ISLAMIC MICRO FINANCE JOURNAL

# Shariah Governance and Financing Risk in Islamic Banks: A Conceptual Analysis

**Yahya Fuad**
Universiti Utara Malaysia
*Corresponding email: *yahyafuad46@gmail.com*

**ABSTRACT -** This study aims to explore the role of Shariah governance in minimizing financing risk in Islamic banking by focusing on the functions of the Shariah Supervisory Board (SSB) and Internal Shariah Review (ISR). The research synthesizes findings from two scholarly articles using a conceptual and qualitative analytical approach. The first article adopts a systematic literature review to identify key indicators in Shariah governance that influence credit risk, such as the qualifications of SSB members and the effectiveness of ISR. The second article utilizes Erving Goffman's frame analysis to understand how interactions between bank managers and SSB members may impact Shariah compliance in practice. The analysis reveals that a well-functioning SSB and ISR significantly contribute to reducing financing risk by ensuring that banking operations align with Shariah principles. Furthermore, managerial strategies, such as impression management, may influence the decisions of Shariah boards, raising concerns about the consistency and integrity of compliance mechanisms. These findings highlight the dual importance of institutional competency and ethical governance in mitigating risk and maintaining public trust in Islamic financial institutions. In conclusion, the study emphasizes the need for capacity building in Shariah governance structures, particularly in enhancing the qualifications and independence of SSB members and strengthening internal Shariah review functions. Future research is encouraged to further examine the effectiveness of ISR across various financial products and jurisdictions, and to explore how governance practices affect credit ratings in Islamic banking.

**Keywords:** Shariah Governance, Islamic Banking, Financing Risk, Shariah Supervisory Board, Internal Shariah Review

## INTRODUCTION

Islamic banking plays an essential role in the economic development of Muslim countries by operating within the boundaries of Shariah principles. The ultimate objective of Islamic banking is not only profit maximization but also achieving social welfare, justice, and equitable economic distribution (Ershad Uddin & Kausar Alam, 2023). To ensure that all financial products and services remain compliant with Islamic principles, Islamic Financial Institutions (IFIs) are required to implement a robust governance framework that upholds Shariah integrity in all operational aspects. This responsibility falls primarily on the Shariah Supervisory Board (SSB), which monitors and ensures compliance with Islamic law at all levels of banking operations (Aam, 2021).

The effectiveness of the SSB is critical in safeguarding Shariah compliance. However, previous studies have raised concerns regarding the competence of some SSB members, particularly their understanding of technical and operational aspects of Islamic banking. A lack of expertise among board members can lead to weak governance structures and inadequate oversight, which may ultimately diminish public trust in Islamic financial institutions (Shafique et al., 2022)This issue is further complicated by the increasing complexity of Islamic financial products and innovations, which require not only legal knowledge but also operational understanding for effective governance.

Another key pillar of Shariah governance is the Internal Shariah Review (ISR), which serves as an internal mechanism to continuously assess and verify compliance with fatwas, guidelines, and Shariah decisions issued by the SSB. According to AAOIFI standards, an effective ISR must cooperate with external auditors and provide comprehensive reports to both the board of commissioners and management to ensure transparency and accountability (Yasoa' et al., 2020). Together, the SSB and ISR form the institutional backbone for Shariah compliance in Islamic banking.

Despite the presence of these governance structures, Islamic banks continue to face substantial financing risks, especially when customers default on their obligations under Shariah-compliant contracts. These risks, if not properly managed, can threaten the financial stability of Islamic banks and undermine their long-term sustainability (Budianto, 2023; Malim, 2015). Shariah-compliant contracts such as Mudarabah and Musyarakah expose Islamic banks to unique forms of risk that differ significantly from conventional credit risk. Effective Shariah governance is thus essential not only to maintain religious compliance but also to mitigate financing risk and protect institutional stability.

However, governance in practice may diverge from governance in theory. Recent studies have begun to explore how Shariah governance is implemented in real-world settings. For example, the use of Erving Goffman's frame analysis has revealed that managerial actors in Islamic banks may engage in impression management when interacting with SSB members, potentially influencing Shariah decisions to serve commercial interests (Karbhari et al., 2024). This phenomenon raises concerns about the autonomy and objectivity of Shariah governance, and whether current oversight mechanisms are sufficient to guard against such influence.

Therefore, this paper aims to explore the role and effectiveness of Shariah governance in mitigating financing risk, based on a critical review of two recent academic studies. The first study employs a systematic literature review to analyze the relationship between Shariah governance structures and credit risk management in Islamic banking (Minaryanti et al., 2024a), while the second applies a sociological lens to investigate the interaction between bank managers and SSB members (Karbhari et al., 2024). By synthesizing these two perspectives, this paper contributes to the discourse on how governance mechanisms can be optimized to enhance both compliance and risk mitigation in Islamic financial institutions.

## LITERATURE REVIEW

The governance of Islamic financial institutions (IFIs), particularly Islamic banks, has become an increasingly important area of academic inquiry due to the unique operational requirements imposed by Shariah principles. Good corporate governance in Islamic banking is not merely a replication of conventional practices but a value-driven system based on Islamic law (Shariah), ethics, and accountability before Allah SWT and society (Muhfiatun et al., 2024).

The Organization for Economic Co-operation and Development (OECD) defines corporate governance as a framework through which objectives are set, and performance is monitored (OECD, 2004). However, in the context of Islamic finance, this framework incorporates Islamic legal traditions and moral values. In this regard, the role of the Shariah Supervisory Board (SSB) becomes paramount. The SSB is entrusted with ensuring that all operations, transactions, and product developments conform to Shariah requirements. Numerous scholars (Aam, 2021; Neifar et al., 2020) argue that the quality and effectiveness of SSB oversight are directly tied to the board's expertise, independence, and understanding of both Islamic law and banking operations.

Minaryanti et al., (2024), in their systematic literature review, conclude that Shariah governance, particularly through the mechanisms of SSB and Internal Shariah Review (ISR), plays a critical role in minimizing credit risk in Islamic banking. The study identifies specific determinants such as SSB education, experience, and reputation, as well as the size and qualifications of ISR members, as key indicators influencing financing risk. Similarly, Baig et al., (2024) emphasize the moderating effect of Shariah board characteristics such as the presence of qualified ulama and the size of the board on the relationship between corporate governance and the credit ratings of Islamic banks.

Furthermore, Baklouti, (2022 and Yasoa' et al., (2020) note that while SSBs are vital for policy-level oversight, the ISR performs operational-level reviews to ensure day-to-day compliance. The ISR acts as an internal auditing mechanism that supports the SSB, and its effectiveness contributes significantly to early detection and resolution of non-compliant activities.

However, some studies adopt a more critical lens. (Karbhari et al., 2024), using Erving Goffman's "frame analysis", explore the symbolic and strategic interactions between bank managers and Shariah boards. They reveal that managers often engage in impression management practices such as "passing" and "covering" to influence or appease Shariah experts, potentially compromising the rigor of Shariah compliance. This suggests that despite formal governance structures, informal power dynamics and institutional behaviors can dilute the effectiveness of Shariah governance in practice.

Moreover, research by Shafique et al., (2022) highlights a significant gap in operational knowledge among some SSB members, which further impedes their ability to identify complex non-compliant financial structures. This reinforces the call for continuous capacity building and institutional reform within Islamic financial governance.

Taken together, the reviewed literature affirms that while Shariah governance is essential for risk mitigation, its success depends heavily on human competence, institutional independence, and internal accountability mechanisms. Nonetheless, few empirical studies investigate the interplay between formal governance structures and the informal strategies employed by managers and board members in real practice. This indicates a critical research gap, particularly concerning the behavioral and relational dimensions of Shariah compliance in risk mitigation, which this study seeks to address.

***Theoretical Framework***

This study is grounded in two key theoretical approaches: Agency Theory and Shariah Enterprise Theory (SET).

Agency theory, traditionally associated with conventional corporate governance, deals with conflicts of interest between principals (owners/shareholders) and agents (managers). In Islamic banking, this agency relationship becomes more complex, as the system must also account for Shariah compliance, thereby involving additional stakeholders such as SSBs. Agency theory explains how governance mechanisms, such as oversight by SSBs and ISRs, are implemented to reduce opportunistic behavior by managers, thereby minimizing risk (Sarkis et al., 2011; Yuliani & Fithria, 2022).

However, due to its limited ethical scope, agency theory alone is insufficient for Islamic banking. This is where Shariah Enterprise Theory (SET) becomes relevant. SET provides a value-based theoretical framework that positions Islamic banking institutions as entities accountable not only to shareholders but also to society and God (Allah SWT). Developed to reflect Islamic ethics and socio-religious obligations, SET posits that Shariah compliance is a collective responsibility involving all stakeholders, including regulators, customers, and the wider Muslim community (Islahi, 2009). SET emphasizes transparency, social justice, and the distribution of value among all parties, which makes it highly appropriate for examining Shariah governance and its relationship to financing risk.

By integrating agency theory's focus on structural controls with SET's emphasis on ethical responsibility and multi-stakeholder accountability, this framework offers a comprehensive lens to understand how Shariah governance mechanisms operate in practice to minimize financing risks in Islamic banking institutions.

## METHODOLOGY

The methods section describes actions to be taken to investigate a research problem and the rationale for the application of specific procedures or techniques used to identify, select, process, and analyze information applied to understanding the problem, thereby, allowing the reader to critically evaluate a study's overall validity and reliability. The methodology section of a research paper answers two main questions: How was the data collected or generated? And how was it analyzed? The writing should be direct and precise, and it should always be written in the past tense.

This study employed a qualitative, descriptive, and analytical approach by conducting a literature-based analysis of two peer-reviewed academic articles that focus on Shariah governance and financing risk in Islamic banking. The primary objective was to synthesize existing knowledge, identify trends, evaluate gaps in the literature, and generate a comprehensive understanding of how the roles of the Shariah Supervisory Board (SSB) and Internal Shariah Review (ISR) contribute to credit risk mitigation.

The first article reviewed was *"The Role of Shariah Governance in Minimizing Credit Risk in Islamic Banking: A Systematic Literature Review"* by Minaryanti et al., (2024), which utilized a systematic review methodology to assess empirical studies on Shariah governance mechanisms. This article provided structured data on measurable indicators such as SSB qualifications, educational background, reputation, and ISR structure in relation to financing risk. The second article, *"Sharia Boards, Managerial Strategies, and Governance Practices in Islamic Banks: A Goffmanesque Discourse"* by Karbhari et al., (2024), applied Erving Goffman's sociological framework to examine the interactional dynamics between bank managers and SSB members, offering a behavioral perspective on governance practice.

Data were collected through documentary analysis of these two key articles, supported by a broader review of academic journal publications, regulatory standards (e.g., AAOIFI and IFSB guidelines), and institutional frameworks relevant to Islamic banking governance. Sources were selected based on their relevance, publication credibility, and contribution to the discourse on Islamic finance governance and risk management.

Data analysis was conducted using content analysis and thematic synthesis. Key themes such as "Shariah compliance," "financing risk," "SSB effectiveness," and "managerial influence" were identified and critically examined to derive insights and comparative evaluations. The literature was interpreted within the conceptual framework of Agency Theory and Shariah Enterprise Theory (SET), which enabled the study to link technical and ethical dimensions of governance with operational risk mitigation.

This methodological approach allowed for a critical assessment of both the formal governance mechanisms and the practical challenges in enforcing Shariah compliance. By triangulating structured evidence with sociological interpretation, the study ensured a balanced understanding of the theoretical and practical dimensions of Shariah governance in Islamic banking.

## RESULT AND DISCUSSION

### *Results*

The study produced key findings through a comparative and thematic analysis of two selected articles on Shariah governance and financing risk in Islamic banking. The first article, by Minaryanti et al., (2024) provided empirical evidence based on a systematic literature review that the effectiveness of Shariah governance measured through SSB qualifications, educational background, experience, and reputation has a significant impact on minimizing credit risk. Likewise, the quality and structure of the Internal Shariah Review (ISR), such as the number of members and their educational qualifications, were found to be influential in ensuring effective risk mitigation.

Indicators used to assess credit risk included the financing-to-total financing ratio, as well as qualitative assessments from the literature concerning governance outcomes. The study identified a strong correlation between well-functioning Shariah governance structures and enhanced financial stability.

The second article, by Karbhari et al., (2024), revealed insights through qualitative analysis using Goffman's frame analysis. This sociological lens exposed managerial behaviours in Islamic banks, particularly how bank executives manage their interactions with SSB members through strategies such as *passing* and *covering*. These behaviours reflect efforts by managers to preserve the image of Shariah compliance, even when underlying practices may deviate from normative standards.

Collectively, both articles showed that effective Shariah governance plays a crucial role in managing financing risk, although practical implementation challenges such as power dynamics and limited technical capacity among Shariah board members remain significant obstacles.

***Discussion***

***Sharia governance as an enabler of risk control***. The results reaffirm the central role of Shariah governance, particularly through the SSB and ISR, as a critical mechanism for managing financing risk in Islamic banking. The synthesis of the reviewed articles demonstrates that competent and independent Shariah board members, alongside an institutionalized internal review system, enhance the integrity of banking operations by ensuring compliance with Islamic legal principles. This echoes previous findings by (Baig et al., 2024; Neifar et al., 2020), which link strong governance to higher credit ratings and investor confidence.

***Managerial influence and compliance integrity***. While formal structures are essential, the second article highlights the nuanced reality of Shariah governance. Goffman’s framework revealed that SSB members may be subject to impression management tactics by bank managers. This raises concerns about the objectivity and autonomy of the SSB in decision-making processes. Such behaviours may result in a disconnect between formal compliance and actual practice, thereby weakening governance quality. This insight provides a fresh interpretation and suggests the need to balance institutional design with behavioural and ethical dimensions of governance.

***Bridging theory and practice***. The integration of Shariah Enterprise Theory (SET) and Agency Theory into the analysis provides a useful framework for understanding both the structural and ethical imperatives of Shariah governance. While agency theory explains the mechanisms for aligning interests between managers and stakeholders, SET expands this view by incorporating accountability to broader societal and spiritual dimensions. The findings suggest that improving governance in Islamic banks is not solely a technical issue but also a moral and institutional one.

***Implications for policy and practice***. These findings point to the necessity of policy reform aimed at enhancing the competency standards for SSB members and formalizing training for ISR units. Regulatory authorities such as Bank Negara Malaysia and the Financial Services Authority in Indonesia may consider implementing standardized guidelines that mandate minimum qualifications for Shariah governance actors. Additionally, rating agencies could integrate Shariah governance indicators into their risk assessments to reflect a more accurate picture of institutional integrity and creditworthiness.

**Table 1.** Key Indicators of Shariah Governance and Financing Risk Mitigation

| Shariah Governance Element | Indicators | Impact on Financing Risk |
|---|---|---|
| Shariah Supervisory Board (SSB) | Education, experience, reputation, independence | Enhances compliance, reduces misjudgment |
| Internal Shariah Review (ISR) | Number of reviewers, educational background | Supports operational monitoring |
| Managerial Strategy | Level of influence on SSB decisions | May compromise compliance integrity |
| Gender Diversity (SSB) | Proportion of female board members | Strengthens decision diversity |
| Board Meeting Frequency | Number of formal sessions per year | Improves supervision consistency |

*Source:* Adapted from Minaryanti et al., (2024); Karbhari et al., (2024)

Table 1 outlines the key indicators that determine the effectiveness of Shariah governance in mitigating financing risk. The qualifications and independence of SSB members emerge as central factors in maintaining Shariah compliance, as they influence the accuracy of financial product assessments and decisions. The ISR, functioning as an internal auditing body, enhances day-to-day oversight and ensures the continuity of compliance. Managerial influence, however, presents a potential threat to governance objectivity, suggesting that informal dynamics must be regulated through clear policies and training. Additionally, gender diversity and frequent board meetings are shown to improve deliberative quality and monitoring effectiveness. These findings emphasize that both structural capabilities and institutional behaviors jointly affect the quality of governance and its impact on financial risk in Islamic banking.

In summary, this study contributes to advancing the understanding of how Shariah governance structures, both formal and informal, interact to shape risk outcomes in Islamic banking. It also underscores the importance of addressing human behaviour, institutional culture, and regulatory structure in improving compliance and financial resilience.

## CONCLUSIONS

This study has explored the role of Shariah governance, particularly the Shariah Supervisory Board (SSB) and Internal Shariah Review (ISR) in mitigating financing risk in Islamic banking. Through the synthesis of two key articles, the research reveals that the effectiveness of Shariah governance depends not only on the qualifications and structure of formal oversight mechanisms but also on behavioral dynamics between bank managers and Shariah board members. The findings demonstrate that well-structured and competent SSB and ISR functions contribute significantly to reducing financing risk by ensuring compliance with Shariah principles.

However, the study also finds that impression management by bank executives can influence Shariah decisions, potentially compromising the integrity of compliance. This highlights the importance of addressing both structural and cultural aspects of governance. By integrating agency theory and shariah enterprise theory (SET), this paper provides a comprehensive framework for understanding the technical, ethical, and institutional elements involved in Shariah-based financial oversight.

Overall, this study contributes to the evolving discourse on Islamic financial governance by identifying both the strengths and the vulnerabilities in current Shariah compliance practices. Future research is recommended to empirically examine how governance attributes influence credit risk performance and how regulatory frameworks can enhance Shariah board independence, particularly in different jurisdictional contexts.

## REFERENCES

Aam. (2021). Sharia Supervisory Board. *Review on Islamic Accounting*, *1*(1). https://doi.org/10.58968/ria.v1i1.69

Baig, M. M., Malik, Q. A., & Ellahi, N. (2024). Corporate Governance and Credit Rating of Islamic Banks: Moderating Role of Shariah Governance Attributes. *SAGE Open*, *14*(2). https://doi.org/10.1177/21582440241247386

Baklouti, I. (2022). Is the Sharia supervisory board a friend or an enemy of Islamic banks? *Journal of Islamic Marketing*, *13*(2), 526–541. https://doi.org/10.1108/JIMA-04-2020-0118

Budianto, E. W. H. (2023). Bibliometric And Literature Review Of Financing Risk In Islamic Banking. *JPS (Jurnal Perbankan Syariah)*, *4*(1), 79–97. https://doi.org/10.46367/jps.v4i1.1031

Ershad Uddin, A. H. M., & Kausar Alam, M. (2023). Legal and Regulatory Frameworks For Sharī'a Governance Practices in the Islamic Banking Industry of Bangladesh. *Mizanu'l-Haqq: Journal of Islamic Studies*, *17*, 663–688. https://doi.org/10.47502/MIZAN.1332588

Islahi, A. (2009). Hennie Van Greuning and Zamir Iqbal Risk Analysis for Islamic Banks The World Bank, Washington, D.C. 2008, 309+xxiii pp. *Journal of King Abdulaziz University-Islamic Economics*, *22*(1), 197–204. https://doi.org/10.4197/ISLEC.22-1.5

Karbhari, Y., Benamraoui, A., & Hassan, A. F. S. (2024). Sharia boards, managerial strategies and governance practices in Islamic banks: a Goffmanesque discourse. *Accounting, Auditing and Accountability Journal*, *37*(4), 1069–1095. https://doi.org/10.1108/AAAJ-07-2017-3037

Malim, K. A. N. (2015). Islamic Banking and Risk Management: Issues and Challenges. *Journal of Islamic Banking and Finance*.

Minaryanti, A. A., Fitrijanti, T., Sukmadilaga, C., & Mihajat, M. I. S. (2024a). The role of Sharia governance in minimizing credit risk in Islamic banking: a systematic literature review. In *Journal of Islamic Accounting and Business Research*. Emerald Publishing. https://doi.org/10.1108/JIABR-11-2022-0301

Minaryanti, A. A., Fitrijanti, T., Sukmadilaga, C., & Mihajat, M. I. S. (2024b). The role of Sharia governance in minimizing credit risk in Islamic banking: a systematic literature review. *Journal of Islamic Accounting and Business Research*, *ahead-of-print*(ahead-of-print). https://doi.org/10.1108/JIABR-11-2022-0301/FULL/XML

Muhfiatun, Prasojo, P., Listiyorini, I., & Utami, R. D. (2024). Shariah Governance Practice on Indonesian Islamic Banks. *Journal of Business*

*Management and Islamic Banking*, *3*(1), 1–14. https://doi.org/10.14421/JBMIB.V3I1.2112

Neifar, S., Salhi, B., & Jarboui, A. (2020). The moderating role of Shariah supervisory board on the relationship between board effectiveness, operational risk transparency and bank performance. *International Journal of Ethics and Systems*, *36*(3), 325–349. https://doi.org/10.1108/IJOES-09-2019-0155

OECD. (2004). *Principles of Corporate Governance*. Organization for Economic Cooperation & Development.

Sarkis, J., Zhu, Q., & Lai, K. H. (2011). An organizational theoretic review of green supply chain management literature. In *International Journal of Production Economics* (Vol. 130, Issue 1, pp. 1–15). Elsevier B.V. https://doi.org/10.1016/j.ijpe.2010.11.010

Shafique, E., Aymen, D.-E.-, & Shahzad, M. A. (2022). Competency of Shariah Auditors in Islamic Banking Institutions: Challenges and Pragmatic Solution. *International Journal of Islamic Economics and Governance*, *3*(2), 1–17. https://doi.org/10.58932/MULD0015

Yasoa', M. R., Wan Abdullah, W. A., & Endut, W. A. (2020). A Comparative Analysis between Shariah Audit and Shariah Review in Islamic Banks in Malaysia: Practitioners' Perspective. *Environment-Behaviour Proceedings Journal*, *5*(14), 195–200. https://doi.org/10.21834/ebpj.v5i14.2208

Yuliani, F. D., & Fithria, A. (2022). The Effect of Implementing Good Corporate Governance on the Profitability and Financing Risk of Sharia Commercial Banks. *EKONOMIKA SYARIAH : Journal of Economic Studies*, *6*(1), 01. https://doi.org/10.30983/es.v6i1.4863