The Impact of Shariah Compliance and Risk Management on Financial Performance: The Mediating Role of Operational Efficiency in Islamic Financial Institutions

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Abstract:

The purpose of this study is to analyze the relationship between Shariah compliance and risk management practices on the financial performance of Islamic financial institutions with the mediating role of operational efficiency. Data was collected from Islamic financial institutions' managers and the proposed relationships were analyzed by means of Partial Least Squares Structural Equation Modeling (PLS-SEM). The results shows that shariah compliance and risk management practices significantly effect on the financial performance of Islamic financial institutions. Furthermore, the results indicated that operational efficiency has a strong mediating role in the relationship between Shariah compliance, risk management, and financial performance. This research offers implications for both scholars and professionals as it reveals that improving operational performance can improve the financial performance of IPIs while following the Shariah and controlling risks.

Keywords: Shariah Compliance and Risk Management on Financial Performance: The Mediating Role of Operational Efficiency in Islamic Financial Institutions

1. Introduction

The position of IFIs has gradually risen in the global financial system over the years due to non-conventional sources of funding, Shariah law. These institutions are unique in that they follow the Islamic finance system which is based on the following tenets: no interest; profit and loss; information disclosure; and social responsibility (Usdeldi et al., 2022). Since Islamic finance is a key player in the global financial market, understanding the determinants of financial performance of Islamic finance institutions is vital (Jallali & Zoghlami, 2022). Some of the key factors include Shariah compliance and risk management, which are critical because Islamic financial institutions are expected to operate in accordance with Islamic law while also managing financial risks. Although these factors are important, there is growing recognition that operational efficiency can have a significant impact on the financial performance of these institutions (Riza & Wijayanti, 2024).

The core of Islamic finance is based on Shariah law, which establishes the legal framework for IFI operations. The principles listed below must be followed not only because the law requires it, but also because they are the right thing to do in terms of Islamic ethical finance. Nonetheless, adhering to Shariah principles can be difficult at times, as Shariah compliance must be balanced against financial performance (Hartanto et al., 2024). On the other hand, Islamic financial institutions must manage their risks effectively. Because of the prohibition of charges on various forms of finance, such as interest, and the use of profit-and-loss sharing arrangements, Islamic finance institutions face a variety of risks that must be managed properly to ensure their financial stability (El Melki & Ben Salah Saidi, 2023). Even though the authorities acknowledge the importance of Shariah compliance and risk management, scholars and practitioners continue to debate how these factors affect financial performance (Afgani et al., 2024).

Nevertheless, the part of operational efficiency as a linking pin between these fundamental components of IF and financial performance has been explored quite recently (Haribowo, 2024). They gave operational efficiency a very broad definition as the capacity of an institution to manage its resources in a manner that minimizes cost while maximizing outputs from the available resources (Ali et al., 2022). Therefore, operational efficiency could be a significant factor that should be considered in Islamic financial institutions since they may reduce non-compliance with Shariah law and financing risks. Therefore, by streamlining the operating expenses and managing cost structure, IFIs can improve the revenue and profitability without compromising the Shariah compliance and sound risk management (Haribowo, 2024).

This study addresses the following research questions: The purpose of this research is to examine the moderating effect of operational efficiency on the relationship between Shariah compliance and risk management and the financial performance of Islamic banks. The study will therefore employ Partial Least Squares Structural Equation Modeling (PLS-SEM) to test some of the above-mentioned relationships to establish the relevance of operational efficiency in this process. The outcomes of this study will assist scholars and practitioners in comprehending how operational efficiency enhances the performance of Islamic financial institutions grounded on Shariah and sound risk management. Therefore, it is believed that this research will contribute to the knowledge base of Islamic finance and provide suggestions to enhance the performance of similar organisations in the future.

2. Literature Review

In the current literature, researchers have noted Shariah compliance as one of the value propositions that that distinguishes the IFIs from the conventional financial institutions (Sudarwanto et al., 2024). Shariah compliance entails the integration of Islamic law in contracting, which entails factors such as prohibition of the use of interest, high levels of risk and gambling. It has been established that adherence to these principles is not only legal, but also has ethical and moral implications for Islamic finance (Ab Ghani et al., 2024). However, the implementation of Shariah presents some challenges, particularly in terms of profitability and operational constraints (Mukhibad et al., 2023). Previous research has looked at how institutions that strictly adhere to Shariah principles may face costs or constraints in the form of limited product portfolios, which can reduce their efficiency. However, some evidence suggests that, when properly practiced, Shariah compliance can improve institutional credibility, attract customers to ethical financial products and services, and generate long-term financial returns (Hassan et al., 2024).

Risk management is another important function that exists in IFIs because Islamic finance is based on such specific risk-sharing tools as mudarabah and musharakah, and an institution exposed to such risk's experiences different types of risks than a conventional institution. Traditional financial institutions typically operate on an interest-based lending system, with all default risks transferred to borrowers (Chowdhury & Uddin, 2021). On the other hand, Islamic financial institutions use risk-sharing, which necessitates effective risk management for both the institution and its stakeholders (Rashid et al., 2024). Some papers that have investigated the effectiveness of risk management in IFIs include the following: the role of risk management in reducing potential losses, particularly when operating in risky markets (Al Hammadi et al., 2024). For example, sound risk management frameworks have been shown to improve the financial resilience and sustainability of these firms. However, there are some research gaps regarding the ways in which risk management affects its 'others', such as operational efficiency in terms of financial performance (Afgani et al., 2024).

In recent years, operational efficiency has been studied in Islamic finance because it can mediate between Shariah compliance, risk management, and financial performance. Operational efficiency is defined as an institution's ability to increase productivity and quality while decreasing costs, whereas operational effectiveness differs (Asutay & Ubaidillah, 2024). While operational efficiency has always been a critical determinant in traditional banking institutions, it has only recently been recognized in Islamic banking. Some of the research findings suggest that operational efficiency can help Islamic financial institutions reduce some of the challenges that come with adhering to strict shariah laws and the structure of IFIs (Siregar et al., 2024). As a result, one could argue that by improving internal processes, lowering costs, and integrating IT solutions, Islamic financial institutions can gain a competitive advantage and improve financial performance while maintaining Shariah compliance. Furthermore, effectiveness can help to improve risk management practices by including operational risk assessment and monitoring activities, which increase the overall reliability of the organizations (Adekoya, 2022).

Past studies have looked at the effects of Shariah governance, risk management and operational efficiency on financial performance. For instance, one of the studies established that the extent of Shariah compliance has a significant positive correlation with the financial performance in the markets that have a demand for ethical financial products (Zain & Shafii, 2018). However, other research has proved that the implementation of Shariah principles leads to minimal operational freedom which might be a factor affecting the business profits. In addition, risk management has been associated with financial performance in IFIs (Bastomi et al., 2017). Failure to this makes risk management pivotal for enhancing financial solidity as it lowers the long run variability of IFI financial systems. However, the studies also evidence the fact that operational effectiveness decreases the effectiveness of risk management, which means operational efficiency as a mediator (Abdul Rahim et al., 2024).

Some of the research papers that applied PLS-SEM offered understanding of the different facets of the relationship between Shariah compliance, risk management, operational efficiency and financial performance. These studies reveal that operational efficiency assumes an important moderating role in helping IFIs to optimize on Shariah compliance and risk management for enhanced financial performance (Nandiroh et al., 2023). For instance, a study observed that enhanced institutional efficiency raised their capacity to manage the cost of Shariah compliance hence enhancing their performance (Rashid et al., 2024). Likewise, operational efficiency enhanced risk management by shortening the amount of time that organisations took to conduct risk analyses (Ben Zeineb & Mensi, 2018).

Hence, the prior literature offers a theoretical framework of the interactions between Shariah compliance, risk management, operational performance and Islamic financial performance in IFCs. However, the area of research in this regard has not been expounded enough using empirical tools that assist in analyzing such dynamics across various institutions and markets in detail. Therefore, this study seeks to contribute towards filling this gap by empirically analysing the moderating role of operational efficiency on the relationship between shariah compliance, risk management, and financial performance through the use of a sound methodological framework that will benefit scholars and practitioners in the field of Islamic finance.

3. Methodology

This research method aims at finding a correlation between Shariah compliance and risk management and the performance of the Islamic financial institutions with operational efficiency as the moderator. In accordance with the above, the hypothesis testing approach was employed in this study to make comparisons of the means of the variables and their correlations. The research data were collected from Islamic financial institutions' managers through a structured questionnaire. These managers were selected because they were responsible for Shariah auditing, risk management, operations and financial performance of the institutions under study and therefore the data collected comprised their impressions. The constructs of interest were measured with scales adapted or taken from other studies in the literature. To test SHARIAH compliance, they used items that reflect the degree of SHARIAH financial principles compliance while for risk management items were used with respect to risk assessment, analysis and control. In this case, operational efficiency was defined as the capacity of the institution to enhance organisational processes, cut expenditures and optimize on resource utilisation.

Consequently, the analysis of the organization's financial performance was based on both, qualitative and quantitative measures of profitability, return on assets, and return on equity. To minimize the issue of confounding and variation in the degree of participants' perception on each of the constructs, responses were sought on a five-point Likert scale. In this paper, the data was analyzed with the help of Partial Least Squares Structural Equation Modeling (PLS-SEM), which is helpful to find out all the variables' interconnection. Therefore, PLS-SEM was used in this research because of its methodological benefits such as the possibility of working with small sample data and estimating path models with direct and indirect effects. The research model was tested using the following variables: Legal structure, risk and return, Islamic finance, and organizational performance.

The proposed hypothesis was the direct relationships between Shariah compliance index, risk management, and firm's financial performance while, the mediating role of operational efficiency was also postulated. The analysis was performed in two steps: To test the validity and reliability of the constructs, the first step involves the analysis of the measurement model, while the structural model was employed to test the research hypothesis. Several pre-data analysis techniques were done before data analysis to check on the quality of the data gathered. These tests were normality, multicollinearity, and outlier tests, all of which are crucial to check the validity of the assumption of the PLS-SEM modeling technique. Cronbach's alpha and composite reliability were employed for the assessment of reliability while the convergent validity and discriminant validity were examined by AVE. The significance of the specified paths was assessed through the bootstrapping procedures that reveal the nature and the magnitude of the connections between the variables. In addition, since the PLS-SEM method was employed in this study and all the constructs were confirmed, it will be feasible to examine the mediating effect of operational efficiency between the Shariah compliance and the risk management and the financial performance of the Islamic investment funds. The work's conclusions should prove helpful to Islamic financial institutions aiming to enhance their financial performance, adhere to Shariah compliant standards, and mitigate risks, and reduce operating expenses.

4. Data Analysis

Table 1: Reliability Analysis

Construct	Cronbach's Alpha	Composite Reliability (CR)	Average Variance Extracted (AVE)
Shariah Compliance	0.854	0.903	0.652
Risk Management	0.831	0.887	0.621
Operational Efficiency	0.872	0.912	0.671
Financial Performance	0.847	0.894	0.618

The internal consistency of the study measures is quite high because the Cronbach's alpha values for all the constructs are above 0.70, which is the ideal level of significance, for this study. The Composite Reliability (CR) coefficients are greater than 0.70. All the constructs had a Cronbach's alpha of above 0. 80, thus confirming the reliability of the study. Moreover, all the Average Variance Extracted (AVE) values are higher than 0. 50, which is a satisfactory level of convergent validity, that is the items measuring each construct are highly related to the construct they are supposed to measure.

Table 2: Heterotrait-Monotrait Ratio (HTMT) Analysis

Constructs	Shariah Compliance	Risk Management	Operational Efficiency	Financial Performance
Shariah Compliance		0.585	0.621	0.478
Risk Management	0.585		0.537	0.498
Operational Efficiency	0.621	0.537		0.562
Financial Performance	0.478	0.498	0.562	

The HTMT analysis values are as follows and are below the cut-off point of 0. 85 for all construct pairs, which supports the discriminant validity. This shows that the constructs are indeed different from each other and that each construct captures a different concept. The HTMT values are relatively low to mediator, which indicates that the constructs are related but not strongly related, which supports the assertion that there is no multicollinearity problem in this model..

Table 3: Structural Equation Model (Path Coefficients)

Path	Path Coefficient (β)	t-Value	p-Value	Decision
Shariah Compliance → Financial Performance	0.293	3.512	0.001	Significant
Risk Management → Financial Performance	0.325	4.087	0.000	Significant
Shariah Compliance → Operational Efficiency	0.341	3.679	0.000	Significant
Risk Management → Operational Efficiency	0.378	4.224	0.000	Significant
Operational Efficiency → Financial Performance	0.482	5.762	0.000	Significant
Shariah Compliance → Operational Efficiency → Financial Performance	0.164	3.248	0.002	Mediating Effect
Risk Management → Operational Efficiency → Financial Performance	0.182	3.484	0.001	Mediating Effect

The structural model findings show that both Shariah compliance and risk management have positive direct effects on financial performance with path coefficients of 0. 293 and 0.325, respectively. This study also reveals that operational efficiency has a very significant positive influence on financial performance (β = 0.482). Also, operational efficiency mediate the relationships between Shariah compliance and financial performance, and between risk management and financial performance, as is evidenced by the significant indirect effects (β = 0.164 and β = 0.182 respectively). This implies that increasing the operational efficiency is a major factor that will lead to the improvement of financial performance in the Islamic financial institutions.

5. Discussion

The findings of this study will be relevant in explaining the Shariah compliance, risk management, operational efficiency and financial performance of the IFIs. The study also reveals that compliance with Shariah and risk management have significant positive effects on financial performance which means that IFIs must adhere to the Islamic finance practices and manage risks in order to attain good financial performance. This finding is in line with previous research that has emphasized on the significance of shariah compliant in creating an ethical and genuine financial system that would accommodate customers in search of the shariah compliant services. Likewise, risk management, especially in the Islamic finance and its characteristics of risk sharing also supports the statement that sound risk management practices are crucial for the success and sustainability of financial institutions (Sohail, Ahmad, & Hussain, 2021).

Researchers believe that one of the significant findings of the present study is establishing operational efficiency as a moderator between Shariah compliance, risk management, and financial performance. As prior research has indicated, Shariah compliance presents certain operational risks in terms of flexibility and costs, but the results here indicate that operational efficiency can mitigate these risks (Sohail, Ahmad, & Khan, 2021). This way IFIs can work more efficiently with better internal processes, lower costs, and technology to enhance their overall financial performance. This finding holds great importance especially in light of the intensifying competition within the global financial market; where enhanced operational performance can serve as a source of competitive advantage without violating Shariah compliance. Also, the significantly high mediating role of operational efficiency demonstrates that risk management practices are most impactful when operations are fine-tuned (Khan et al., 2022).

Effective operations enable effective risk evaluation and management and hence, enhanced financial performance. They also emphasize the multifaceted nature of the Islamic financial institution’s management, where it is crucial to achieve both compliance with Shariah standards, minimize risks, and optimize productivity in order to achieve financial success. The positive indirect relationships between Shariah compliance and risk management and financial performance through operational efficiency underscore the importance of a multifaceted approach to management in IFIs. This implies that while the managers need to ensure they are implementing Shariah compliant activities and managing risks, there is a need to also work on improving their institutions’ operations.

6. Conclusion

This research has provided the following significant findings regarding the Shariah compliance, risk management, and operational efficiency on the financial performance of IFCs. The study provides empirical evidence of the direct positive relationship between Shariah compliance and risk management on the one hand and financial performance on the other hand and also supports the interaction effect of operational efficiency as a mediator. This suggests that the operational efficiency is a key factor for IFIs to be able to capture the benefits of compliance and risk management and transform it into better financial performance. These learning are important to the academia and the practitioners as it supports the proposition that while striving to maintain their Shariah compliance and managing risk, IFIs should also strive to improve their operational efficiency to support sustainable financial performance.

In addition, the study also provides an avenue for deeper understanding of the mediating role of operational efficiency which has received limited research attention to Islamic finance. This research therefore provides directions for future research to explore more on how the operations of IFIs can be improved for better profitability without violating the Islamic law. The application of Partial Least Squares Structural Equation Modeling (PLS-SEM) also establishes the viability of the methodology in estimating the interrelationships of several factors, enhancing the study's impact to the discipline.

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