abdelslam & Nizamee [11]	Strategic role and function of SSB						
Belal, Abdelslam & Nizamee [11]	Mechanisms for balancing the accountability of the above organs						

			Belal, Abdelslam & Nizamee [11]	Does the organisation comply with internationally recognised corporate governance standards	
			Belal, Abdelslam & Nizamee [11]	Has the Board of Directors (BOD) set up a governance policy framework	
			Belal, Abdelslam & Nizamee [11]	Has the Board of Directors set up a Governance Committee	
			Belal, Abdelslam & Nizamee [11]	Does the Governance Committee include a member of the Audit Committee	
			Belal, Abdelslam & Nizamee [11]	Does the Governance Committee include a member of the SSB	
			Belal, Abdelslam & Nizamee [11]	Does the Governance Committee provide the BOD with reports and recommendations based on findings	
			Belal, Abdelslam & Nizamee [11]	Does the role of the Governance Committee overlap with the role of the Audit Committee	
	7	Corporate Governance Indicator (Fairness and Transparency) - BOD aspects	BOD (Composition, Appointment and Re-appointment, Board meetings, and Director's fees and remuneration)	Belal, Abdelslam & Nizamee [11], Haniffa & Hudaib [5]	Names of board members
				Belal, Abdelslam & Nizamee [11], Haniffa & Hudaib [5]	Positions of board members
				Belal, Abdelslam & Nizamee [11], Haniffa & Hudaib [5]	Pictures of board members
				Belal, Abdelslam & Nizamee [11], Haniffa & Hudaib [5]	Profile of board members
			UK CGC (FRC, 2014)	Does Board composition is diverse?	
			UK CGC (FRC, 2014)	Number of meetings by BoD (if more than 4=1, if no = 0)	
			UK CGC (FRC, 2014), Principles for enhancing corporate governance (Basel Committee, 2010)	Does the board stated in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted?	
			OECD (2004)	In case of Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.	
		Corporate Governance Indicator (Fairness and Transparency) - Executive Management aspects	Executive Management	Belal, Abdelslam & Nizamee [11], Haniffa & Hudaib [5]	Names of management team
				Belal, Abdelslam & Nizamee [11], Haniffa & Hudaib [5]	Positions of management team
				Belal, Abdelslam & Nizamee [11], Haniffa & Hudaib [5]	Picture of management team
				Belal, Abdelslam & Nizamee [11], Haniffa & Hudaib [5]	Profile of management team
			Principles for enhancing corporate governance (Basel Committee, 2010)	Are key management decisionse made by more than one person ("four eyes principle") - Is any Management Board?	

		Corporate Governance Indicator (Fairness and Transparency) - Committees aspects	Audit, Remuneration and Nomination Committee	OECD (2004), UK CGC (FRC, 2014), FSF Principles for Sound Compensation Practices (FSF, 2009)	Is remuneration policy for members of the board and key executives disclosed?
				UK CGC (FRC, 2014)	Is there a Remuneration committee?
				UK CGC (FRC, 2014)	Does a Remuneration committee consist of at least 3 independent non-executive directors?
				UK CGC (FRC, 2014)	Is the remuneration committee meeting at least 4 times per year?
				FSF Principles for Sound Compensation Practices (FSF, 2009)	Does the remuneration committee or BoD periodically supervise and review compensation schemes in the firm?
				Clarkson et al. (2006)	Are other types of remuneration of executives disclosed?
				OECD (2004)	Are selection and nomination processes disclosed?
				UK CGC (FRC, 2014)	Is there a Nomination committee?
				UK CGC (FRC, 2014)	Is the majority of members of a Nomination committee independent non-executives?
				Hameed et al. (2004)	f. There is an audit committee
				Hameed et al. (2004)	g. The Audit Committee consists of at least three non-executive directors, whom a majority are independent
				Hameed et al. (2004)	h. Audit committee includes someone with expertise in accounting
				Hameed et al. (2004)	i. Audit committee recommends the external auditor at the annual shareholder's meeting
				Hameed et al. (2004)	j. At least, once a year the committee met with the external auditors without executive board members present, to review financial statements
				Hameed et al. (2004)	k. Details of the activities of audit committees, the number of audit meetings held in a year and details of the attendance of each individual director in respect of meetings are disclosed
				Hameed et al. (2004)	l. Audit committee members attend at least 75% of meetings on average
	8	Corporate Governance Indicator (Fairness and Transparency) – Shari'ah Governance	Shari'ah Governance	GSIFI-1 (AAOIFI, 2010)	Are the fatwas, and rulings of the Shari'ah supervisory board binding on the Islamic financial institution?
				GSIFI-1 (AAOIFI, 2010), IFSB-10 (IFSB, 2009)	Is Shari'ah supervisory board appointed by the shareholders in their annual general meeting or by BoD, but not by Management?

			GSIFI-1 (AAOIFI, 2010)	The Shari'ah supervisory board should not include directors or significant shareholders of the Islamic financial institution.	
			GSIFI-1 (AAOIFI, 2010), Haniffa & Hudaib [5]	Does IFIs publish the fatwas, rulings and guidelines issued by its SSB during the year (including newly issued, revised or amended decisions)?	
			IFSB-10 (IFSB, 2009)	Are SSB members and ISCU/ISRU staff providing training to other staff: management, back and front-office?	
			IFSB-10 (IFSB, 2009)	Is there a process of assessment of effectiveness of SSB (collectively and individually per each member)?	
			IFSB-10 (IFSB, 2009)	Is the assessment report on effectiveness of SSB provided to BoD/AGM for making decisions on SSB (resignation/nomination new members and etc.)?	
			IFSB-10 (IFSB, 2009)	In case of conflict between BoD and SSB, is SSB provided with direct access to AGM?	
			IFSB-10 (IFSB, 2009)	Is there a mechanism for ensuring absence of conflict of interest for SSB members? (i.e. disclosure to other governance bodies)?	
			IFSB-10 (IFSB, 2009)	Do SSB follow Shari'ah pronouncements of national Shari'ah bodies (if existed) or internationally recognised bodies?	
			IFSB-10 (IFSB, 2009)	In case of not following national/international Shari'ah pronouncements in SSB's decision, are such decisions disclosed so that they can be openly assessed by the industry's stakeholders (subject to confidentiality)?	
			IFSB-10 (IFSB, 2009)	Do SSB periodically on systematic manners interact with BoD?	
			IFSB-10 (IFSB, 2009)	Does SSB oversee the computation and distribution of zakat to be distributed to charity?	
			Haniffa & Hudaib [5]	Are names, positions and pictures of the SSB members provided?	
	9	Corporate Governance Indicator (Fairness and Transparency) - Other aspects	Other	Hameed et al. (2004)	c. There is a Risk Management Committee
				Hameed et al. (2004)	f. The maintenance of an effective system of internal controls is disclosed
				Belal, Abdelslam & Nizamee [11]	Does the bank have a formal disclosure policy that has been approved by BOD?
	10	Ethical aspects	Ethical behaviour and consumers' rights	Belal, Abdelslam & Nizamee [11]	Does the organisation comply with an ethical code of conduct ?
				Belal, Abdelslam & Nizamee [11]	Has this ethical code of conduct been described?

						Belal, Abdelslam & Nizamee [11]	Is there an ethical committee?
						Belal, Abdelslam & Nizamee [11]	Are employees trained in ethical policies?
						Belal, Abdelslam & Nizamee [11]	Does the organisation comply with customer protection legislation?
B	Safeguarding the Human self	3. Self	11	Investment in vital real sector and SME	Investment ratios in vital real sector	Mohammed, Dzuljastri & Fauziah [37]	Investment in Real Economic Sector/Total Financing
					Financing microfinance	Ngalim and Ismail (2014)	Investments to Microfinance and SME
		4. Intellect	12	Advancement of Knowledge	Education grant and research	Mohammed, Dzuljastri & Fauziah [37]	Education grant or scholarship/total expenses
						Mohammed, Dzuljastri & Fauziah [37]	Research expenses/total expenses
						Belal, Abdelslam & Nizamee [11], Haniffa & Hudaib [5]	Does the company sponsor work experience programmes for students?
						Belal, Abdelslam & Nizamee [11]	Has the organisation been involved in establishing educational institutions?
						Belal, Abdelslam & Nizamee [11]	Is the organisation involved in any arts related activities?
						Ngalim and Ismail (2014)	Does IB provide educational financing?
			13	Installing new skills and improvement	Training	Mohammed, Dzuljastri & Fauziah [37]	Training expense/total expenses
			14	Creating Awareness of Islamic Banking	Publicity / Awareness on Islamic Banking	Mohammed, Dzuljastri & Fauziah [37]	Publicity expense/total expenses
						Haniffa & Hudaib [5]	vi. Conferences on Islamic economics
C	Safeguarding the society	5. Posterity	15	Redistribution of wealth	Wages (RO1)	Ngalim and Ismail (2014)	Wages / Net income
					Tax (RO2)	Ngalim and Ismail (2014)	Tax / Net income
					Shareholders (RO3)	Ngalim and Ismail (2014)	Shareholders dividends / Net income
					Depositors (RO4)	Ngalim and Ismail (2014)	Depositors returns / Net income
					Zakat (RO5)	Ngalim and Ismail (2014), Mohammed, Dzuljastri & Fauziah [37]	Zakat / Net income
					Waqf (RV1)	Ngalim and Ismail (2014)	Waqf / Net income
					Sadaqah & Infaq (RV2)	Ngalim and Ismail (2014)	Sadaqah & Infaq / Net income
		6. Social entity	17	Developmental and Social Goals	Zakah, charity and benevolent loans	Haniffa & Hudaib [5]	i. Bank liable for zakah
						Haniffa & Hudaib [5]	ii. Amount paid for zakah
						Haniffa & Hudaib [5]	iii. Sources of zakah
						Haniffa & Hudaib [5]	iv. Use/beneficiaries of zakah
						Haniffa & Hudaib [5]	v. Balance of zakah not distributed-amount
						Haniffa & Hudaib [5]	vi. Reasons for balance of zakah
						Haniffa & Hudaib [5]	ix. Zakah to be paid by individuals-amount
						Haniffa & Hudaib [5]	x. Sources of charity (saddaqa)
						Haniffa & Hudaib [5]	xi. Uses of charity (saddaqa)
						Haniffa & Hudaib [5]	xii. Sources of qard al-hassan
						Haniffa & Hudaib [5]	xiii. Uses of qard al-hassan
						Haniffa & Hudaib [5]	xiv. Policy for providing qard al-hassan
						Haniffa & Hudaib [5]	xv. Policy on non-payment of qard al-hassan
					G. Community	Haniffa & Hudaib [5]	i. Creating job opportunities
						Haniffa & Hudaib [5]	ii. Support for org. that provide benefits to society
						Haniffa & Hudaib [5]	iii. Participation in govt. social activities

						Haniffa & Hudaib [5]	iv. Sponsor community activities
						Haniffa & Hudaib [5]	v. Commitment to social role
						Belal, Abdelslam & Nizamee [11], OECD (2004)	Does the organisation work closely with the local community?
						Belal, Abdelslam & Nizamee [11], OECD (2004)	Does the organisation develop and apply self-regulatory practices and management systems that foster a relationship of confidence and trust between enterprises and the community?
						Belal, Abdelslam & Nizamee [11], Haniffa & Hudaib [5]	Is the organisation committed to supporting community organisations?
						Belal, Abdelslam & Nizamee [11]	Any mention of commitment to local economic development made?
						Belal, Abdelslam & Nizamee [11]	Is there a description of charitable activities achieved?
						Belal, Abdelslam & Nizamee [11]	Does the bank support employee involvement in charities?
						Belal, Abdelslam & Nizamee [11]	Does the organisation sponsor any community programmes?
						Belal, Abdelslam & Nizamee [11]	Amount spent on School, art or sport sponsorship
D	Safeguarding physical environment	7. Wealth	18	Fair Returns	Fair Returns	Mohammed, Dzuljastri & Fauziah [37]	Profit Equalization Reserves (PER)/Net Income
			19	Earning Ability	Return on Asset	Jaffar and Marnavi (2011)	Net income/total assets
					Return on Equity	Jaffar and Marnavi (2011)	Net income/total equities
			20	Distress predictability	Altman's Z-score for Emerging Markets	Othman and Shahadan (2015)	Altman's Z-score for Emerging Markets
		8. Ecology	21	Environment Indicators	Policy Objectives and Environmental Issues	GSIFI-7 (AAOIFI, 2010)	Mandatory policy - screening investments on environmental impact
						GSIFI-7 (AAOIFI, 2010)	Recommended policy on reduction of adverse impact on environment
						GSIFI-7 (AAOIFI, 2010)	Investments and funds for contribution to environment improvements
						Hameed et al. (2004)	f. Energy, Paper or Water Savings
						GRI (2013)	Is the environmental section of AR following GRI or other best practices?

Additional Questions:

1. Originality: Does the paper contain new and significant information adequate to justify publication?: **Weak. Please enhance the introduction part through add some point of views related to Islamic social performance. Don't forget to add the Maqasid al-Shariah principle to solve social problem in Islamic countries.**

We have elaborated more on Maqasid al-Shariah in the introduction, while social performance was already discussed quite extensively.

2. Relationship to Literature: Does the paper demonstrate an adequate understanding of the relevant literature in the field and cite an appropriate range of literature sources? Is any significant work ignored?: **Weak. Please provide literature and hypotheses part separately.**

We have separated literature review and hypotheses

3. Methodology: Is the paper's argument built on an appropriate base of theory, concepts, or other ideas? Has the research or equivalent intellectual work on which the paper is based been well designed? Are the methods employed appropriate?: **Weak. Please provide indicators which adapted in this study. The indicators will help the reader to understand this work.**

Indicators are now provided in appendix.

4. Results: Are results presented clearly and analysed appropriately? Do the conclusions adequately tie together the other elements of the paper?: **Without indicators, hard to understand the result.**

Indicators are now provided in appendix.

5. Implications for research, practice and/or society: Does the paper identify clearly any implications for research, practice and/or society? Does the paper bridge the gap between theory and practice? How can the research be used in practice (economic and commercial impact), in teaching, to influence public policy, in research (contributing to the body of knowledge)? What is the impact upon society (influencing public attitudes, affecting quality of life)? Are these implications consistent with the findings and conclusions of the paper?: Good

6. Quality of Communication: Does the paper clearly express its case, measured against the technical language of the field and the expected knowledge of the journal's readership? Has attention been paid to the clarity of expression and readability, such as sentence structure, jargon use, acronyms, etc.: Good

The Influence of National and Individual Islamic Governance on Islamic Banks' Social Performance

Abstract

Purpose - This study investigates the relationship between Islamic governance and the social performance of Islamic banks, pioneering a new aspect in terms of the impact of the national *Shariah* board on the social performance of Islamic banks. The Shariah Supervisory Board (SSB) is the essential body in Islamic banks in charge of Islamic governance. Therefore, this study explores how the characteristics of *the Shariah* board and Islamic governance mechanisms influence the social performance of Islamic banks.

Design/methodology/approach – Panel data methods were applied to the annual data of 43 banks from 14 countries over the period 2012-2018 to explore the impact of Islamic governance on Islamic banks' social performance. We use all available bank annual reports for the given period. Social performance was measured by *the Maqasid al-Shariah* (in term of the goals of Islamic moral economy) index using a comprehensive evaluation framework. Islamic governance is represented by improved Islamic Governance Score (IG-Score) index, which measures the quality of Islamic governance in Islamic banks. In our research, we also introduced the frequency of SSB meetings in the IG-Score.

Findings - The findings suggest a strong link between Islamic governance and the social performance of Islamic banks, illustrating the importance of *the Shariah* board in achieving *maqasids*. On the other hand, the research discovered that National Shariah Boards are inefficient, and the existence of NSB can jeopardize the social performance of Islamic banks. The results of this research provide valuable recommendations for Islamic banks that are keen to improve their social performance.

Originality/value – To investigate the impact of SSB governance on the social performance of Islamic banks using an improved IG score index, this is the first study to investigate the impact of national Shariah boards (NSB) on the social performance of Islamic banks. This study provides insight into the efficiency of the NSB's role in supporting Islamic banks to achieve a higher level of social performance.

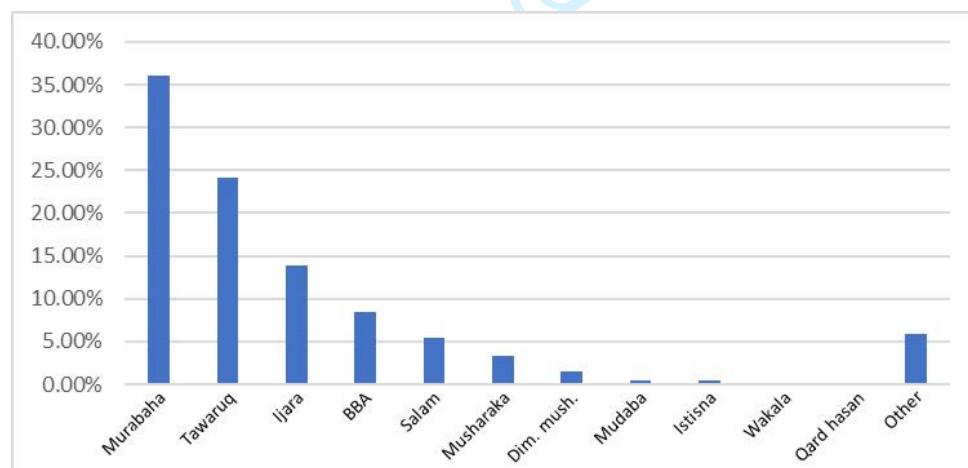
Keywords: Islamic banks, Islamic governance, *Shariah* board, social performance, *maqasid al-Shariah*

1. Introduction

Social performance is at the heart of the Islamic Moral Economy (IME), since operations of Islamic banks according to IME should not only formally be under Islamic teachings, but these institutions should also promote human well-being (Asutay, 2012). Therefore, Islamic banks should have both financial and social (Haniffa and Hudaib, 2007). Mergaliyev *et al.* (2021) noted that the Islamic moral economy provides a framework for the assessment of Islamic banking and finance in practice.

Existing literature suggests that, in practice, Islamic banks seem to be more concerned with the legal and mechanical aspects of *Shariah* observance than with promoting Islamic ethical values (Nienhaus, 2011). The prevailing general view is that Islamic banking has *de facto* failed to meet social and ethical goals (Ahmed, 2011). From a theoretical point of view, Musa (2011) noted that “the current literature on Islamic finance and Islamic business ethics lacks an assessment of the extent to which Islamic financial institutions enforce the ideal ethical norms of Islam”. Authors such as Kuran (2004), Pollard and Summers (2007), Asutay (2012), and Belal *et al.* (2015) recognized that there are differences between Islamic banks in their compliance to Islamic teachings, especially if we consider IME requirements regarding social responsibility. They found that Islamic banks developed a debt-oriented culture similar to conventional banks, keeping in mind that debt-based instruments such as *murabaha*, *al-bay' bithaman ajil*, and similar are the most popular financing products of Islamic banks, with a share of more than 70% in their balance sheets in some cases. This indicates the preference of Islamic banks for the neoclassical profit-maximization approach instead of the approach suggested by IME.

Figure 1. Structure of Islamic banks' financing in practice



Source: Adewale & Archer (2019)

Apart from apparent “anomalies” from the balance sheet, empirical research confirmed these suspicions regarding failing to meet the goals of IME, since Asutay and Harningtyas (2015), Rusydiana and Firmansyah (2018), as well as Antonio *et al.*, (2012), indicated a lack of social responsibility, the frequent absence of the expected positive effects of Islamic financial intermediaries on society. Such positive effects are often highlighted in theory as an argument in favor of Islamic financial institutions. In addition to weak social performance, Asutay and

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3 Harningtyas (2015), Ngaliim *et al.* (2015), Mohamed (2018), Hasan and Ali (2018), Mergaliyev
4 *et al.* (2019), and Meskovic *et al.* (2021) confirmed significant differences in social
5 performance among Islamic banks.
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8 Since IME draws its principles from *the Qur'an* and *Sunnah*, it has become a common practice
9 for Islamic financial institutions to appoint a *Shariah* committee, which will oversee the banks'
10 operations and ensure they are compatible with Islamic principles. This gives clients the
11 security of having their money handled following Islamic teaching. Junaidi (2022) noted that
12 both the government and the SSB need to enhance control and promote Islamic values, which
13 should lead to higher clients' commitment to Islamic banking products. Overall, all others,
14 including traditional and Islamic institutions, can learn from Islamic banks when it comes to
15 applying governance mechanisms to improve benefits to society. This also includes Zakat
16 institutions, as noted by Widiastuti *et al.* (2021).
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21 Budi (2021) notes that from an Islamic perspective, Islamic corporate governance is a
22 responsibility and obligation not only at the company level but also at the individual level. The
23 foundation of Islamic banks is rooted in Islamic law, and Islamic banks adhere to the principle
24 that contracts that are exploitative based on interest, uncertainty, or contain risk or speculation
25 cannot be executed. This study also considers Islamic governance at the national level. Some
26 authors have recognized the importance of the *Shariah* supervisory board for the social
27 performance of Islamic banks. However, the field has not been researched sufficiently to
28 include the impact of the national *Shariah* boards, which some countries have introduced. In
29 addition, this study considers an improved index of *Shariah* governance in Islamic banks.
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33 Elamer, Ntim, & Abdou (2020) in their research took into account national governance quality
34 measure based on the index consisted of "conventional" governance dimensions, while our
35 research takes into account Islamic governance at the national level, embodied in the National
36 *Shariah* Board. No country has gone further than Malaysia to set standards for Islamic financial
37 institutions, including corporate governance. Bank Negara Malaysia (BNM) has a long tradition
38 of providing minimum standards and specific requirements for Islamic banks and *Takaful*
39 operators. Meskovic *et al.* (2021) noted that Malaysia is among the countries with the highest
40 Islamic banking social performance, although they did not explore the reasons for such
41 performance. BNM issued a *Shariah* Governance Policy Document (2019), which includes the
42 robust responsibilities of *the Shariah* Supervisory Board (SSB) at the individual (bank) level.
43 Hasan *et al.* (2020) noted that *Shariah* governance processes among Islamic funds in Malaysia
44 are well managed and praise the current regulations issued by regulators. Muhamat and McIver
45 (2019) confirmed this on a sample of Malaysian *Takaful* operators, while Noordin and Kassim
46 (2019) confirmed that *Shariah* governance quality in Malaysian Islamic banks influences
47 disclosure. Shahar *et al.* (2020) arrived at similar conclusions, noting a difference in risk
48 reporting between small and large Islamic financial institutions.
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54 Keeping in mind that the SSB is the crucial body ensuring *Shariah* compliance with Islamic
55 banking operations, this paper addresses the following research questions:
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58 What is the impact of *Shariah* board characteristics on social performance of Islamic banks?
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3 What is the impact of the existence of the National Shariah Board on the social performance of
4 Islamic banks in the country?
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6 The purpose of this study is to gain new knowledge that can help elevate the social performance
7 of Islamic banks. The motivation for this study is that the answer to these questions can support
8 Islamic banks and regulators in achieving a higher level of social performance. We use the
9 improved Islamic governance score by employing panel data methods, including FEM, REM,
10 and PCSE.
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13 In previous literature, several authors, such as Mergaliyev *et al.* (2021), Iryani *et al.* (2019),
14 Lesmana and Haron (2019), Mukhibad (2019), Rahman and Haron (2019), Sencal and Asutay
15 (2020), and others have confirmed that the characteristics or quality of the internal *Shariah*
16 governance system have significant effects on the social performance of Islamic banks.
17 However, this study was conducted on a global scale, with a much larger sample size.
18 Furthermore, to the best of our knowledge, no research has been conducted on the impact of
19 national *Shariah* governance on the social performance of Islamic banks.
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23 This study contributes additional insights into the role of *Shariah* governance in achieving
24 higher social performance of Islamic banks and explores the importance of national *Shariah*
25 boards. Hence, this study is important because it provides new insights into the impact and
26 relevance of Islamic governance quality at the individual and national levels on Islamic banks'
27 ability to achieve higher ethical objectives in the Islamic moral economy.
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31 The rest of the paper is organized as follows: Section 2 presents the theoretical framework,
32 Section 3 discusses the relevant literature and hypotheses development, Section 4 presents the
33 study sample and methodology, Section 5 reports the results, and Section 6 discusses them.
34 Section 6 provides theoretical and practical implications, and Section 7 concludes the paper and
35 offers recommendations.
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37

38 **2. Literature Review, Theoretical Framework, and Research Hypotheses**

39 This study uses systems-oriented theories (Farook *et al.*, 2011), including political economy,
40 stakeholder theory, and legitimacy theory. The theory of Islamic political/moral economy is
41 structured from the axioms found in the ontological and epistemological resources of Islam (*the*
42 *Qur'an* and *Sunnah*). Compared with mainstream Islamic finance, IME promotes value-
43 oriented financing characterized by embeddedness; in other words, dependence on the
44 environment and the system within which different social activities take place and on which
45 they depend. The opposite of this integration is the lack of integration of the financial and real
46 sectors, as we have in the modern capitalist economy. The two main theories explaining
47 organizations' social responsibility and their social impact are stakeholder theory (Deegan and
48 Unerman, 2011) and legitimacy theory (Deegan, 2002). Although these two theories also
49 overlap in some aspects (Gray *et al.*, 1995), stakeholder theory implies a more precise approach,
50 as it separates different stakeholders into groups, while legitimacy theory looks at society.
51 Legitimacy theory could be considered a particular case of stakeholder theory, where all
52 stakeholders are treated equally, which Fernando and Lawrence (2014) called the "ethical
53 perspective". Al-Shamali, Sharif, and Irani (2013) noted that the social function of Islamic
54 banks refers to bank responsibility for the well-being of all stakeholders. The managerial
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perspective implies that organizations (in this case, Islamic banks) consider only economically powerful stakeholders. However, both approaches are still beneficial to companies (Fernando and Lawrence, 2014). Legitimacy theory involves an invisible “social contract” between company and society (Deegan, 2006), whose purpose is to ensure that the organization is perceived as functioning within the norms of the society in which they operate. Organizations that fail in this matter will not survive in the long term, so they will participate in socially responsible activities to maintain, gain, or regain their legitimacy, thus positively impacting their social performance.

A stakeholder that is critical for any Islamic bank’s legitimacy is *the Shariah* board or committee. The *Shariah* board is a unique governance structure in the Islamic financial system, entrusted with directing, reviewing, and overseeing the activities of Islamic financial institutions to ensure compliance with *Shariah*. Corporate governance in Islamic financial institutions requires the existence of a *Shariah* committee to ensure that the institution’s operations are in line with the principles of Islamic business law (Cadbury, 2002). The International Council of the Fiqh Academy defined the *Shariah* committee as Decision No. 177 (19/3) regarding its role in regulating the operations of Islamic banks as a group of specialists in Islamic jurisprudence, especially civil jurisprudence (*fiqh al-mu’amalat*), whose number will not be less than three and were selected from among those with the ability and knowledge given the practical reality, whose job is to pronounce judgments and revise everything that needs to be revised, to confirm and ensure that all transactions conducted by Islamic financial institutions comply with *Shariah* guidelines, and for decisions to be made public and Islamic financial institutions must support SSB decisions. Although they considered “conventional” governance variables, such as board independence, directors and institutional ownership, and overall governance quality, Naveed and Abidin (2020) found that governance quality is helpful in reducing the total and downside risk exposure of Islamic mutual funds.

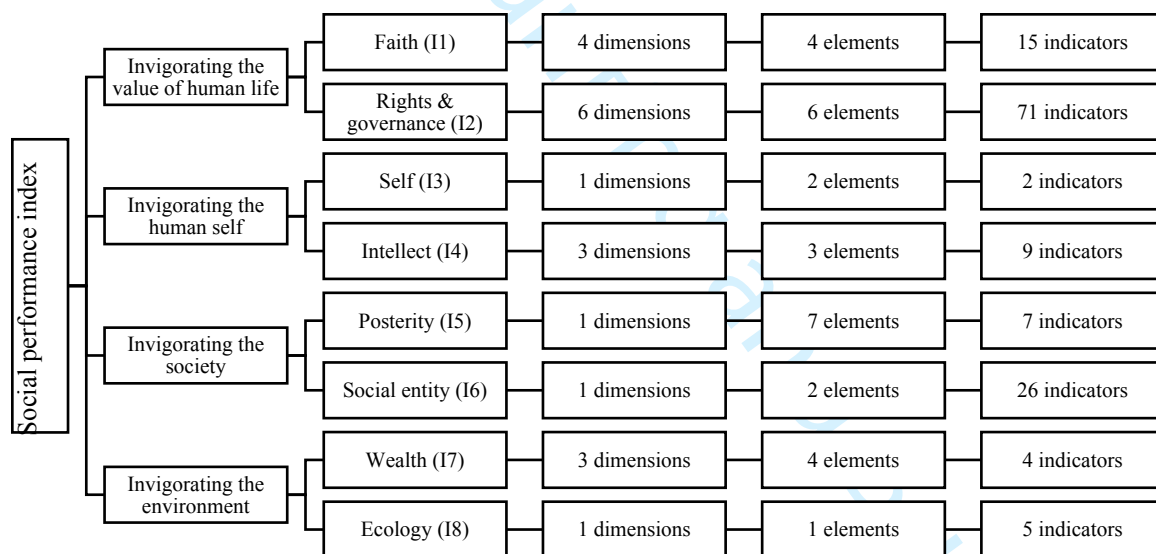
Islamic financial products and instruments must be legitimate by *Shariah* principles. Thus, the primary goal of a *Shariah* committee is to ensure compliance with the principles and values of IME, thereby legitimizing the bank as Islamic. Alam *et al.* (2021) thoroughly explored the expected duties, roles, and functions of *the Shariah* board in Bangladesh, using an interview method. This includes opinions on *Shariah* issues, taking into account modern banking circumstances as well, developing appropriate *Shariah* governance policies and implementing them, approving new products, and reviewing them, that is, overall ensuring *Shariah* compliance. On the other hand, Jan, Lai & Tahir (2021) proposed a more general role for Islamic corporate governance covering the *Shariah* dimension and conventional context of corporate governance to examine its nexus with sustainability performance.

In addition to the existence itself, specific characteristics of a *Shariah* board, such as the independence or authority of the board members, can affect legitimacy (Alsartawi, 2019). In this process, Islamic financial institutions require the existence of specialized committees with experts on *Shariah* issues, especially *fiqh al-mu’amalat*, which would support banks in determining the legitimacy of Islamic financial products and the overall business of such institutions (Ainley *et al.*, 2007). Various aspects are involved in this process, including transparency, accountability, reporting structure, and the independence of *the Shariah*

committee (Wilson, 2009). Kaaroud *et al.* (2020) note that the audit report lag in Islamic financial institutions can be decreased with appropriate governance mechanisms. Sencal and Asutay (2020) attempted to constitute an Islamic corporate governance framework as a theoretical construct by exploring the Shariah annual reports of Islamic banks in the second stage of their study. All of these aspects are essential for achieving the legitimacy of Islamic banks.

Since social responsibility is embedded in the core business of Islamic banking, *the Shariah* board should examine technical issues regarding Islamic modes of financing and collecting deposits and consider the broader ethical perspective of IME. Therefore, in this study, we use *the Maqasid al-Shariah* index based on the IME to measure Islamic banks' social performance. In constructing the social performance index, we used Najjar's approach to *maqasid*, which considers four goals and eight dimensions. This index was initially introduced by Mohammed *et al.* (2008), and further refined by Bedoui and Mansour (2014), Asutay and Herningtyas (2015), and Mergaliyev *et al.* (2019). The methodology includes a dichotomous approach of Haniffa and Hudaib (2007), which means that the observed item received a rating of "1", if it is found in the annual report, or "0", otherwise. Furthermore, some sub-indices are extracted from banks' financial statements and, hence, quantitative rather than qualitative data.

Figure 2. Social performance index based on a *maqasid al-Shariah* evaluation framework



Source: Adapted from (Mergaliyev *et al.*, 2019; Mohammed *et al.*, 2008; Bedoui and Mansour, 2014; Asutay and Harningtyas, 2015)

Research on the influence of Islamic corporate governance (*i.e.*, *Shariah* board characteristics) has gone into two main directions: some authors have examined its impact on financial performance, while most studies have investigated the impact of *the Shariah* board on the corporate social responsibility (CSR) disclosure of Islamic banks. However, most studies investigating the impact on social performance have been conducted with fewer observations than those in this study.

When it comes to social performance, authors use different terms, such as social performance, ethical performance, environmental, social, and governance (ESG) performance, and *maqasid*

performance (Meskovic *et al.*, 2021). As most authors agree that the social performance of Islamic banks is not at a satisfactory level, research is now shifting towards the causes of such low performance, and Islamic corporate governance is recognized as one of the major determinants.

Islamic governance was measured using the IG-Score developed by Farook *et al.* (2011). In a pioneering work, Farook *et al.* (2011) developed the IG-Score by combining several variables:

- Existence of SSB,
- The number of SSB board members,
- The existence of SSB members with cross-memberships,
- The existence of SSB members with doctoral qualifications, and
- Existence of reputable scholars presiding on SSB board.
- In our study, we include additional variables that consider the frequency of SSB meetings held during the year, according to Alsartawi (2019) and Mukhibad (2019).

They hypothesized a positive association between IG-scores and the level of CSR disclosure presented by Islamic banks in their annual reports. They tested this hypothesis on 47 banks and their results revealed that the IG-Score is highly significant, indicating that *Shariah* board characteristics are important determinants of CSR disclosures in Islamic banks. Following Farook *et al.* (2011), Rahman and Bukair (2013) investigated the effects of *the Shariah* board on the CSR disclosure of 53 Islamic banks in 2008. Their findings indicate that the combination of *Shariah* board characteristics has a significant positive influence on CSR disclosure, illustrating the importance of *the Shariah* board for CSR in Islamic banks.

The board of directors (BoD) plays an important role in social performance. There is no doubt that the characteristics and even personal beliefs of BoD members can impact institutions' CSR strategy and social performance. Exploring the influence of *Shariah* governance on the CSR of 10 Islamic banks during 2011-2018, Ridwan and Mayapada (2020) concluded that the effectiveness of the board of directors plays a vital role in enforcing CSR disclosure. Their results show that audit committees and *Shariah* supervisory boards have no significant effect on CSR disclosure in Islamic banks. Therefore, the conclusion regarding Islamic corporate governance is that *the Shariah* board still focuses on *Shariah* principles regarding products and operations.

Together with governance, social performance of Islamic banks is the main idea in this study. To the best of our knowledge, the most extensive study of the determinants of Islamic banks' social performance was conducted by Mergaliyev *et al.* (2019). This study explored various internal and external determinants that affect the social performance of Islamic banks. A panel analysis of several key factors, such as the political and socioeconomic environment, ownership structures, and factors related to corporate and *Shariah* governance, was used to identify the main determinants of *maqasid* disclosure success. The authors found that the share of the Muslim population, CEO duality, and *Shariah* governance positively affected Islamic banks' social performance.

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3 An additional constituent of the IG score used in this study was the frequency (number) of SSB
4 meetings. Alsartawi (2019) explored whether the independence and frequency of *Shariah* board
5 meetings influenced the performance of 48 Islamic banks over the period 2013-2017. This
6 research showed a negative impact of *Shariah* board composition on financial performance
7 regarding return on assets. The author concludes that this may be due to the passive role of the
8 *Shariah* board, whose members act more as advisors and less as supervisors, allowing managers
9 to supersede their decisions. Nugraheni (2018) investigated the effect of SSB characteristics on
10 the level of social performance in Islamic banks in Indonesia during 2010-2014. The research
11 revealed that on the one hand, the size and reputation of SSB members significantly affect social
12 performance. On the other hand, the frequency of meetings, educational qualifications, and
13 cross membership of SSB do not significantly affect social performance.
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19 As an important body that is highly positioned on the organizational chart of any Islamic bank,
20 the SSB can influence the performance of these institutions. Some authors, such as Almutairi
21 and Quttainah (2017), explored the impact of *the Shariah* board and its attributes on Islamic
22 banks' performance. Their findings suggest that increasing the size of corporate boards and
23 SSBs should improve the monitoring and advisory functions, management behavior, and
24 organizational performance of Islamic banks. Similarly, Khalil and Taktak (2020) examined
25 the relationship between *Shariah* board characteristics and financial soundness (Z-score) of 67
26 Islamic banks from to 2005-2014. The authors did not investigate the social performance of
27 Islamic banks, but they found a negative relationship between *Shariah* board size, which could
28 indicate the existence of a trade-off between social and financial performance. However, the
29 only significant result they obtained was that the size of the *Shariah* board negatively impacts
30 financial soundness. Generally, the reputation of *Shariah* scholars is important as Khan (2010)
31 noted that one of the explanations for the poor "Islamic" of Islamic banks is that Islamic
32 financial institutions choose those scholars who are more cooperative, *i.e.*, eager to certify
33 *Shariah* transactions while being paid relatively large sums of money per year. In this regard,
34 the engagement of a national *Shariah* board could be one way to fight this phenomenon.
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40 Sencal and Asutay (2020) analyzed disclosure in *the Shariah* annual reports of Islamic banks
41 through AAOIFI standards and the Islamic moral economy. Their findings suggest that AAOIFI
42 guidelines impact the level of *Shariah* disclosure by Islamic banks. Furthermore, the popularity
43 of *Shariah* scholars has been found to be significant. At the national level, the adoption of
44 AAOIFI, quality of regulation, and the duration of *Shariah* compliance have some explanatory
45 power.
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49 Furthermore, each component of the IG-Score should positively affect the social performance
50 of Islamic banks. With a greater number of *Shariah* scholars on the committee, the *Shariah*
51 board should be more effective in ensuring *Shariah* compliance and the commitment of Islamic
52 banks towards their social function (Nugraheni, 2018). The number of SSB meetings held
53 during the year should be disclosed in an Islamic bank's annual report (Hameed *et al.*, 2004),
54 and the SSB's contribution to the social function of Islamic banks should increase with the
55 number of meetings held. In addition, educational qualifications, that is, the presence of SSB
56 members with a doctorate, should help banks achieve higher social performance (Farook, *et al.*,
57 2011). Similarly, the reputation and cross-membership of SSB members should help share
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experiences between Islamic financial institutions, including activities regarding social responsibility.

Considering the aforementioned, we hypothesize that:

H1: Islamic banks' quality of Islamic governance, represented by IG-Score, has a positive effect on their social performance.

Recognizing that *Shariah* incompliance is a risk that can severely impact Islamic financial institutions' asset values with possible loss of investments, funds, and potential incomes (Grassa, 2015) some countries have decided to introduce national *Shariah* boards. Muneeza and Hassan (2014) called *Shariah* corporate governance "the Islamic version of corporate governance. Thus, considering the systemic importance of banks in a financial system, we can claim that the approach with the introduction of national *Shariah* boards has similar intentions as the overall banking regulation. It aims to protect institutions, deponents, shareholders, the general public, and the financial system. Ahmed (2011) recommends active regulatory participation in *Shariah* governance to maintain stability. Therefore, as Grassa (2015) noted, some countries have developed comprehensive regulatory frameworks governing *Shariah* practices at both the national and institutional levels, while others have adopted a regulatory framework for *Shariah* supervision only at the institutional level.

Although some countries formally introduced *the Shariah* board at the national level, it has a very passive and usually only advisory role. Therefore, the national *Shariah* board (NSB) plays different roles in different countries. In some countries, such as the United Arab Emirates, Qatar, Bangladesh, and Jordan, NSB exists, but its role is limited to commenting on some issues or giving *fatwas* regarding the central bank's products (Grassa, 2015). Therefore, such an NSB does not have any authority at the institutional level, as Grassa (2015) stated, so we cannot claim that such a *Shariah* board affects individual Islamic banks and their operations. Thus, we must distinguish between NSB with an active supervisory and advisory role and NSB without an active role in individual Islamic bank operations, as shown in Table 1.

Table 1. National *Shariah* governance system across different countries

NSB with an active role	NSB without active role	No NSB
Malaysia, Indonesia, Pakistan, Sudan, Bahrain*	United Arab Emirates, Qatar, Bangladesh, Jordan, Kuwait	Kingdom of Saudi Arabia, United Kingdom, Bosnia and Herzegovina, Sri Lanka

* Since 2017

Source: Authors

Some countries have positioned NSB at the central bank or securities commission (Malaysia, Indonesia, Pakistan, Sudan, and Bahrain). Simultaneously, Kuwait, Jordan, Qatar, and the United Arab Emirates have given jurisdiction to the Ministry of *Awaqaf* and religious affairs or the Ministry of Justice and Islamic Affairs (Grassa, 2015).

Therefore, we hypothesize that:

H2: The existence of a National Shariah Board with an active role towards individual Islamic banks has a positive effect on the social performance of Islamic banks in the country.

3. Data and methodology

This study uses a balanced panel of annual data for 43 banks from 14 countries from 2012 to 2018. Based on the publication "Top Islamic Financial Institutions," published by the respected magazine "The Banker," in 2013, 185 commercial banks provided Islamic banking services. Of that number, 70 are conventional banks that have so-called Islamic windows and were not observed either because, in principle, they are not Islamic banks (only in the range of their products, among other things, they offer Islamic products). Thus, 115 commercial Islamic banks represent the population. Of these 115 banks, 43 regularly published annual reports during the observation period. The main criterion for composing the sample is the availability of the data, since some of the banks in the sample stopped publishing annual reports after 2018; thus, our sample would not be balanced. Initially, 115 Islamic banks from The Banker Among the selected countries, there is one country from Africa (Sudan), two countries from Europe (Bosnia and Herzegovina and the United Kingdom), five countries from Asia (Bangladesh, Indonesia, Malaysia, Pakistan, and Sri Lanka), and six countries from the Middle East (Bahrain, Jordan, Kingdom of Saudi Arabia, Kuwait, Qatar, and the United Arab Emirates).

Explaining the impact of differences in *Shariah* governance between individual banks and countries on the social performance of Islamic banks is the motivation for this research. Consequently, this paper aims to investigate the relation between Islamic governance score (IG-Score) at the individual bank level and the existence of *Shariah* supervisory board at the national level in the country, on the one hand, and social performance of Islamic banks, on the other hand. To test the abovementioned hypotheses, social performance was measured using the *Maqasid al-Shariah* index, an index based on the foundational axioms of IME, which was previously developed by Asutay and Harningtyas (2015) and further enhanced by Mergaliyev *et al.* (2019).

Table 2. Variables included in the model

Variable	Variable definition	Source
SPI	Social performance index of Islamic banks	Indicators based on the information from the Islamic banks' annual reports
IG-Score	The quality of <i>Shariah</i> governance in the bank	Annual reports
NSB	Existence of a NSB with an active role in the country (dummy)	National legislation and Refinitiv database
SIZE	The size of Islamic bank's assets (log)	Annual reports of the banks
LEV	The leverage ratio of an Islamic bank (log)	Annual reports of the banks
AGE	The age of an Islamic bank	Annual reports of the banks
GDP	GDP of the country (log)	World Bank database

Source: Authors

The degree of development of Islamic governance in individual banks is measured using the IG Score. It is an index developed by Farook *et al.* (2011) that sums the value of the dichotomous characteristics of the *Shariah* board, that is, the existence of the SSB itself, the number of SSB board members (1 if more than three members, otherwise 0), the existence of SSB members with cross-memberships (1 if there are scholars with cross-memberships), the existence of SSB

members with doctoral qualifications, and the existence of reputable scholars presiding on SSB boards (Farook *et al.*, 2011). Since we consider that the number of *Shariah* board meetings during the year impacts the quality of *Shariah* governance (Alsartawi, 2019; Mukhibad, 2019) we also add a number of meetings held during the year in this sum for the IG-Score, thereby further enhancing the index. All the variables are presented in Table 2.

The following regression model was used to analyze and test the hypotheses under the stated objectives:

$$SPI_{i,t} = \alpha + \beta_1 IGScore_{i,t} + \beta_2 NSB_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 LEV_{i,t} + \beta_5 AGE_{i,t} + \beta_6 GDP_{i,t} + \varepsilon_{i,t} \quad (1)$$

To operationalise the research, a social performance index (SPI) based on *maqāsid al-Shariah* was constructed to measure the social performance of Islamic banks. In the calculation of the social performance index (*maqāsid*), content analysis of available publishable text was used through a dichotomous approach, as suggested by Mohammed *et al.* (2008), Haniffa and Hudaib (2007), and Hameed *et al.* (2004) to mitigate any possible bias.

In conducting the content analysis for generating disclosure-related data for index, the value of “qualitative” components implies the arithmetic mean of the values of individual indicators within these components, which take the value 1, if complete information for a particular indicator exists in the Islamic bank’s annual report, or 0 if the information is not existing in the annual report (Haniffa and Hudaib, 2007; Belal *et al.*, 2014, Mergaliyev *et al.*, 2019). In the same way, the values of “quantitative” components from annual reports of Islamic banks are calculated using the arithmetic mean within these components of *the maqāsid* index, such as ROA. Daud (2019) noted that Islamic governance can have a significant impact on the quality of reporting of (any) Islamic organizations, suggesting several approaches to reinforce reporting through governance frameworks.

The data used to construct some of the sub-indices, in particular categories I3, I5, and I7, were extracted from the financial statements of the banks. Furthermore, the indicators of categories I5 and I7 were scaled to a value between 0 and 1. This was done using the linear scaling transformation (LST) method of Singh *et al.* (2009), which compresses the indicator original values to lie between 0 and 1. In any particular year, the lowest value of the indicator is 0, and the highest value is 1.

4. Data analysis method

In hypothesis testing, we use several estimators generally available when it comes to panel data methods, with the main three being pooled ordinary least squares (OLS), the fixed effects model (FEM), including “within” estimation and least-squares dummy variables (LSDV), and the random effects model (REM). Accordingly, this study applied these methods to estimate Model (1). Furthermore, we apply panel corrected standard error (PCSE) estimation to estimate Model (2) to correct for some issues existing in the previous Model (1) and test for robustness.

General panel data methods, including FEM and REM (and others employed in Table 6), do not account for the simultaneous presence of cross-sectional dependence and serial correlation (Hoechle, 2007; Reed and Ye, 2011; Sarafidis & Wansbeek, 2012), which our model suffers

from. In fact, diagnostic tests of model (1) show the existence of autocorrelation (using the Wooldridge test), heteroskedasticity (using the Breusch-Pagan/Cook-Weisberg and Modified Wald tests), and cross-sectional dependence (using Pesaran's test). One potential estimator that overcomes the simultaneous presence of serial and cross-sectional correlation is Park's feasible GLS (FGLS) (Parks, 1967) but it suffers from standard error downward bias (Beck and Katz, 1995). Therefore, a more effective and efficient estimator called panel corrected standard errors (PCSE) of Beck and Katz (1995) is used in the current paper. FGLS assumes $N > T$, which is the case in our sample, and the suitability of PCSE to samples such as ours has been confirmed in a number of studies (Blackwell 2005; Plümper et al. 2005; Hoechle, 2007; Reed and Ye, 2011). Therefore, the main panel data analysis method used in this study is the panel corrected standard error estimator (PCSE).

5. Results

As already stated, the main purpose of this study is to investigate the relationship between Islamic governance and the social performance of Islamic banks. We consider the standard Islamic governance measures at the individual-bank level and improve this measure, but we are also pioneering a new aspect in terms of the impact of the national Shariah board on the social performance of Islamic banks. Essentially, we explore how the characteristics of the Shariah board and Islamic governance mechanisms at the bank and national levels influence Islamic banks' social performance. This section presents the results of the research.

Table 3 summarizes the descriptive statistics for the variables in Model (1) and reports an average SPI value of 0.3539 (or 35.39%). SPI is the overall social performance of Islamic banks constructed during 2012-2018. The score can be considered low compared with the theoretical expectations and the index's maximum value, which is 1 (or 100%).

Since it considers the number of meetings held during the year, the IG-Score does not have a theoretical maximum; however, the largest value of the IG-Score is 12, while the smallest is 2. NSB is a dummy variable taking a value of 1 if the country (in the observed year) has active NSB; otherwise, this variable takes a value of 0.

Table 3. Descriptive statistics for the variables included in the model

Variable	Obs.	Mean	Std. dev.	Min.	Max.
SPI	301	0.3539	0.1143	0.1124	0.6818
IG-Score	301	4.7009	1.9279	2	12
NSB	301	0.3820	0.4867	0	1
SIZE	301	8.4518	1.6213	1.9643	11.3405
LEV	301	2.0693	0.4723	0.8070	3.1101
AGE	301	23.3720	13.5615	3	64
GDP	301	25.8759	1.1902	23.5681	28.6867

Source: Authors

Regarding the control variables, SIZE shows a bank's asset size (logarithm) in the corresponding year in USD (mil.) while LEV (leverage) represents the ratio of debt to capital. AGE shows how old the bank is in a corresponding year, while GDP is the GDP (logarithm) of the country in the observed year. The correlation matrices of the variables in the model are presented in Table 4.

Table 4. Correlations between the variables

	SPI	IG-Score	NSB	SIZE	LEV	AGE	GDP
SPI	1.0000						
IG-Score	0.2961*	1.0000					
NSB	0.3178*	-0.0839	1.0000				
SIZE	0.0146	0.1523*	-0.1753*	1.0000			
LEV	0.4587*	0.1633*	0.4069*	-0.0742	1.0000		
AGE	0.0784	0.1884*	0.0148	0.2027*	-0.0855	1.0000	
GDP	0.0600	-0.0390	0.2190*	0.3087*	0.2746*	-0.1236*	1.0000
	0.2995	0.5001	0.0001	0.0000	0.0000	0.0320	

Source: Authors

Gujarati (2003) noted that if there is a correlation between the independent variables larger than ± 0.8 , we can conclude that severe multicollinearity problems exist. As shown in Table 5, such a level of correlation does not exist in the model, and the results of the variance inflation factor (VIF) test confirm that model (1) does not suffer from multicollinearity. For this reason, according to Gujarati (2003) and Hair et al. (1995), VIF values below 10 are acceptable and indicate no multicollinearity problems. Moreover, model (1) also satisfies the strict criterion of other authors who set the threshold to five (Becker *et al.*, 2015).

Table 5. VIFs

	VIF	1/VIF
LEV	1.35	0.7384
GDP	1.34	0.7446
NSB	1.32	0.7554
SIZE	1.31	0.7608
AGE	1.14	0.8784
IGS	1.13	0.8830
Mean VIF	1.27	

Source: Authors

We start by estimating model (1) using Pooled OLS, LSDV, and “within” as fixed effects (FEM) and random effects (REM) estimators (generalized least square - GLS). The Breusch-Pagan/Cook-Weisberg test and the modified Wald test indicate the presence of heteroskedasticity. Therefore, the standard Hausman test cannot be used to select between FEM and REM. Thus, the Sargan-Hansen test with robust FEM and REM (p-value=0.0001) was applied, which shows that FEM is preferred.

FEM is also a theoretically preferred model (Allison, 2009). Furthermore, the FEM is a superior method when there is an unobservable omitted variable bias (Halaby, 2004; Allison, 2009). Considering the nature of the quality of Islamic governance, which is the main focus of this study, the model does not cover all potential macro factors (variables) such as regulation and competition, nor all bank-specific factors such as shareholders, management, intellectual capital, human resources, and management principles.

The results of OLS, LSDV, FE, FE robustness, and RE show that the IG-Score (i.e., the quality of *Shariah* governance in an Islamic bank, represented by IG-Score) and NSB (i.e., the existence of NSB with an active role) are consistently significant at standard significance levels

(except for NSB in the RE estimator). Surprisingly, NSB has a negative sign in LSDV and FE/FE robustness. Leverage (LEV) is significant (at different significance levels) in OLS and RE. Bank AGE plays a significant role, as the variable is significant in all estimators except OLS. GDP is also significant in all estimators, except RE, but with a negative sign.

Table 6. OLS, LSDV, FE, FE robust and RE model results

Variable	OLS	LSDV	FE	FE robust	RE
IG-Score	0.0139*** (0.00307)	0.0312*** (0.00767)	0.0312*** (0.00767)	0.0312** (0.0147)	0.0268*** (0.00596)
NSB	0.0519*** (0.0131)	-0.0260* (0.0138)	-0.0260* (0.0138)	-0.0260*** (0.00963)	0.000803 (0.0139)
SIZE	0.00472 (0.00393)	0.00190 (0.00242)	0.00190 (0.00242)	0.00190 (0.00232)	0.00225 (0.00260)
LEV	0.0883*** (0.0137)	0.0166 (0.0110)	0.0166 (0.0110)	0.0166 (0.0143)	0.0311*** (0.0116)
AGE	0.000311 (0.000437)	0.0166*** (0.00221)	0.0166*** (0.00221)	0.0166*** (0.00452)	0.00431*** (0.000876)
GDP	-0.00918* (0.00541)	-0.189*** (0.0488)	-0.189*** (0.0488)	-0.189* (0.102)	0.0178 (0.0123)
CONS	0.277** (0.129)	4.758*** (1.278)	4.662*** (1.220)	4.662* (2.497)	-0.418 (0.312)
N	301	301	301	301	301
Adj. R ²	0.291	0.908	0.268	0.372	

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Source: Authors

PCSE assumes autocorrelation and heteroskedasticity between panels when calculating the standard errors, variance, and covariance (Beck and Katz, 1995) and therefore, to account for autocorrelation, the Prais-Winsten transformation - AR(1) (Beck and Katz, 1995) is used to estimate model (2). The results are presented in Table 7.

Table 7. PCSE model (2) results

Variable	PCSE
IGS	0.0289*** (0.00836)
NSB	-0.0222 (0.0136)
SIZE	0.00255* (0.00139)
LEV	0.0160** (0.00701)
AGE	-0.000885 (0.00110)
GDP	-0.173*** (0.0418)
CONS	4.754*** (1.146)
N	301
Adj. R ²	0.372

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Source: Authors

Table 7 shows that the quality of *Shariah* governance in the Islamic banks has a significant positive impact on social performance of these banks, at 1% significance level. In contrast, the

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3 existence of NSB and the bank's age do not significantly impact SPI in this model. Bank size
4 is significant at the 10% level, while leverage shows significance at the 5% error level. The
5 significance of leverage implies that the Islamic banks which use available resources more
6 efficiently are also more efficient when implementing principles of IME.
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9 6. Discussion

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11 Since our results confirm the first hypothesis, we can conclude that the quality of *Shariah*
12 governance in Islamic banks plays a crucial role in explaining their social performance. Several
13 researchers in the field of Islamic economics and banking also found a positive impact of
14 *Shariah* board characteristics, *i.e.*, the degree of development of Islamic governance structures
15 or the quality of Islamic governance, on social performance of Islamic banks, such as
16 Mergaliyev *et al.*, (2021), Iryani *et al.*, (2019), Lesman and Charon (2019), Mukhibad (2019),
17 as well as Rahman and Charon (2019). Consequently, on a practical level, the improvement of
18 internal Shari'ah governance structures would enhance maqāsid orientation and the
19 performance of IBs for the benefits of wider stakeholders within society.
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23 This is proof of the importance of *Shariah* governance for the identity and business of Islamic
24 banks and the achievement of *maqasid al-Shariah* in terms of the goals of IME in practice.
25 Moreover, Fersi and Boujelbéne (2016), using the example of Islamic microfinance institutions,
26 confirmed the importance of Shariah governance for the social performance of this kind of
27 Islamic financial institution. Nugraheni (2018) found that certain characteristics of *the Shariah*
28 committee, such as size (number of members) and reputation, have a statistically significant
29 effect on the social performance of Islamic banks in Indonesia, whereas the number of meetings,
30 education, and cross-membership do not. Moreover, according to Shafii and Salleh (2010),
31 internal *Shariah* audits have a special place to ensure the quality of *Shariah* governance. This
32 is also in line with the proposals of Shafii *et al.* (2015) that the combination of internal and
33 external *Shariah* revisions provides the best effects.
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37 The second hypothesis, which considers the impact of NSB on the social performance of
38 Islamic banks, is not only unconfirmed, but the variable NSB is significant with a negative sign
39 in Model (1). Based on the results of this study, we can conclude that NSB is not an efficient
40 mechanism when it comes to Islamic banks' social performance and their role in implementing
41 *maqasid*.
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45 *Shariah* governance is one of the main features of IBs, ensuring that their products and
46 operations are *Shariah*-compliant, particularly at the NSB level. Although Farook *et al.* (2011)
47 proposed that *Shariah* governance should be a factor in social disclosures, it does not have a
48 positive impact on the maqāsid performance of IBs. Perhaps this is not surprising, as social and
49 moral expectations never come from the centers of power; hence, it is applied to *Shariah* boards.
50 Essentially, this result is similar to the result of Khalil (2021), who found that *Shariah* boards
51 reduce Islamic banks' financial soundness.
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55 Although these studies on *Shariah* governance emphasise *Shariah* compliance in the overall
56 functions of Islamic banks, *Shariah* denotes some rules, regulations, guidelines, objectives, and
57 directions to enhance accurate functions and activities, which are solely based on *Shariah*
58 principles (Alam *et al.*, 2021). This is important for Islamic banks to implement *Shariah*
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principles, confirm Shariah compliance, and monitor the functions of banks at the micro level. However, the NSB failed at the macro level. In addition, it is necessary for a well, efficient, effective, profitable business to achieve higher performance and, finally, to eliminate confusion among the management, executives, conventional bankers, and banks.

In other words, the executive management of Shariah boards needs to endorse *the Tawhidi* approach (complementarity and unitarity or God's unity and sovereignty), which implies that the nature of knowledge and its articulation should lead to the equality of all stakeholders without anyone's dominance over the other. This indicates that *Shariah* governance as an operational tool of IME within IBs essentialises de-centering of capital and bringing capital to the same level as other stakeholders through the *ihsani* process for enhancing *maqāsid* performance.

In summary, for Islamic banks to achieve the goals of IME in practice, they should have an appropriate level of quality of Islamic governance in the banks themselves. The results, therefore, suggest that Islamic banks seeking to improve their social performance should pay special attention to the appointment of members of the Shariah committee, which is consistent with Farook *et al.* (2011), Rahman and Bukair (2013), Mergaliyev *et al.* (2019), and partially with Nugraheni (2018). Alam (2021) proposed a centralized Shariah governance framework for Islamic banks in Bangladesh, which includes institutional SSB and centralized National Shariah supervisory boards.

7. Implications of the study

A positive social impact is one of the main objectives of Islamic banks. This social impact has become one of the main issues for researchers in this field and policymakers, as research has shown that Islamic banks do not have a significant positive social impact in practice (compared to theoretical expectations). It can be concluded that these institutions failed to meet their (Islamic) obligations to society overall. This directs us to search for different (internal and external) ways to improve the social performance of these institutions, including those that can be tackled by different regulatory or policy measures. Among the potential determinants, the characteristics of the Shariah Board as an Islamic governance mechanism are among the most promising.

The results of our research show that the quality of internal Shariah governance mechanisms positively affects the social performance of Islamic banks. Surprisingly, according to our results, the external *Shariah* governance mechanism in the form of a national/centralized Shariah Board has a negative impact on social performance. This suggests that policymakers should strengthen the *Shariah* Supervisory Board as an Islamic governance mechanism for individual banks instead of introducing centralized *Shariah* boards at the national level. The quality of Islamic governance at the level of individual Islamic banks can be improved in different ways, with the *Shariah* Annual Report being the critical communication instrument, as noted by Sencal and Asutay (2020).

In our research, all observed banks had an internal *Shariah* supervisory board, while banks in some countries also had a centralized Shariah board as an additional Shariah supervisory body. It could be that the introduction of an external *Shariah* Board made the internal one less

efficient by making its members less engaged in *Shariah* and *maqasid* issues in the bank. If boards on different levels overlap in their responsibility, members of the internal board will tend to transfer their responsibility towards members of the centralized *Shariah* board. This way, the board which is less "demanding" (and less efficient) takes precedence, thus weakening *Shariah* governance and harming social performance.

Contribution to knowledge is reflected in findings that Islamic governance quality has a positive impact on the ability of Islamic banks to achieve higher social performance, while it provides directions for further research into why national *Shariah* boards fail in such a mission. When it comes to practice, this research provides important inputs for policymakers and Islamic banking decision-makers on how to improve the social performance of Islamic banks.

The research results can impact the quality of life in society if policymakers take into account the poor impact of national SSB's and take measures to improve them. In addition, the board of directors of Islamic banks can learn from this study about the importance of Islamic governance for achieving higher social performance in their banks; thus, the banks themselves are more legitimate as Islamic. This is especially important in Muslim countries, as Junaidi (2021) found that extrinsic religiosity plays a crucial role in consumers' awareness and consumer attitudes in Indonesia.

8. Conclusions and future research

This study investigated the impact of *Shariah* governance quality on the social performance of Islamic banks because making an impact on society is one of their primary purposes of Islamic banks. SSBs should take care that Islamic banks not only use models that are technically *Shariah*-compliant, but they should also take care of *maqasid al-Shariah*, that is, the aims and objectives of *Shariah* and the "spirit" of the principles of Islamic banking. In hypothesis testing, the level of social performance is measured by an index based on the theory of IME, where the values of its indicators are derived from the annual reports of Islamic banks based on both qualitative and quantitative data. This index follows the goals of IME (or *maqasid*), following the work of classical authors of Islamic law.

The results show that the quality of *Shariah* governance in Islamic banks has a significant positive impact on their social performance at the 1% significance level. In contrast, the existence of NSB and bank age did not significantly impact SPI in this model. Bank size is significant at the 10% level, while leverage is significant at the 5% error level.

According to the results of this research, to meet social impact objectives Islamic banks should focus on improving internal *Shariah* governance mechanisms. Today, it is common practice for Islamic financial institutions to appoint a *Shariah* board, which oversees all agreements and ensures that they are compatible with Islamic economic principles. The confirmed hypothesis in this research refers to the positive impact of the quality of Islamic governance on banks' social performance.

Some countries, particularly those in Southeast Asia, have established special central *Shariah* committees for all banks in the banking system because of doubts about the quality of *Shariah* governance at the level of individual banks. However, the results of our research show that it

has a negative impact on the social performance of Islamic banks; thus, the effectiveness of such supervisory mechanisms is questionable.

The most significant limitation of this research is the use of SPI based on information from annual reports, as the index is based only on information published in the reports. Although most large banks publish annual reports, some do not. However, this does not mean that their social contribution is nonexistent. Furthermore, there are sometimes significant differences in the quality of published reports.

Because this research focuses on Islamic governance-related factors that affect the social performance of Islamic banks, there is room for further research on other internal and external determinants of Islamic banks' social performance (e.g., corporate culture, management style, ownership, regulatory aspects, and economic environment).

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3 Reviewer(s)' Comments to Author:

4 Reviewer: 1

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7 Additional Questions:

8 1. Originality: Does the paper contain new and significant information adequate to justify
9 publication?: Weak. **The author(s) fall to provide best reason why this study is worthy
10 and also the author(s) forgot to provide research questions, contributions and
11 implications.**

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14 We have provided research questions, contributions and implications.

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18 2. Relationship to Literature: Does the paper demonstrate an adequate understanding of
19 the relevant literature in the field and cite an appropriate range of literature sources? Is
20 any significant work ignored?: **Poor. Majority the literatures before 2015.**

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22 We have consulted and included new literature (2021-2022)

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26 3. Methodology: Is the paper's argument built on an appropriate base of theory,
27 concepts, or other ideas? Has the research or equivalent intellectual work on which the
28 paper is based been well designed? Are the methods employed appropriate?: **Poor.**
29 **Why the study period from 2012-2018. Furthermore, the author(s) also fall to
30 provide justification the data analysis method.**

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32 We have included explanation in the methodology part.

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36 4. Results: Are results presented clearly and analysed appropriately? Do the conclusions
37 adequately tie together the other elements of the paper?: **Weak.**

38
39 We have improved this part.

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42 5. Implications for research, practice and/or society: Does the paper identify clearly any
43 implications for research, practice and/or society? Does the paper bridge the gap
44 between theory and practice? How can the research be used in practice (economic and
45 commercial impact), in teaching, to influence public policy, in research (contributing to
46 the body of knowledge)? What is the impact upon society (influencing public attitudes,
47 affecting quality of life)? Are these implications consistent with the findings and
48 conclusions of the paper?: **Weak.**

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51 Implications part is before the conclusion.

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54 6. Quality of Communication: Does the paper clearly express its case, measured against
55 the technical language of the field and the expected knowledge of the journal's
56 readership? Has attention been paid to the clarity of expression and readability, such as
57 sentence structure, jargon use, acronyms, etc.: **Enough.**

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3 **Reviewer: 2**
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6 It is a well conducted paper.
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8 Additional Questions:
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10 1. Originality: Does the paper contain new and significant information adequate to justify
11 publication?: **Yes**
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15 2. Relationship to Literature: Does the paper demonstrate an adequate understanding of
16 the relevant literature in the field and cite an appropriate range of literature sources? Is
17 any significant work ignored?: **The literature is okay and additional improvements**
18 **have been made based on the other reviewers suggestions.**
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23 3. Methodology: Is the paper's argument built on an appropriate base of theory,
24 concepts, or other ideas? Has the research or equivalent intellectual work on which the
25 paper is based been well designed? Are the methods employed appropriate?: **It is okay**
26 **and additional explanations have been made based on the other reviewers.**
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31 4. Results: Are results presented clearly and analysed appropriately? Do the conclusions
32 adequately tie together the other elements of the paper?: **It is okay and further**
33 **elaborated based on the other reviewer.**
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38 5. Implications for research, practice and/or society: Does the paper identify clearly any
39 implications for research, practice and/or society? Does the paper bridge the gap
40 between theory and practice? How can the research be used in practice (economic and
41 commercial impact), in teaching, to influence public policy, in research (contributing to
42 the body of knowledge)? What is the impact upon society (influencing public attitudes,
43 affecting quality of life)? Are these implications consistent with the findings and
44 conclusions of the paper?: **Okay**
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50 6. Quality of Communication: Does the paper clearly express its case, measured against
51 the technical language of the field and the expected knowledge of the journal's
52 readership? Has attention been paid to the clarity of expression and readability, such as
53 sentence structure, jargon use, acronyms, etc.: **it is okay**
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Reviewer: 3

Dear Authors. Thank you for the effort. However the paper is not ready for publications.

1. Get a sample paper from the journal and write your abstract following the format for the journal.

We have reorganized the abstract and we have followed the format of the journal.

2. Introduction section does not indicate any research gap to be closed. The introduction can be structured as follows.

Para 1; how important is social performance

Para 2; What is known about social performance from literature

Para 3; How important are the independent variables towards social performance.

Para 4 ; Identify the research gaps in literature for example, empirical,, methodological, theoretical, contextual gaps.

Para 5; The purpose of the study, motivation and snap short of the methodology

Para 6; The contribution of the study

Para 7; The structure of the remaining

We have adapted the introduction section as requested.

3. Literature review; The theoretical framework is part of the literature review so it should be taken there. The research hypotheses have not been clearly stated .

We have adapted the theoretical framework and stated the hypotheses clearly.

4. methodology; What was the population and how was the sample selected? Why select those countries?

We have included more detailed clarification in data & methodology section.

5. Should have a discussion section separate from results.

We have introduced discussion section separate from results.

6. Summary and Conclusion, this may start with stating the purpose of the study, then a summary of the results and their implications to literature, practice and society

We have adjusted the conclusion part.

Additional Questions:

1. Originality: Does the paper contain new and significant information adequate to justify publication?: **Not adequate for publication**

We have included originality section in the abstract.

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6 2. Relationship to Literature: Does the paper demonstrate an adequate understanding of
7 the relevant literature in the field and cite an appropriate range of literature sources? Is
8 any significant work ignored?: **No. See comments**

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10 **Improved.**

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14 3. Methodology: Is the paper's argument built on an appropriate base of theory,
15 concepts, or other ideas? Has the research or equivalent intellectual work on which the
16 paper is based been well designed? Are the methods employed appropriate?: **Should be**
17 **improved (see comments)**

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19
20 **Improved.**

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24 4. Results: Are results presented clearly and analysed appropriately? Do the conclusions
25 adequately tie together the other elements of the paper?: **Not clearly presented**

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27 **Improved.**

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31 5. Implications for research, practice and/or society: Does the paper identify clearly any
32 implications for research, practice and/or society? Does the paper bridge the gap
33 between theory and practice? How can the research be used in practice (economic and
34 commercial impact), in teaching, to influence public policy, in research (contributing to
35 the body of knowledge)? What is the impact upon society (influencing public attitudes,
36 affecting quality of life)? Are these implications consistent with the findings and
37 conclusions of the paper?: **Study implications are not clearly identified in the paper**

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40 **Improved.**

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44 6. Quality of Communication: Does the paper clearly express its case, measured against
45 the technical language of the field and the expected knowledge of the journal's
46 readership? Has attention been paid to the clarity of expression and readability, such as
47 sentence structure, jargon use, acronyms, etc.: **Weak**

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49 **Improved.**

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52 DEADLINE: 02-Aug-2022. If you need additional time to complete your revision please
53 contact me to ask for an extension. Please note that the deadline expires at the start of
54 the day and not the end of the day.
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The Influence of National and Individual Islamic Governance on Islamic Banks' Social Performance

Abstract

This study aims to investigate the relationship between Islamic governance and social performance of Islamic banks. Islamic governance is represented by Islamic Governance Score (IG-Score), which measures the quality of Islamic governance in Islamic banks. The authors also investigate the impact of *Shariah* board on a national level on social performance of Islamic banks in a country. The essential body in the Islamic banks in charge of Islamic governance is the *Shariah* supervisory board. Therefore, in this study the authors attempt to explore how the characteristics of *Shariah* board and Islamic governance mechanisms influence social performance of Islamic banks. Panel data methods are applied to the annual data of 40 banks from 13 countries over the period 2012-2018 to explore the impact of Islamic governance on Islamic banks' social performance. Social performance is measured by *maqasid al-Shariah* (in term of the goals of Islamic moral economy) index using a comprehensive evaluation framework. The findings suggest a strong link between Islamic governance and social performance of Islamic banks, illustrating the importance of *Shariah* board in achieving *maqasid*. The results of this research also imply valuable recommendations for Islamic banks that are keen to improve their social performance.

Keywords: Islamic banks, Islamic governance, *Shariah* board, social performance, *maqasid al-Shariah*

1. Introduction

Since Islamic moral economy (IME) draws its principles from *Qur'an* and *Sunnah*, it has become common practice for Islamic financial institutions to appoint a *Shariah* committee, which will oversee the banks' operations and ensure they are compatible with Islamic principles. This gives clients the security of having their money handled following Islamic teachings. According to IME, operations of Islamic banks should not only formally be under Islamic teachings but these institutions should also promote human wellbeing (Asutay, 2012). Therefore, Islamic banks should have dual objectives – financial and social (Haniffa and Hudaib, 2007).

In practice, Islamic banks seem to be more concerned with the legal and mechanical aspects of *Shariah* observance than with promoting Islamic ethical values (Nienhaus, 2011). The prevailing general view is that Islamic banking has de facto failed to meet social and ethical goals (Ahmed, 2011). From a theoretical point of view, Musa (2011) noted that “the current literature on Islamic finance and Islamic business ethics lacks an assessment of the extent to which Islamic financial institutions enforce the ideal ethical norms of Islam”. Authors such as Kuran (2004), Pollard and Summers (2007), Asutay (2012), as well as Belal *et al.*, (2015), recognized that there are differences between Islamic banks in their compliance to Islamic teachings, especially if we consider IME requirements regarding social responsibility. They found that Islamic banks developed a debt-oriented culture similar to conventional banks, keeping in mind that debt-based instruments such as *murabaha*, *al-bay' bithaman ajil*, and similar are the most popular financing products of Islamic banks, with a share of more than 70% in their balance sheet in some cases. This indicates the preference of the neoclassical profit-maximization approach by Islamic banks instead of the approach suggested by IME.

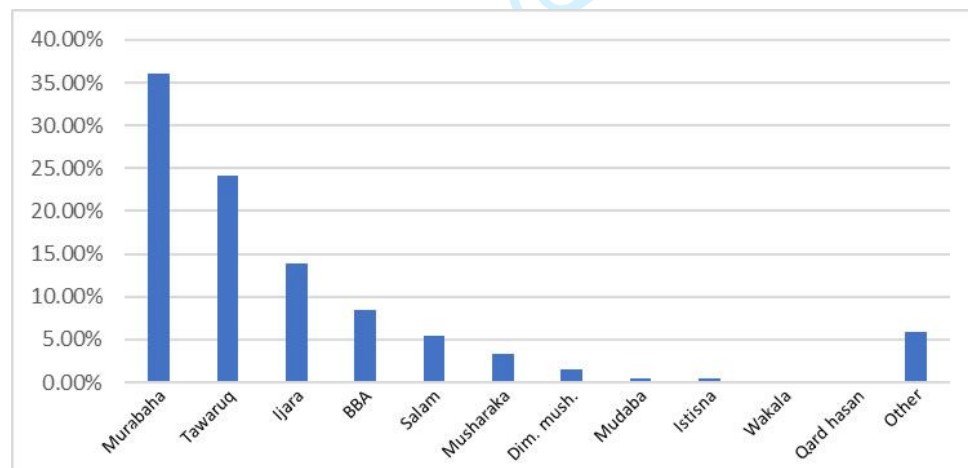


Figure 1. Structure of Islamic banks' financing in practice

Source: Adewale & Archer (2019)

Apart from apparent anomalies from the balance sheet, empirical research confirmed these suspicions regarding failing to meet the goals of IME, since Asutay and Harningtyas (2015), Rusydiana and Firmansyah (2018), as well as Antonio *et al.*, (2012), indicated a lack of social responsibility, the frequent absence of the expected positive effects of Islamic financial intermediaries on society. Such positive effects are often highlighted in theory as an argument

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3 in favour of Islamic financial institutions. Besides weak social performance, authors such as
4 Asutay and Harningtyas, 2015; Ngalim *et al.*, 2015; Mohamed, 2018; Hasan and Ali, 2018;
5 Mergaliyev *et al.*, (2019) and Meskovic *et al.*, (2021) confirmed significant differences in social
6 performance among Islamic banks.
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9 Keeping in mind that *Shariah* supervisory board (SSB) is the crucial body ensuring *Shariah*
10 compliance of Islamic banking operations, in this paper it is addressed the question of the
11 impact of *Shariah* board characteristics and Islamic governance mechanisms on social
12 performance of Islamic banks. The answer to this question can support Islamic banks in
13 achieving a higher level of social performance.
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16 In previous literature, several authors such as Mergaliyev *et al.* (2021), Iryani *et al.* (2019),
17 Lesmana and Haron (2019), Mukhibad (2019), Rahman and Haron (2019), Sencal and Asutay
18 (2020) and others confirmed that characteristics or quality of internal *Shariah* governance
19 system has significant effect to social performance of Islamic banks. However, this study has
20 been conducted on a global scale with a much larger sample. Furthermore, according to our
21 best knowledge, there has been no research on the impact of national *Shariah* governance on
22 social performance of Islamic banks as of today.
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25 The rest of the paper is organised as follows: Section 2 presents the theoretical framework,
26 Section 3 discusses relevant literature and hypotheses development, Section 4 presents the study
27 sample and methodology, Section 5 reports the results and discusses them, and Section 6
28 concludes and offers recommendations.
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32 33 34 35 **2. Theoretical framework of the study**

36 This study uses systems-oriented theories (Farook *et al.*, 2011), including political economy,
37 stakeholder theory, and legitimacy theory. Islamic political economy, *i.e.* IME, is based on the
38 ontology and epistemology of Islam (*Qur'an* and *Sunnah*). Compared to mainstream Islamic
39 finance, IME promotes value-oriented financing characterized by embeddedness; in other
40 words, dependence on the environment and the system within which different social activities
41 take place and on which they depend. The opposite of this integration is the lack of integration
42 of financial and real sectors, as we have in the modern capitalist economy. Two main theories
43 explaining organisations' social responsibility and their social impact are stakeholder theory
44 (Deegan and Unerman, 2011) and legitimacy theory (Deegan, 2002). Although these two
45 theories also overlap in some aspects (Gray *et al.*, 1995), stakeholder theory implies a more
46 precise approach as it separates different stakeholders into groups, while legitimacy theory
47 looks at society. Legitimacy theory could be considered a particular case of stakeholder theory,
48 where all stakeholders are treated equally, which Fernando and Lawrence (2014) called "ethical
49 perspective". Al-shamali, Sharif, and Irani (2013) noted that social function of Islamic banks
50 refers to bank responsibility for the wellbeing of all stakeholders. The managerial perspective
51 implies that organisations (in this case, Islamic banks) will consider only economically
52 powerful stakeholders. However, both approaches are still beneficial for a company (Fernando
53 and Lawrence, 2014). Legitimacy theory involves an invisible "social contract" between
54 company and society (Deegan, 2006), whose purpose is to ensure that organisation is perceived
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3 as functioning within the norms of the society in which they operate. Organisations that fail in
4 this matter will not survive in the long term, so they will participate in socially responsible
5 activities to maintain, gain or regain their legitimacy, positively impacting their social
6 performance.
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9 A stakeholder that is critical for any Islamic bank's legitimacy is *Shariah* board or *Shariah*
10 committee. The *Shariah* board is a unique governance structure in an Islamic financial system,
11 entrusted with directing, reviewing, and overseeing the activities of Islamic financial
12 institutions to ensure compliance with *Shariah*. Corporate governance in Islamic financial
13 institutions requires the existence of a *Shariah* committee to ensure that the institution's
14 operations are in line with the principles of Islamic economics, finance, and banking (Cadbury,
15 2002). The International Council of the Fiqh Academy defined the *Shariah* committee by
16 Decision No. 177 (19/3) regarding its role in regulating the operations of Islamic banks as a
17 group of specialists in Islamic jurisprudence, especially civil jurisprudence (*fiqh al-mu'amalat*),
18 whose number will not be less than three and were selected from among those with the ability
19 and knowledge given the practical reality, whose job is to pronounce judgments and revise
20 everything that needs to be revised, to confirm and ensure that all transactions conducted by
21 Islamic financial institutions comply with *Shariah* guidelines and for decisions to be made
22 public and Islamic financial institutions must support SSB decision.
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29 Islamic financial products and instruments must be legitimate and by *Shariah* principles. Thus,
30 the primary goal of a *Shariah* committee is to ensure compliance with the principles and values
31 of IME, thereby legitimising the bank as Islamic. In addition to existence itself, specific
32 characteristics of a *Shariah* board, such as independence or authority of the board members,
33 can affect the legitimacy (Alsartawi, 2019). In this process, Islamic financial institutions require
34 the existence of these specialised committees with experts on *Shariah* issues, especially *fiqh al-*
35 *muamalat*, which would support banks to determine the legitimacy of Islamic financial products
36 and the overall business of such institutions (Ainley *et al.*, 2007). Various aspects are involved
37 in this process, including transparency, accountability, reporting structure, and independence
38 of *Shariah* committee (Wilson, 2009). All these aspects are essential for achieving the
39 legitimacy of an Islamic bank.
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44 Since social responsibility is embedded in the core business of Islamic banking, *Shariah* board
45 should look at technical issues regarding Islamic modes of financing and collecting deposits,
46 and consider the broader ethical perspective of IME. Therefore, in this study we use *maqasid*
47 *al-Shariah* index based on IME to measure Islamic banks' social performance. In constructing
48 the social performance index, we use Najjar's approach to *maqasid*, which considers four goals
49 and eight dimensions. Such index was initially introduced by Mohammed *et al.*, (2008) and
50 further refined by Bedoui and Mansour (2014), Asutay and Herningtyas (2015), and Mergaliyev
51 *et al.*, (2019). The methodology includes a dichotomous approach of Haniffa and Hudaib
52 (2007), which means that the observed item received a rating of "1", if it is found in the annual
53 report, or "0", otherwise. Furthermore, some sub-indices are extracted from the banks' financial
54 statements, hence quantitative rather than qualitative data.
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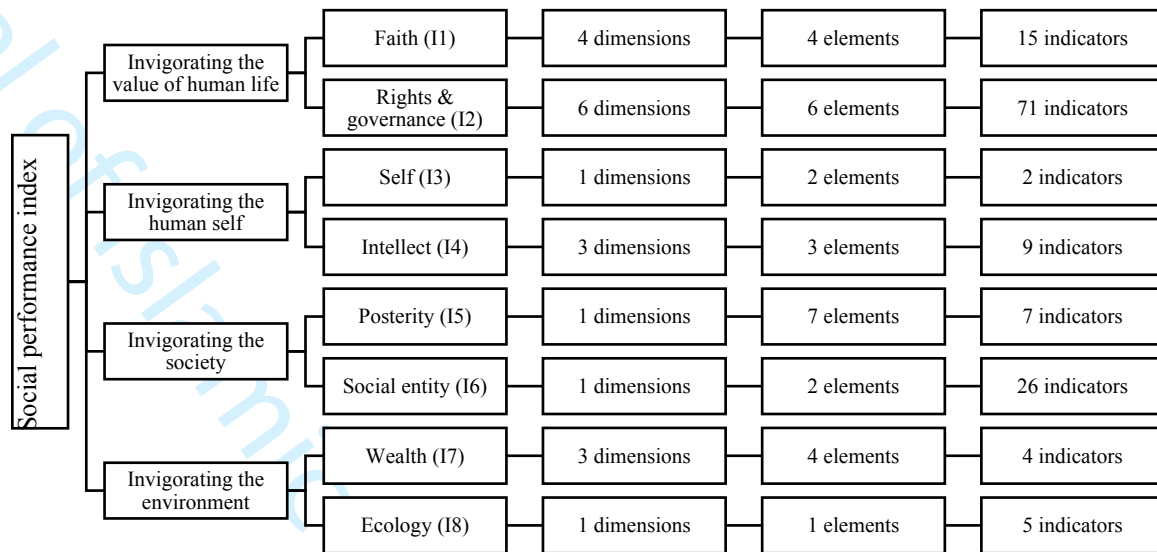


Figure 2. Social performance index based on a *maqasid al-Shariah* evaluation framework

Source: Adapted from (Mergaliyev *et al.*, 2019; Mohammed *et al.*, 2008; Bedoui and Mansour, 2014; Asutay and Harningtyas, 2015)

3. Literature review and research hypotheses

Research of influence of Islamic corporate governance (*i.e.*, *Shariah* board characteristics) has gone into two main directions – some authors have examined its impact on financial performance while most articles have investigated the impact of *Shariah* board on corporate social responsibility (CSR) disclosure of Islamic banks. However, most studies investigating the impact on social performance have been conducted on fewer observations than this study.

When it comes to social performance, authors use different terms such as social performance; ethical performance; environmental, social, and governance (ESG) performance; *maqasid* performance; etc. (Meskovic *et al.*, 2021). As most authors agree that social performance of Islamic banks is not on a satisfactory level, research is now shifting towards causes of such a low performance and Islamic corporate governance is recognized as one of the major determinants.

Islamic governance in this study is measured by IG-Score developed by Farook *et al.*, (2011). In a pioneering work, Farook *et al.*, (2011) develop IG-Score by combining a number of variables:

- Existence of SSB,
- The number of SSB board members,
- The existence of SSB members with cross-memberships,
- The existence of SSB members with doctoral qualifications, and
- Existence of reputable scholars presiding on SSB board.

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3 They hypothesized a positive association between IG-Score and the level of CSR disclosure
4 presented by Islamic banks in their annual reports. They tested this hypothesis on 47 banks and
5 their results revealed that IG-Score is highly significant, indicating that *Shariah* board
6 characteristics are important determinants of CSR disclosures in Islamic banks. Following
7 Farook *et al.*, (2011), Rahman and Bukair (2013) investigated characteristics of *Shariah* board
8 on CSR disclosure of 53 Islamic banks in the year 2008. Their findings indicated that the
9 combination of *Shariah* board characteristics has a significant positive influence on CSR
10 disclosure, illustrating the importance of *Shariah* board for CSR in Islamic banks.
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14 Khalil and Taktak (2020) examined the relationship between *Shariah* board characteristics and
15 financial soundness (Z-score) of 67 Islamic banks over 2005-2014. The authors did not
16 investigate social performance of Islamic banks but as they found a negative relation between
17 *Shariah* board size, this could indicate the existence of trade-off between social and financial
18 performance. However, the only significant result they got is that size of *Shariah* board
19 negatively impacts financial soundness.
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23 Exploring *Shariah* governance's influence on 10 Islamic banks' CSR during 2011-2018,
24 Ridwan and Mayapada (2020) concluded that the board of directors' effectiveness plays a vital
25 role in enforcing CSR disclosure. Their results showed that audit committees and *Shariah*
26 supervisory boards have no significant effect on CSR disclosure in Islamic banks. Therefore,
27 the conclusion regarding Islamic corporate governance was that *Shariah* board still focuses on
28 the *Shariah* principles regarding the products and operations.
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32 According to our best knowledge, the most extensive overall study of determinants of Islamic
33 banks' social performance so far was conducted by Mergaliyev *et al.*, (2019). This research
34 explored various internal and external determinants that affect social performance of Islamic
35 banks. A panel analysis of several key factors such as political and socioeconomic environment,
36 ownership structures, and factors related to corporate and *Shariah* governance was used to
37 identify the main determinants of *maqasid* disclosure success. The authors found that the share
38 of the Muslim population, the duality of CEO, and *Shariah* governance positively affect Islamic
39 banks' social performance.
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43 Alsartawi (2019) explored whether the independence and frequency of *Shariah* board meetings
44 influenced the performance of 48 Islamic banks over the period 2013-2017. This research
45 showed a negative impact of *Shariah* board composition on financial performance regarding
46 return on assets. The author concluded that this may be due to the passive role of the *Shariah*
47 board, whose members act more as advisors and less as supervisors, allowing managers to
48 supersede their decisions.
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52 Moreover, Nugraheni (2018) investigated the effect of SSB characteristics on the level of social
53 performance in Islamic banks in Indonesia during 2010-2014. The research revealed that, on
54 the one hand, size and reputation of SSB members significantly affect social performance. On
55 the other hand, frequency of meetings, educational qualification, and cross membership of SSB
56 does not significantly affect social performance.
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60 Generally, the reputation of *Shariah* scholars is important as Khan (2010) noted that one of the
explanations for the poor "Islamic" of Islamic banks is that Islamic financial institutions choose

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3 those scholars who are more cooperative, *i.e.*, eager to certify *Shariah* transactions while being
4 paid relatively large sums of money per year. In that regard, the engagement of a national
5 *Shariah* board could be one way to fight this phenomenon.
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8 Almutairi and Quttainah (2017) explored the impact of *Shariah* board and its attributes on
9 Islamic banks' performance. Their findings suggested that increasing the size of corporate
10 boards and SSBs should improve monitoring and advisory functions, management behaviour,
11 and organizational performance of Islamic banks.
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14 Further, each component of IG-Score should positively affect social performance of Islamic
15 banks. With a greater number of *Shariah* scholars in the committee, the *Shariah* board should
16 be more effective in ensuring *Shariah* compliance and the commitment of Islamic banks
17 towards their social function (Nugraheni, 2018). The number of SSB meetings held during the
18 year should be disclosed in an Islamic bank's annual report (Hameed *et al.*, 2004), and SSB's
19 contribution towards social function of Islamic bank should grow with the number of meetings
20 held. Besides, educational qualifications, *i.e.*, presence of SSB members with a doctorate,
21 should help the bank achieve higher social performance (Farook, *et al.*, 2011). In the same vein,
22 the reputation and cross-membership of SSB members should help share experience between
23 Islamic financial institutions, including activities regarding social responsibility.
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27 Considering the aforementioned we hypothesize that the quality of Islamic governance in
28 Islamic banks, represented by IG-Score, has a positive effect on social performance of Islamic
29 banks.
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33 Namely, recognizing that *Shariah*-incompliance is a risk that can hit Islamic financial
34 institutions' asset values severely with possible loss of investments, funds and potential
35 incomes (Grassa, 2015) some countries have decided to introduce national *Shariah* boards.
36 Muneeza and Hassan (2014) called *Shariah* corporate governance "the Islamic version of
37 corporate governance". Thus, considering the systemic importance of banks in a financial
38 system, we can claim that the approach with the introduction of national *Shariah* boards has
39 similar intentions as overall banking regulation. It aims to protect the institutions, deponents,
40 shareholders, and the general public and financial system. Ahmed (2011) recommended active
41 regulatory participation in *Shariah* governance to maintain stability. Therefore, as Grassa
42 (2015) noted, some countries have developed comprehensive regulatory frameworks governing
43 *Shariah* practices at both national and institutional levels, while some have adopted a regulatory
44 framework for *Shariah* supervision only at institutional level.
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49 Although some countries formally introduced *Shariah* board at national level, such *Shariah*
50 board has a very passive and usually only advisory role. Therefore, national *Shariah* board
51 (NSB) has different roles in different countries. In some countries, such as the United Arab
52 Emirates, Qatar, Bangladesh, and Jordan, NSB exists but its role is limited to commenting on
53 some issues or giving *fatwas* regarding the central bank's products (Grassa, 2015). Therefore,
54 such NSB does not have any authority at the institutional level, as Grassa (2015) stated, so we
55 cannot claim that such *Shariah* board impacts individual Islamic banks and their operations.
56 Thus, we must distinguish between NSB with an active supervisory and advisory role and NSB
57 without an active role in individual Islamic banks' operations, as shown in Table 1.
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Table 1. National *Shariah* governance system across different countries

NSB with an active role	NSB without active role	No NSB
Malaysia, Indonesia, Pakistan, Sudan, Bahrain*	United Arab Emirates, Qatar, Bangladesh, Jordan, Kuwait	Kingdom of Saudi Arabia, United Kingdom, Bosnia and Herzegovina, Sri Lanka

* Since 2017

Source: Authors

Some countries have positioned NSB at the central bank or the securities commission (Malaysia, Indonesia, Pakistan, Sudan, and Bahrain). At the same time, Kuwait, Jordan, Qatar, and the United Arab Emirates have given jurisdiction to the ministry of *awqaf* and religious affairs or the ministry of justice and Islamic affairs (Grassa, 2015).

Therefore, we hypothesize that the existence of a NSB with an active role towards individual Islamic banks has a positive effect on social performance of Islamic banks in the country.

4. Data and methodology

This study uses a balanced panel of annual data for 43 banks from 14 countries, covering 2012 to 2018. The main criterion for composing the sample is the availability of the data. Among the selected countries, there is one country from Africa (Sudan), two countries from Europe (Bosnia and Herzegovina and the United Kingdom), five countries from Asia (Bangladesh, Indonesia, Malaysia, Pakistan, and Sri Lanka), and six countries from the Middle East (Bahrain, Jordan, Kingdom of Saudi Arabia, Kuwait, Qatar, and the United Arab Emirates).

Explaining the impact of the differences in *Shariah* governance between individual banks and countries on social performance of Islamic banks is the motivation for this research. Consequently, this paper aims to investigate the relation between Islamic governance score (IG-Score) at the individual bank level and the existence of *Shariah* supervisory board at the national level in the country, on the one hand, and social performance of Islamic banks, on the other hand. To test the above-mentioned hypotheses, social performance is measured by *maqasid al-Shariah* index, an index based on the foundational axioms of IME, which was previously developed by Asutay and Harningtyas (2015) and further enhanced by Mergaliyev *et al.*, (2019).

The degree of development of Islamic governance in the individual banks is measured via IG-Score. It is an index developed by Farook *et al.*, (2011), which sums the value of the dichotomous characteristics of *Shariah* board, i.e., existence of the SSB itself, the number of SSB board members (1 if more than three members, otherwise 0), the existence of SSB members with cross-memberships (1 if there are scholars with cross memberships), the existence of SSB members with doctoral qualifications, and the existence of reputable scholars presiding on SSB board (Farook *et al.*, 2011). Since we consider that number of *Shariah* board meetings during the year impacts the quality of *Shariah* governance (Alsartawi, 2019), we also add a number of meetings held during the year in this sum for IG-Score, therefore further enhancing the index. All variables are presented in Table 2.

Table 2. Variables included in the model

Variable	Variable definition	Source
SPI	Social performance index of Islamic banks	Indicators based on the information from the Islamic banks' annual reports
IG-Score	The quality of <i>Shariah</i> governance in the bank	Annual reports
NSB	Existence of a NSB with an active role in the country (dummy)	National legislation
SIZE	The size of Islamic bank's assets (log)	Annual reports of the banks
LEV	The leverage ratio of an Islamic bank (log)	Annual reports of the banks
AGE	The age of an Islamic bank	Annual reports of the banks
GDP	GDP of the country (log)	World Bank database

Source: Authors

The following regression model is used to analyse and test the hypotheses under the stated objectives:

$$SPI_{i,t} = \alpha + \beta_1 IGScore_{i,t} + \beta_2 NSB_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 LEV_{i,t} + \beta_5 AGE_{i,t} + \beta_6 GDP_{i,t} + \varepsilon_{i,t} \quad (1)$$

In operationalising the research, a social performance index (SPI) based on *maqāsid al-Shariah* has been constructed for measuring the social performance of Islamic banks. In the calculation of the social performance index (*maqāsid*) content analysis of available publishable text was used through dichotomous approach as suggested by Mohammed *et al.*, (2008), Haniffa and Hudaib (2007), as well as Hameed *et al.*, (2004) to mitigate any possible bias.

In conducting the content analysis for generating disclosure-related data for index, the value of “qualitative components implies the arithmetic mean of the values of individual indicators within these components, which take the value 1, if complete information for a particular indicator exists in the Islamic bank's annual report, or 0 if the information is not existing in the annual report (Haniffa and Hudaib, 2007; Belal *et al.*, 2014, Mergaliyev *et al.*, 2019). In the same way, the values of “quantitative” components from annual reports of Islamic banks are calculated using the arithmetic mean within these components of *maqāsid* index such as ROA for instance.

Some sub-indices use quantitative data from the banks' financial statements, especially concerning categories I3, I5, and I7, of which indicators from categories I5 and I7 have to be scaled for the values to be in the range of 0 to 1. The linear scaling transformation (LST) method is applied according to Singh *et al.* (2009), who specifically addressed the methodologies for estimating sustainability indices consisting of their sub-indices. LST involves “compressing” the original values of the indicators so that the values become between 0 and 1. The lowest indicator in a corresponding year gets a value of 0 and the largest gets a value of 1.

In hypotheses testing we use several estimators generally available when it comes to panel data methods, with the main three are pooled ordinary least square (OLS), fixed effects model (FEM), including “within” estimation and least-squares dummy variables (LSDV), and random effects model (REM). Accordingly, this paper will apply these methods to estimate model (1).

Furthermore, we will apply panel corrected standard errors (PCSE) estimation to estimate the model (2) to correct for some issues existing in the previous model (1) and test for robustness.

5. Results and discussion

Table 3 summarizes descriptive statistics for the variables in the model (1) and reports an average value of SPI of 0.3539 (or 35.39%). SPI is the overall Islamic banks' social performance, constructed for 2012-2018. The score can be considered low compared to the theoretical expectations and the index's maximum value, which is 1 (or 100%).

Since it considers the number of meetings held during the year, IG-Score does not have a theoretical maximum; however, the largest value of IG-Score is 12 while the smallest is 2. NSB is a dummy variable taking a value of 1, if the country (in the observed year) has an active NSB; otherwise, this variable takes a value of 0.

Table 3. Descriptive statistics for the variables included in the model

Variable	Obs.	Mean	Std. dev.	Min.	Max.
SPI	301	0.3539	0.1143	0.1124	0.6818
IG-Score	301	4.7009	1.9279	2	12
NSB	301	0.3820	0.4867	0	1
SIZE	301	8.4518	1.6213	1.9643	11.3405
LEV	301	2.0693	0.4723	0.8070	3.1101
AGE	301	23.3720	13.5615	3	64
GDP	301	25.8759	1.1902	23.5681	28.6867

Source: Authors

Regarding control variables, SIZE shows a bank's asset size (logarithm) in the corresponding year in USD (mil.), while LEV (leverage) represents the ratio of debt and capital. AGE shows how old the bank is in a corresponding year, while GDP is the GDP (logarithm) of the country in an observed year. The correlation matrix of the variables in the model is presented in Table 4.

Table 4. Correlations between the variables

	SPI	IG-Score	NSB	SIZE	LEV	AGE	GDP
SPI	1.0000						
IG-Score	0.2961*	1.0000					
NSB	0.3178*	-0.0839	1.0000				
SIZE	0.0146	0.1523*	-0.1753*	1.0000			
LEV	0.4587*	0.1633*	0.4069*	-0.0742	1.0000		
AGE	0.0784	0.1884*	0.0148	0.2027*	-0.0855	1.0000	
GDP	0.0600	-0.0390	0.2190*	0.3087*	0.2746*	-0.1236*	1.0000
	0.2995	0.5001	0.0001	0.0000	0.0000	0.0320	

Source: Authors

Gujarati (2003) noted that if there is a correlation between the independent variables larger than ± 0.8 , then we can conclude that severe multicollinearity problems exist. As shown in Table 5, such a level of correlation does not exist in the model, and the results of the variance inflation factor (VIF) test confirm that model (1) does not suffer from the multicollinearity problem. For that reason, according to Gujarati (2003) and Hair et al. (1995), values of VIF below 10 are

acceptable and indicate no multicollinearity problem. Moreover, our model (1) also satisfies the strict criterion of other authors who set the threshold at 5 (Becker *et al.*, 2015).

Table 5. VIFs

	VIF	1/VIF
LEV	1.35	0.7384
GDP	1.34	0.7446
NSB	1.32	0.7554
SIZE	1.31	0.7608
AGE	1.14	0.8784
IGS	1.13	0.8830
Mean VIF	1.27	

We start by estimating model (1) using Pooled OLS, LSDV, and “within” as fixed effects (FEM) and random effects (REM) estimators (generalized least square - GLS). Breusch-Pagan/Cook-Weisberg test, as well as Modified Wald test, indicate the presence of heteroskedasticity. Therefore, the standard Hausman test cannot be used to select between FEM and REM. So the Sargan-Hansen test with robust FEM and REM (p-value=0.0001) is applied, which shows that FEM is preferred.

FEM is also a theoretically preferred model (Allison, 2009). As Allison (2009) highlighted, FEM is superior if some variables that affect the observed phenomenon are omitted from the model. Given that this research focuses on quality of Islamic governance, the model certainly does not cover all macro variables and does not consider all internal and external variables specific to each bank individually, *e.g.*, those concerning external variables such as the regulation, competition, or internal ones such as management, human resources, intellectual capital, shareholders, management principles, *etc.* FEM helps control the bias of omitted variables even if these characteristics cannot be measured (Halaby, 2004; Allison, 2009).

Table 6. OLS, LSDV, FE, FE robust and RE model results

Variable	OLS	LSDV	FE	FE robust	RE
IG-Score	0.0139*** (0.00307)	0.0312*** (0.00767)	0.0312*** (0.00767)	0.0312** (0.0147)	0.0268*** (0.00596)
NSB	0.0519*** (0.0131)	-0.0260* (0.0138)	-0.0260* (0.0138)	-0.0260*** (0.00963)	0.000803 (0.0139)
SIZE	0.00472 (0.00393)	0.00190 (0.00242)	0.00190 (0.00242)	0.00190 (0.00232)	0.00225 (0.00260)
LEV	0.0883*** (0.0137)	0.0166 (0.0110)	0.0166 (0.0110)	0.0166 (0.0143)	0.0311*** (0.0116)
AGE	0.000311 (0.000437)	0.0166*** (0.00221)	0.0166*** (0.00221)	0.0166*** (0.00452)	0.00431*** (0.000876)
GDP	-0.00918* (0.00541)	-0.189*** (0.0488)	-0.189*** (0.0488)	-0.189* (0.102)	0.0178 (0.0123)
CONS	0.277** (0.129)	4.758*** (1.278)	4.662*** (1.220)	4.662* (2.497)	-0.418 (0.312)
N	301	301	301	301	301
Adj. R ²	0.291	0.908	0.268	0.372	

Note: * significant at 10%, ** significant at 5% and *** significant at 1%

Source: Authors

The results of OLS, LSDV, FE, FE robust, and RE show that variable IG-Score (i.e., the quality of *Shariah* governance in an Islamic bank, represented by IG-Score) and NSB (i.e., the existence of NSB with an active role) are consistently significant on standard significance levels (except for NSB in RE estimator). Surprisingly, NSB has a negative sign in LSDV and FE/FE robust. Leverage (LEV) is significant (on different significance levels) in OLS and RE. Bank AGE plays a role as the variable is significant in all estimators except OLS. GDP is also significant in all estimators except RE, but with a negative sign.

Since the relevant statistical tests indicate the existence of heteroskedasticity (Breusch-Pagan / Cook-Weisberg test, and Modified Wald test with $p=0.0000$), autocorrelation (Wooldridge test with $p=0.0012$), and cross-sectional dependence (Pesaran's test with $p=0.0002$), it is necessary to control for these phenomena in the final model. Standard panel data estimators cannot simultaneously handle both serial correlation and cross-sectional dependence (Hoechle, 2007; Reed and Ye, 2011; Sarafidis and Wansbeek, 2012). One estimator that can account for serial and cross-sectional correlation simultaneously is Park's feasible GLS (FGLS) (Parks, 1967). However, as Beck and Katz (1995) highlighted, the Park's FGLS estimator underestimates standard errors in the final samples. A procedure and estimation method called panel corrected standard errors (PCSE), which is more effective than FGLS in cases of samples like ours where $N>T$, was proposed by Beck and Katz (1995). They demonstrated that PCSE provides a more efficient estimate than the FGLS model and, according to Hoechle (2007), Blackwell (2005), Reed and Ye (2011), and Plümper et al. (2005), it is suitable for the sample used in this study.

As Beck and Katz (1995) pointed out, PCSE calculates the standard errors and estimates the variance and covariance assuming heteroskedasticity and autocorrelation between panels, while in the case of (confirmed in this study) autocorrelation, it is necessary to add an appropriate option for Prais-Winsten transformation, AR(1). Therefore, PCSE with Prais-Winsten transformation is used to estimate model (2) and the results are reported in Table 7.

Table 7. PCSE model (2) results

Variable	PCSE
IGS	0.0289*** (0.00836)
NSB	-0.0222 (0.0136)
SIZE	0.00255* (0.00139)
LEV	0.0160** (0.00701)
AGE	-0.000885 (0.00110)
GDP	-0.173*** (0.0418)
CONS	4.754*** (1.146)
N	301
Adj. R ²	0.372

Note: * significant at 10%, ** significant at 5% and *** significant at 1%

Source: Authors

Table 7 shows that the quality of *Shariah* governance in the Islamic banks has a significant positive impact on social performance of these banks, at 1% significance level. In contrast, the existence of NSB and the bank's age do not significantly impact SPI in this model. Bank size is significant at the 10% level, while leverage shows significance at the 5% error level. The significance of leverage implies that the Islamic banks which use available resources more efficiently are also more efficient when implementing principles of IME.

Hence, *Tawhid* as fundamental axiom of IME which means complementarity and unitarity or God's unity and sovereignty, constitutes the nature of knowledge and its articulation implying that none of the stakeholders can have dominance over the others. This identifies that Shari'ah governance as operational tool of IME within IBs essentialise de-centring of capital and bringing capital to the same level with other stakeholders through the *ihsani* process for enhancing maqāsid performance.

Hence, the results confirm the first hypothesis, concluding that the quality of *Shariah* governance in Islamic banks plays a crucial role in explaining social performance of these banks. Several researchers in the field of Islamic economics and banking also found a positive impact of *Shariah* board characteristics, i.e., the degree of development of Islamic governance structures or the quality of Islamic governance, on social performance of Islamic banks, such as Mergaliyev *et al.* (2021), Iryani *et al.* (2019), Lesman and Charon (2019), Mukhibad (2019), as well as Rahman and Charon (2019). Consequently, on very practical level, improvement of internal Shari'ah governance structures would enhance maqāsid orientation and the performance of IBs for the benefits of wider stakeholders within society.

This is a proof of the importance of *Shariah* governance for the identity and business of Islamic banks and the achievement of *maqasid al-Shariah*, in term of the goals of IME, in practice. Moreover, Fersi and Boujelbéne (2016) on the example of Islamic microfinance institutions confirmed the importance of Sharia governance for social performance of this kind of Islamic financial institutions. Nugraheni (2018) found that certain characteristics of *Shariah* committee, such as size (number of members) and reputation, have a statistically significant effect on social performance of the Islamic banks in Indonesia, while the number of meetings, education, and cross-membership do not. Also, according to Shafii and Salleh (2010), internal *Shariah* audit has a special place in ensuring the quality of *Shariah* governance. This is also in line with the proposals of Shafii *et al.* (2015) the combination of internal and external *Shariah* revision gives the best effects.

The second hypothesis, which considers the impact of NSB on social performance of Islamic banks, is not only unconfirmed but the variable NSB is significant with a negative sign in the model (1). Based on the results of this study, we can conclude that NSB is not efficient in social performance of Islamic banks and its role in implementing *maqasid*.

Shariah governance is one of the main features of IBs, ensuring that their products and operations are *Shariah* compliant, particularly on NSB level. Despite that Farook *et al.* (2011) proposed that *Shariah* governance should be a factor for social disclosures, however, the NSB does not have positive impact the maqāsid performance of IBs. Perhaps this is not surprising as

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3 social and moral expectations never come from the centres of power hence it applied for Shariah
4 boards.
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7 In a nutshell, for Islamic banks to achieve the goals of IME in practice, they should have an
8 appropriate level of quality of Islamic governance in the banks themselves. The results therefore
9 suggest that Islamic banks seeking to improve their social performance should pay special
10 attention to the appointment of members of Shariah committee, which is consistent with Farook
11 *et al.* (2011), Rahman and Bukair (2013), Mergaliyev *et al.* (2019) and partially with Nugraheni
12 (2018).
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15 **6. Conclusions, implications and future research**

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17 In this paper we investigate the impact of *Shariah* governance quality on social performance of
18 Islamic banks because making an impact on society is one of the primary purposes of Islamic
19 banks. SSBs should take care that Islamic banks not only use models that are technically
20 *Shariah*-compliant but they should also take care of *maqasid al-Shariah*, i.e., aims and
21 objectives of *Shariah* and the “spirit” of the principles of Islamic banking. In hypotheses testing,
22 the level of social performance is measured by an index based on the theory of IME, where the
23 values of its indicators are derived from the annual reports of Islamic banks, based on both
24 qualitative and quantitative data. This index follows the goals of IME (or *maqasid*) following
25 the work of classical authors in Islamic law.
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30 According to the results of this research, to meet social impact objectives Islamic banks should
31 focus on improving internal *Shariah* governance mechanisms. Today, it is common practice for
32 Islamic financial institutions to appoint a *Shariah* board, which will oversee all agreements and
33 ensure that they are compatible with Islamic economic principles. The confirmed hypothesis in
34 the research refers to the positive impact of the quality of Islamic governance in the bank on its
35 social performance.
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39 Some countries, particularly those in Southeast Asia, have established special central *Shariah*
40 committees for all banks in the banking system due to doubts about the quality of *Shariah*
41 governance at the level of individual banks. However, results of our research show that it has a
42 negative impact on social performance of Islamic banks, thus the effectiveness of such
43 supervisory mechanisms can be questionable.
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46 The most significant limitation of this research lies in using SPI based on information from the
47 annual reports, as the index is based only on information published in the reports. Although
48 most large banks publish annual reports, the fact is that some banks do not publish. This does
49 not mean, however, that their social contribution is non-existent. Furthermore, sometimes there
50 are significant differences in the quality of published reports.
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53 Due to the fact that this research focuses on Islamic-governance-related factors that affect social
54 performance of Islamic banks, there is room for further research about other internal and
55 external determinants of Islamic banks' social performance (*e.g.*, corporate culture,
56 management style, ownership, regulatory aspects, economic environment, *etc.*).
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