

# THE EFFECTS OF SHARIAH GOVERNANCE ON TAKAFUL PERFORMANCE OF TAKAFUL OPERATORS IN MALAYSIA

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**Abstract:** *This study investigates the relationship between the Shariah Governance and the financial performance of Takaful operators in Malaysia. There are a lot of researches focused on determinants factors that affecting the financial performance of banks rather than insurance companies especially in Malaysia. Thus, this study is very important and beneficial to regulators, investors and customers. By understanding determinants contributing to the financial performance, the regulators could play a vital role in helping Takaful operators to increase their market share. Hence, the objective of the paper is to investigate the relationship between shariah governance and financial performance of Takaful operators in Malaysia. Data were gathered using secondary data collection method from annual report for each of Takaful operators and Bank Negara Malaysia from year 2018 until 2022. The data consist of profitability, Shariah Committee, Shariah Risk Management and Shariah Review for 5 registered Takaful operators in Malaysia namely; Syarikat Takaful Malaysia Berhad, Takaful Ikhlas Sdn Bhd, Prudential BSN Malaysia Berhad, Sun Life Malaysia Takaful Berhad (CIMB Aviva Takaful Berhad) and Hong Leong MSIG Takaful Berhad. Data were analysed using multiple regression analysis. From the analysis, Shariah Committee was found significantly positive effect towards financial performance. In contrast, Shariah Risk Management and Shariah Review were found significantly negative effect related to the financial performance. Thus, this study is very important and beneficial to regulators, investors and customers. As recommendation, Takaful operators should improve their effectiveness of the Shariah Governance through expanding the size of Shariah Committee, hiring more experts in Islamic and risk management in designing effective policy for the Takaful operators. Regulators could use this study to formulate of suitable and useful ways to efficiently supervise the operations of Takaful insurance.*

**Keywords:** *Shariah Governance, Takaful Operators, Malaysia*

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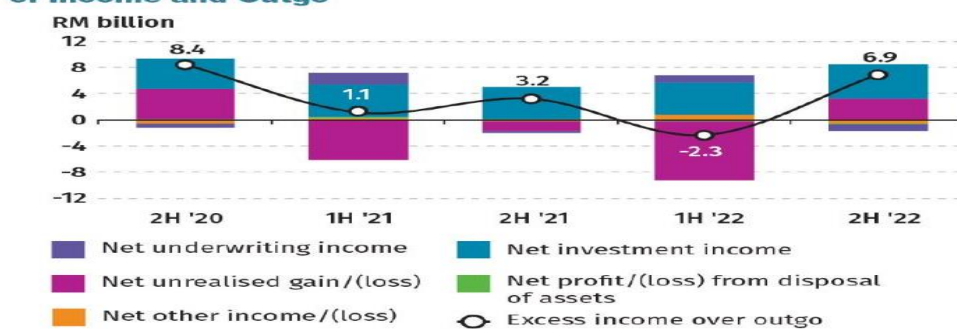
## Introduction

Takaful or Islamic insurance is coined from the Islamic word kafalah, which means ‘guaranteeing each other’ or ‘joint guarantee’. This concept which is grounded in Islamic Muamalat, observing the rules and regulation of Islamic law that involves participants and operators. Participants will contribute a certain amount to a fund as his or her obligation and managed by a third party which is called Takaful operators as a protection and profit sharing venture. Takaful operators will disburse the funds accordingly to its participants when the event of loss or damage suffered. In Malaysia, there are 11 registered Takaful operators which included 2 foreign and 9 local Takaful operators. According to statistics by Bank Negara Malaysia (BNM), Takaful operators have been showing rising from the year 2010 until 2019. It is supported by Fitch Ratings report, where Malaysian Takaful sector saw strong growth in 2019. Besides that, BNM also reported Malaysia dominates two-third market share of Takaful in ASEAN.

Financial performance is a primary concern in all types of industry including with Takaful industry. Financial performance is an indicator for organization’s well-being and ultimately its subsistence. The good financial performance reflects the management effectiveness and competence in using the company resources. The profitability of insurance and takaful funds improved in the second half of 2022 (2H2022) amid better investment returns, Bank Negara Malaysia (BNM) said in its Financial Stability Review report for 2H2022 as shown in Figure 1. Life insurance and family takaful funds’ excess income over outgo jumped 116% to RM6.9 billion in 2H2022 compared with RM3.2 billion in 2H2021.

In addition to that, there are a lot of researches focused on determinants factors that affecting the financial performance of banks rather than insurance companies especially in Malaysia. Thus, this study is very important and beneficial to regulators, investors and customers. By understanding determinants contributing to the financial performance, the regulators could play a vital role in helping Takaful operators to increase their market share. For investors, they can choose their investment places while customers will select the best Takaful operators for their Islamic insurance protection. Hence, this study used ROA to measure financial performance as dependent variable, whereas Shariah Committee, Shariah Review and Shariah Risk Management as the independent variables, in identifying the factors that affecting the financial performance of Takaful operators in Malaysia. Hence, the objective of the paper is to investigate the relationship between shariah governance and financial performance of Takaful operators in Malaysia.

**Life Insurance and Family Takaful Fund – Composition of Income and Outgo**



Note:  
1. Data excludes investment-linked unit funds.  
2. Net underwriting income refers to excess of net premium after deducting benefit payouts, agency remuneration and management expenses.

Source: Bank Negara Malaysia

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Source: Bank Negara Malaysia (2022)

## Literature Review

### Financial Performance

Financial performance is an essential to management as the act of performing the financial activity. It can be used to compare with similar companies across the same sectors to measure overall financial health at a certain period. BenSaid (2023) stated that assessing the financial performance of companies can be measured by Return on Assets (ROA) which focuses the company's ability to earn profit from its assets. Based on the study done by Suhadak et al. (2018), the study relies on the assumptions that financial balance influences most of the indicators towards company's performance. Lestari et al. (2022) also suggested that although there are different ways to measure profitability, ROA is the best measurement to measure the financial performance.

### Shariah Governance

The Islamic Financial Services Board defines Shariah governance as the set of institutional and organizational arrangements through which IFIs ensure that there is effective and independent oversight of compliance with Shariah principles of each unit of the structures. Given the market maturity and heightened business complexity in the operations of Islamic financial institutions, BNM has recently issued Shariah Governance Policy (SGP) on 20 September 2019, which supersedes the SGF. In line with the BNM's strengthened expectation for effective Shariah governance in IFIs, the new and revised version of SGP aims to enhance the oversight accountabilities of the board, Shariah committee, and senior management.

The SGP highlighted that the board of directors, the Shariah Committee, and the management are the key players responsible for the Shariah governance of the IFIs. Although the board is ultimately accountable and responsible for the overall Shariah governance framework and Shariah compliance of the IFIs, the Shariah Committee has to advise the board and provide all the input to IFIs regarding Shariah matters. In essence, it is the Shariah Committee that is accountable and responsible to the decisions and opinions of the Shariah related matters (Hussain, 2019). Shariah compliance is indeed an important factor in IFIs because it provides the legitimacy of the operations and practices (Saad & Abd Rahman, 2018). As an independent body that supervises the Shariah issues and compliance, Shariah Committee is seen as pivotal in ensuring the development and success of the respective institutions (Ghayad, 2008). In addition, Eldaia, Mohd Hanefah, Marzuki, and Shatnawi (2020) also indicates that Shariah Committee quality plays a significant role in moderating the relationship between the audit committee characteristics and the performance of the Malaysian takaful performance. This signifies the important role played by the Shariah Committee in the governance of IFIs. The requirement to establish the Shariah Committee is stipulated in the Islamic Financial Services Act 2013 (IFSA) as follows: 30. (1) A licensed person shall establish a Shariah committee for purposes of advising the licensed person in ensuring its business, affairs and activities comply with Shariah.

Furthermore, Shariah Risk Management is very crucial in Takaful organization. A Takaful Operator is expected to manage risks in two primary areas: the investment aspect, where hazards such as underwriting and investment risks occur. Risk management is a process in the Takaful sector that involves recognizing prospective losses for an operator and selecting the most appropriate strategies for dealing with those potential losses when they arise (Abu Al-Haija and Houcine, 2023). Among the most critical areas of risk management for takaful operations are Shariah compliance, investment activities management, and human resources

administration. Ineffective risk management may result in liquidity problems, unsuccessful procedures, and the likelihood of continuing the firm in the future. It is frequently the result of a lack of structured risk management practices, including risk detection, analysis, and control (Tah&Carr, 2001). Failure to follow up on risks across the various stages of risk management and a lack of communication among the different partners could result in ineffective risk management (Liu, Li, Lin, & Nguyen, 2007).

### Research Method

Data for this study were obtained using secondary data collection method. The data consist of profitability, Shariah Committee, Shariah Risk Management and Shariah Review for 5 registered Takaful operators in Malaysia namely; Syarikat Takaful Malaysia Berhad, Takaful Ikhlas Sdn Bhd, Prudential BSN Malaysia Berhad, Sun Life Malaysia Takaful Berhad (CIMB Aviva Takaful Berhad) and Hong Leong MSIG Takaful Berhad. A total of 11 registered Takaful operators but only 5 Takaful operators were selected because the limitation of data. The data were collected from annual report for each of Takaful operators and Bank Negara Malaysia from year 2018 until 2022.

### Conceptual Framework

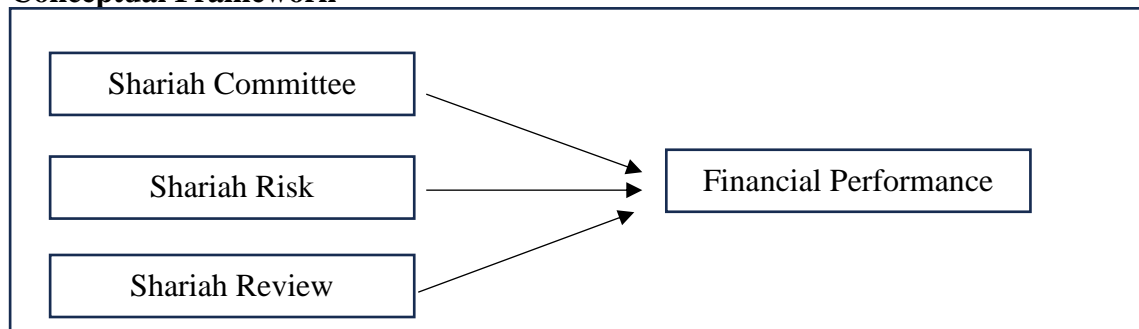


Table 1

Variables	Proxies	Formulas
Financial performance	Return on assets	Net income ÷ Total assets
Shariah Committee	Number of Shariah Committee	Total number of Shariah Committee Members
Shariah Risk Management	Disclosure on the Shariah Risk Management Policy and function	Dichotomous variables of 0 and 1
Shariah Review	Disclosure on Shariah review and Shariah Audit activities	Dichotomous variables of 0 and 1

### Regression model

This study used multiple regression analysis to investigate the effects of Shariah Committee, Shariah Risk Management and Shariah Review on financial performance of Takaful operators in Malaysia. The regression models used in this study are as the following:

$$FP = \alpha_0 + \beta_1(SC) + \beta_2(SRM) + \beta_3(SR) + \epsilon$$

Where:

FP = financial performance;  $\alpha$  = constant value;  $\beta$  = regression coefficient; SC = Shariah Committee; SRM = Shariah Risk Management; SR = Shariah Review; and  $\varepsilon$  = residual term  
Based on the preceding discussion, five hypotheses are developed:

*H1: There is a significant effect of Shariah Committee towards financial performance of Takaful operators in Malaysia.*

*H2: There is a significant effect of Shariah Risk Management towards financial performance of Takaful operators in Malaysia.*

*H3: There is a significant of Shariah Review towards financial performance of Takaful operators in Malaysia.*

### Findings

Table 2 presents the multiple regression analysis, in which to identify the effect of Shariah Committee, Shariah Risk Management and Shariah Review towards financial performance of Takaful operators in Malaysia. Based on the Table 1, Shariah Committee (p-value = 0.000, t = 6.451) was found to be positively and significantly related to financial performance. This result is consistent with the assertion by Eldaia et al. (2023). It shows positive effect of Shariah Committee quality with the performance. This result indicates that a high level of Shariah Committee quality will improve the performance.

On the other hand, Shariah Risk Management (p-value = 0.000, t = -3.231) and Shariah Review (p-value = 0.032, t = -2.106) were found to be negatively and significantly related to the financial performance. This is consistent with Zain et al. (2022) with the argument that it is crucial for the Takaful operators to carry out the responsibilities by the principles of Shariah as otherwise the risk of Shariah non-compliance would be triggered. The negative relationship with the performance has shown the risk exist in Takaful operations and the failure to adhere to the compliance will jeopardize the relationship between takaful operator and the takaful fund and expose the takaful operator to reputational damage.

In addition, R-squared value for financial performance is 0.561 indicating that 56.1% of the variation of determinants factors that affecting the financial performance of Takaful operators in Malaysia, could be explained by the 3 independent variables. The remaining 43.9% variance in the financial performance is an unexplained variation which due to the unpredictability or exclusion of some important independent variables in the model. After adjusting for the degrees of independence, the value of the coefficient of determination has declined to 55.9%. There is a possibility that one of the variables in this model does not have a strong relationship with the financial performance. Besides, p-value for F-statistic is 0.000 which is below than 5% significance level and thus, accept the hypothesis and the model have a good fit. Hence, the regression model demonstrates leverage, liquidity and firm size significantly influence financial performance at 95% confidence interval.

Last but not least, Variance Inflation Factor (VIF) test is to avoid bias decision making process that will affect a part of independent variables on the dependent variable. Based on the table 1, VIF test shows that the degree of multicollinearity is not severe. According to Gujarati (2003), the values of VIF for all independent variables should be less than 5 and it indicates that the data has no multicollinearity problem.



**Table 2**

Variables	$\beta$	t-value	p-value	VIF
Shariah Committee	0.222	6.451	0.000	1.010
Shariah Risk Management	-0.142	-3.321	0.000	1.269
Shariah Review	-0.014	-2.106	0.032	1.266
R-squared	0.561			
Adjusted R-squared	0.559			
F-statistic	21.725			
Prob (F-statistic)	0.000			

### Conclusion

The main purpose of this study has been answered where all the independent variables, Shariah Committee, Shariah Risk Management and Shariah Review are affected to the Takaful operator's financial performance. From the findings, Shariah Committee has significantly positive effect related to financial performance. This indicates that Takaful operators require an effective shariah committee for improved financial performance using Shariah compliance practices and activities. Hence, the Takaful operators need to cautiously select effective Shariah Committee for high financial performance.

However, Shariah Risk Management and Shariah Review have significantly negative effect towards financial performance of Takaful operators in Malaysia. This is due to the amount of risk and when it comes to investing in takaful funds, the highest level of care must be taken. Hence, it is very critical to conduct periodic internal assessment to control the risk.

This evidence could serve as a reference to make up Shariah Committee with these effective Shariah governance mechanism in developing countries to overperform other companies.

### Limitations and future research

There is obvious limitation while conducting this study in terms of data collection. In Malaysia, we have 11 registered Takaful operators, however, this study only used 5 Takaful operators due to limited accessibility in collecting the data. In addition, these 5 Takaful operators were among the earliest local operators that registered in Bank Negara Malaysia. Thus, this study would be an indicator to the other Takaful operators in sustaining their performance.

**Table 3**

Hypothesis	t-value	p-value	Remark	Result
H1	6.452	0.000	Accept	Supported
H2	-3.321	0.000	Accept	Supported
H3	-2.106	0.032	Accept	Supported

## Acknowledgement

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