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Impact of External Governance on Financial Performance: Evidence from Islamic Banks

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Abstract

The basic purpose of this study is to analyze the impact of external governance system on the financial performance of Islamic banks. Strong governance system protects all the stakeholders either they belong to primary or secondary stakeholders. The recent increase in the acceptance of Islamic economic system in the entire world brings attention to the researcher to know the impact of governance system on the banks financial performance. This study collected data from selected Asian countries, including, Pakistan, Afghanistan, Jordan, Maldives, Qatar, Saudia Arabia, and United Arab Emirates and the sources of data are Bank scope and world bank. This study covers twenty-five banks, and the study covers the period from 2016 to 2020. This study employed a panel data analysis on 125 observations to extract the results. In this study, authors used two proxies to measure the financial performance of the Islamic banks, i.e. Return on Assets (ROA) and Return on Equity (ROE). Based on the panel data analysis and estimation techniques, this study found that external governance has no impact on Islamic banks financial performance. This study provides a direction that external governance has no meaningful impact on the performance, but the management cannot ignore the external governance for their operations. The current study strengthens the literature of corporate governance and the determinants of financial performance of Islamic banks.

Keywords: External Governance, Financial Performance, Islamic Banks

Background of the study:
Islamic banking is described as a form of banking that abides by Islamic Shariah law and is in accordance with the religion's spirit, values, and ethics. In accordance with the Organization of Islamic Conference's (OIC) approval, a financial organization is an Islamic bank if its policies, reputation, and daily conduct explicitly reflect its adherence to Islamic law and the rejection of interest payments on any aspect of its business activities. In Muslim and non-Muslim nations alike, Islamic banks have

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grown. The report by the Global Islamic Finance Forum (2021) stated that assets related to Islamic finance were valued at 3.06 trillion US dollars.

Archer and Karim (2012) define the Islamic banks as a morally sound entity that serves the requirements of Islamic communities by making investments in accordance with Sharia law. The banking on the subcontinent was founded on the notions of Mudarabah and Ijrah, and later, the idea was supported by the Council of Islamic Ideology.

Specifically, because of the unique aspect of the riba prohibition, various studies have looked into the factors that influence the performance of Islamic banks (Hassan & Bashir, 2003; Harisa et al., 2019; Srairi, 2010). Additionally, there has been a rapid rise in interest from those who are religiously conservative, invest according to their personal values, and favor institutions that adhere to Shariah (Ashraf et al., 2015; Hidayat et al., 2017). Islamic banking is becoming more popular as a substitute for traditional banking (Abdel-Baki & Leone Sciabolazza, 2014; Pathan & Faff, 2013).

The performance of Islamic banks has not been thoroughly examined in the associated literature with regard to the influence of external control mechanisms and the standard of regulatory frameworks. Particularly for Islamic banks doing business in Asia, there is very little research on this connection. It is distinctive research since it is a thorough investigation of the Islamic banking industry.

Literature Review:

Islamic banks were founded to accommodate Muslims' desire to conduct business in accordance with Shari'ah (Antonio, 2001). With the exception of acts that are against Islamic law, banks are permitted to finance identical activities to regular banks. Thus, riba finances including debentures, payables, receivables and bonds are forbidden (Haniffa & Hudaib, 2004; Sulaiman, 2003).

Numerous research has looked into the factors that affect performance of the banks throughout the past three decades. The results of empirical research published in the literature suggested that the factors that affect a bank's profitability may normally be divided into three factors: factors specific to the bank, factors specific to the industry, and factors specific to the country. Numerous studies have chosen distinct explanatory variables in the empirical literature to measure the impact of both internal and extrinsic influences. Most studies have focused on internal or factors specific to the bank, taking into consideration variables including credit risk, bank size, CAR (Capital Adequacy ratio), liquidity risk, operational effectiveness and asset quality (Anbar & Alper, 2011; Grira et al., 2016; Louzis et al., 2012; Petria et al., 2015; Ramadan, 2011; Rjoub et al., 2017). Additionally, a number of studies have used macroeconomic indicators such as interest rates, growth in gross domestic product, inflation rate and currency exchange rate as the country-level drivers (Aburime, 2008; Athanasoglou et al., 2008; Dietrich & Wanzenried, 2011; Schumacher & McDonald, 2009; Trujillo-Ponce, 2013).

According to Bukhair (2013), among the factors affecting the profitability of Islamic banks, capitalization, and GDP have a considerably favorable impact on return on asset of Islamic banks, however asset size only has a significantly good impact on

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return on equity. According to research done by Masood (2012), asset size has a large positive impact on profitability for Islamic banks, whereas capital sufficiency, asset quality, operational effectiveness, and financial risk has a considerable negative impact.

Although many studies have concentrated on the impact of extrinsic and internal factors on the profits of commercial banks, few research has focused primarily on investigating the performance drivers of Islamic banks. Hassan & Bashir (2003); Ramadan (2011); Shahid et al. (2015) investigated the organization-specific (CAR) and macroeconomic (exchange rate, GDP growth rate, and inflation rate) factors that influence the viability of Islamic banks in Pakistan. The conclusions were significantly favorable, and similar results came out for studies using alternate variables by (Ali et al., 2012; Asadullah, 2017; Saleem & Ashfaque, 2020).

H1: External governance has a significant effect on the performance of Islamic banks.

Methodology:

To test the hypothesis, we collected data of Islamic banks which belong to Asia for the period of 2016 to 2020. Due to lack of availability of data, we came up with these seven countries namely Afghanistan, Jordan, Maldives, Pakistan, Qatar, Saudi Arabia, and UAE. We collected data from the 25 Islamic banks which are operating in the counties mentioned above. For the data analysis we came up with 125 observations. The data related to bank specific collected from annual reports and industry & country related data is collected from world bank database. We propose that Islamic banking profitability is the function of banking, industry, and country factors. The functional form is given below,

Profitability = *f* (Banking factors, industry sectors, country factors)

The above functional form of the model is presented below in the form of econometric equation,

$$ROA_{it} = \beta_0 + \beta_1 SIZE_{it} + \beta_2 CAD_{it} + \beta_3 CONC_{it} + \beta_4 DC_{it} + \beta_5 CG_{it} + \beta_6 IP_{it} + \beta_7 GDPG_{it} + \beta_8 INF_{it} + \varepsilon_{it} \text{ .... (1)}$$

Results and Discussions:

Table 1 shows the descriptive statistics, carrying the information about the number of observations used in the study, tells us the means, standard deviations, minimum and maximum values of the variables. In this study we have used 125 observations for analysis. This table shows that ROA has a lot of variations ranges from the minimum value of -0.0264 to the maximum value of 0.107, resulting in the standard deviation of 0.0162 which is higher than the mean value of 0.0157. If we compare the ROE with ROA, we find that ROE is stable as the standard deviation (0.0692) is almost half as compared to mean (0.104). We find that the minimum value of ROE is -0.09 while its maximum value is 0.346, which suggests that on average return is on positive side. We can say that stable efficiency in asset utilization and shareholder return. However, the variability shows that some banks operated at a loss while others achieved strong performance. The other variables namely firm size, capital adequacy, concentration, and domestic credit have not much variation as compared to the mean. The standard

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deviations of these variables are less than the value of their means respectively. On the other hand, GDP growth, inflation, and corporate governance index have more variations, i.e. their minimum values are negative and maximum values are positive, resultantly they produced value of standard deviation more than the value of their means respectively. It is pertinent to mention that the mean score of governance index score is positive.

Table 1: Descriptive Statistics

Variables	N	Mean	SD	Min	Max
ROA	125	0.0157	0.0162	-0.0264	0.107
ROE	125	0.104	0.0692	-0.09	0.346
Firm Size	125	17.05	3.362	7.501	22.3
CAD	125	0.19	0.182	0.043	0.841
Concentration	125	67.43	18.73	39.7	100
Domestic credit	125	53.85	36.59	3.097	138.9
GDP growth	125	1.035	5.372	-33.5	8.1
Inflation	125	2.001	3.059	-2.5	10.6
Governance index	125	0.0666	2.571	-4.347	3.266

Table 2 represents correlations among the variables. This table tells us financial performance measures (ROA and ROE) are positively related to the governance index. On the other hand, we may say that governance index impacts financial performance. The correlations between independent variables are not very high except one variable. From the table we can see that some variables are positively related to financial performance measures (ROA and ROE), and some are negatively correlated with ROA and ROE. Overall Table 2 points out that the relationship among the variables is as per expectations. Governance quality strongly correlates with domestic credit, highlighting the role of institutions in financial development.

Table 2: Correlations Matrix

	ROA	ROE	FS	CAD	Cons	DC	GDP	Inf	GI
ROA	1								
ROE	0.477	1							
FS	0.099	0.011	1						
CAD	0.427	-0.22	0.049	1					
Cons	0.442	0.144	-0.01	0.257	1				
DC	0.246	0.175	0.238	-0.01	0.566	1			
GDP	-0.25	-0.03	-0.03	-0.09	-0.23	-0.237	1		

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Inf	-0.23	0.028	-0.11	-0.15	-0.62	-0.604	0.261	1	
GI	0.272	0.194	0.243	-0.03	0.491	0.9163	-0.15	-0.52	1

Table 3 represents the regression results of common effect, fixed effect, and random effect. In this table our dependent variable is ROA, and independent variables are divided into three categories namely, firm's related variables, industry related variables, and country related variables. As it is mentioned above, to know the determinants of ROA for Islamic banks, three panel estimation models were evaluated: Pooled OLS, Fixed Effects (FE), and Random Effects (RE). According to the Breusch and Pagan Lagrangian multiplier test and Hausman test, it is found that the Fixed Effect model may be considered. Therefore, interpretation will be emphasized based on the fixed effects results, while comparisons are made with common effects and random effects for robustness.

In the FE model, firm size has a Z-value < 1.96, indicating no significant impact on ROA. Since p > 0.05 in all models, we fail to reject the null hypothesis and conclude that firm size has no significant effect on ROA. CAD shows a positive impact on ROA in all three models but in the FE model probability is more than 0.05, therefore we cannot say that CAD significantly impacts the ROA. The market concentration has a negative and statistically significant impact on ROA. As p < 0.05, we reject the null hypothesis and infer that increased market concentration decreases asset profitability i.e. ROA. Domestic credit is statistically insignificant across all models. Given p > 0.05, we fail to reject the null and conclude that domestic credit depth does not significantly influence ROA. GDP growth exhibits a negative and significant effect on ROA in all the models. Since p-value is less than 0.05, we reject the null hypothesis and conclude that higher economic growth is associated with lower ROA, potentially due to lagging returns during volatile recovery periods. Inflation is statistically insignificant as p > .05 so we can fail to reject the null, indicating no significant impact on financial performance. The governance index is not statistically significant. Again, p > 0.05, so we fail to reject the null; formal governance quality has no measurable effect on ROA. The details of the results for effect of independent variables on the dependent variable i.e. ROA from all three methods are shown the Table 3 below. The overall results are not significant. One reason might be small sample size, and another reason might be accounting based performance measures rather than market-based performance measures, e.g. Tobin's Q.

Table 3: Return on Assets (ROA)

	Pooled OLS			**Fixed Effects**			**Random Effects**		
Variables	**Coeff.**	**Z**	**Prob.**	**Coeff.**	**Z**	**Prob.**	**Coeff.**	**Z**	**Prob.**
Size	0.00038	1.02	0.308	-0.0038	-0.26	0.794	0.0002	0.42	0.672
CAD	0.03115	4.38	0.000	0.02764	0.38	0.703	0.0308	2.88	0.004
CONC	0.00041	2.84	0.005	-0.0011	-2.19	0.031	0.0001	0.88	0.377
DC	-0.0001	-1.06	0.291	-0.0000	-0.54	0.591	-0.0001	-1.44	0.149
GDP G	-0.0005	-2.13	0.035	-0.0008	-3.11	0.003	-0.0005	-2.73	0.006

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Inflation	0.00065	1.19	0.238	-0.0004	-0.61	0.545	0.00027	0.53	0.596
Gov. Index	0.00151	0.78	0.440	-0.0022	-0.20	0.840	0.00349	1.76	0.078

Similarly, the results from all three models explaining the effects on ROE are shown in Table 4. For ROE, the Hausman test result (p = 0.180) favors the Random Effects model. The following interpretation is based primarily on the RE model. The coefficient for firm size is small and statistically insignificant. Since probability value is more than 0.05, we fail to reject the null hypothesis, concluding that firm size does not significantly influence ROE. CAD is negatively related to ROE and the p -value is greater than 0.05, we fail to reject the null at the 5% level, therefore, results suggest that potential negative effect of CAD on equity profitability. Market concentration shows a negative and insignificant impact on ROE. As p > 0.05, we fail to reject the null hypothesis, concluding that higher market concentration has no significant impact on ROE. Domestic credit remains statistically insignificant, indicating no significant impact on ROE. Therefore, we fail to reject the null for this variable. The coefficient for GDP growth is also not significant, suggesting no clear influence on equity returns. Therefore, we fail to reject the null hypothesis. Inflation has a positive co-efficient but insignificant impact on ROE as e p > 0.05, therefore, no significant impact of inflation on ROE is found. Governance index has positive and significant (at 10% level of significance) impact on ROE. Hence, we reject the null. Based on these results, we conclude that governance index has impact on return on equity but with the level of significance at 10%.

Table 4: Return on Assets (ROE)

	Pooled OLS			**Fixed Effects**			**Random Effects**		
Variables	**Coeff.**	**Z**	**Prob.**	**Coeff.**	**Z**	**Prob.**	**Coeff.**	**Z**	**Prob.**
Size	0.00046	0.25	0.806	0.0109	0.20	0.842	-0.00017	-0.05	0.963
CAD	-0.0935	-2.65	0.009	-0.044	-0.17	0.869	-0.09627	-1.42	0.155
CONC.	0.00152	2.11	0.037	-0.0040	-2.09	0.040	-0.00030	-0.4	0.690
DC	0.0001	0.36	0.721	-0.000	-0.68	0.497	-0.00037	-0.87	0.384
GDPG	-0.0002	-0.19	0.849	-0.001	-1.06	0.292	-0.00081	-1.05	0.292
Inflation	0.00592	2.18	0.031	0.0002	0.09	0.932	0.00236	1.18	0.239
Gov. Index	-0.00131	-0.14	0.892	0.0118	0.29	0.771	0.01453	1.66	0.096

Conclusion and Recommendations:

Empirical researchers are putting a lot of efforts to know the determinants of financial performance of Islamic banks. This study holds academic significance as it contributes new insights to the existing body of literature. By addressing the empirical gap in current knowledge, it offers an updated and enriched foundation that can support and guide future research in the field. There were also a few limitations to the study due to the unavailability of financial data in a few countries. Building on the empirical results, several recommendations emerge for policymakers, regulators, and Islamic bank managers. Given the limited impact of governance indicators, stronger

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enforcement mechanisms are needed to ensure that reforms move beyond legislative adoption and are effectively incorporated into bank-level practices. The negative association between market concentration and ROE highlights the need to encourage greater competition, innovation, and the entry of new participants in the Islamic banking sector, which could enhance both service quality and financial performance. Furthermore, Islamic banks should integrate macroeconomic monitoring into their strategic planning by aligning asset portfolios with prevailing economic conditions and employing tools such as stress testing and scenario analysis to better navigate periods of volatile GDP growth. Although capital adequacy shows a positive effect on ROA, emphasis should be placed on optimizing capital utilization so that it supports income-generating activities while maintaining regulatory compliance. Finally, institutional and regulatory reforms should be tailored to the unique operational and contractual nature of Islamic finance, as uniform approaches designed for conventional banking may overlook sector-specific needs and limit effectiveness.

This research investigated the influence of external governance, macroeconomic conditions, and banking-sector characteristics on the profitability of Islamic banks in Asian countries, using panel data from 25 institutions covering the period 2016 to 2020. The findings indicate that while governance quality holds theoretical significance, they do not exert a measurable impact on profitability in practice. Instead, factors such as macroeconomic volatility and structural characteristics of the banking sector—particularly high market concentration—emerge as more influential determinants. These results suggest that institutional reforms must be reinforced through effective implementation and supported by policies that promote competition to achieve meaningful performance gains. Furthermore, the distinct operational framework of Islamic banking necessitates regulatory, capital allocation, and market design strategies that are specifically adapted to its principles. Future studies could broaden the analysis by incorporating dual banking systems for comparative evaluation or by exploring the role of Shariah governance as a mediating factor in profitability, thereby offering deeper insights into how Islamic banks respond to institutional and economic dynamics.

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