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Impact of Audit Committees in Islamic Banks: Corporate Governance and Financial Risk Under Sharīʿah Law in Pakistan

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Abstract. To explore the impact of corporate governance especially audit committees on the financial risk of Islamic banks in Pakistan under Sharīʿah law. The study used panel data between (2018-2022) of Islamic banks in Pakistan. To facilitate the data analysis, we employed the fixed effect model in panel data regression. The study highlights that Islamic bank in Pakistan maintain a healthy financial position, with an average NPF of 3.91%, indicating strong risk management. Regression analysis confirms significant negative effects of audit committee size (ADC) and return on assets (ROA) on NPF, with coefficients of -0.199 (p = 0.0052) and -10.2036 (p = 0.0099), respectively. These findings emphasize the importance of profitability and effective audit committees in reducing financial risks. However, SSB1 and SSB2 show no significant relationships, with p-values of 0.3838 and 0.1045, respectively. The fixed-effect model, validated by the Chow test (p = 0.000), ensures the robustness of the analysis. The major limitation of the research is time and resources and the availability of the quality and quantity of data. We conclude that due to the ultimate need to reduce financial risk, auditors must play an important role in banks, including Islamic banks. Our findings suggest that Islamic banks need to ensure audit committees operate efficiently. An effective system in Islamic banks that enhances accountability and transparency will be in the collective interest of society to enhance financial risk management First, to the extent of our knowledge, there is no previous research conducted to examine the effect of the effectiveness of audit committees. Second, our study aims to provide empirical evidence on the effect of audit committee effectiveness on financial risk in Islamic banks.

Keywords: Islamic Banks, Corporate Governance, Financial Risk, Sharīʿah Law

***JEL Classification*:** G21, G32, G34, K10

***KAUJIE Classification*:** E22, E23

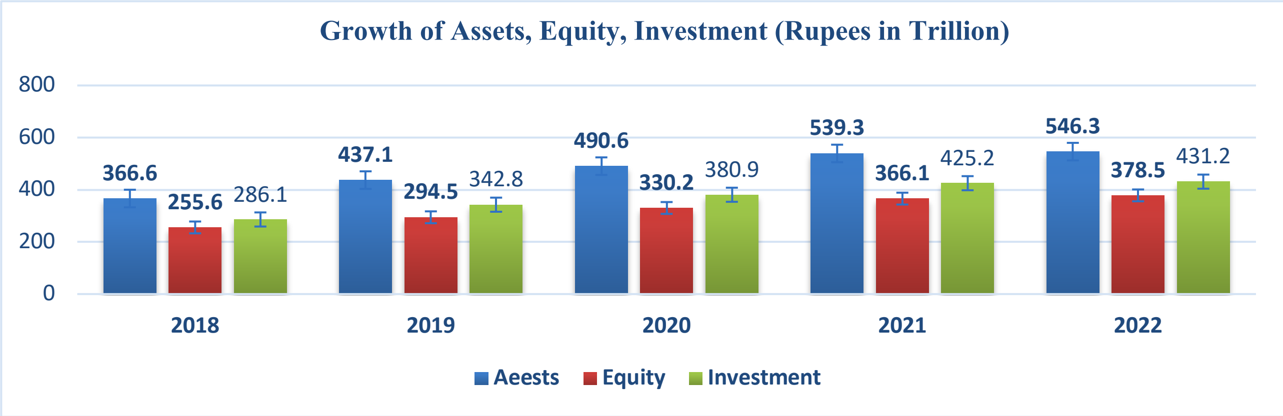
1. Introduction

Islamic banking has steadily gained prominence across Pakistan over the past few decades. It has carved a unique niche as a financial system adhering strictly to Sharīʿah law ethical standards. This article examines how Islamic banks in the country ensure sound corporate governance and prudently manage risk, as per Iqbal et al. (2023). Upholding transparency, accountability and integrity is paramount for Islamic banks to honor high governance standards. According to Khan et al. (2022), corporate governance in Islamic banking echoes Sharīʿah principles of fairness, justice and social responsibility. To cement effective oversight, Pakistani Islamic banks have instituted varied measures such as Size of the supervisory board: Charged with charting strategic direction, overseeing hazards and confirming adherence to regulations, the board involves executive and non-executive members well-versed in Islamic finance, as discussed by (Najwa et al., 2019). Sharīʿah supervisory board: Mandated to independently supervise transactions and endorse Sharīʿah -compliance, this assembly of Islamic legal specialists scrutinizes complex deals and novel commodity/service offerings, as explored by (Meslier et al., 2020).

Islamic banks have always prioritized financial risk given their responsibility to ensure long-term viability. Pakistan employs various techniques, balancing complexity and prudence. Unlike their conventional counterparts, Islamic institutions operate through profit and loss sharing with customers, incentivizing caution and mitigating moral hazards. Precluded from interest under Sharīʿah, alternatives like profit sharing, leasing and trade financing generate sustainable income. Additionally, assets always back investments to reduce default likelihood while confirming allocation according to real economic needs. However, constant evaluation remains imperative as global conditions change and diversification proves necessary for weathering uncertainty. Going forward, balancing innovation with established practices while upholding the underlying principles will help Pakistani Islamic banks succeed financially and fulfill their social objectives (Saqib et al., 2015; Rasli et al., 2017 and Utami et al., 2020).

Islamic finance institutions have significantly expanded over the past 20 years, and they now play a significant role in the international financial system (Mahdi et al., 2018; Iqbal et al., 2025). One of the banking industries' fastest-growing segments is Islamic banking. The banking services authority (FSA) has compiled the following information on Sharīʿah banking growth. Islamic banking is a growing global phenomenon with huge potential. Islamic banking has become increasingly popular in recent years, with Sharīʿah-compliant banks increasing by nearly 30% in 2018. Over the years, this growth will continue, and Shari'ah banking will play an increasingly significant role in the global financial system (GFS). To fully realize Sharīʿah banking's potential, it is imperative to comprehend its consequences.

Figure 1: Growth of assets, Equity, Investment and External funds

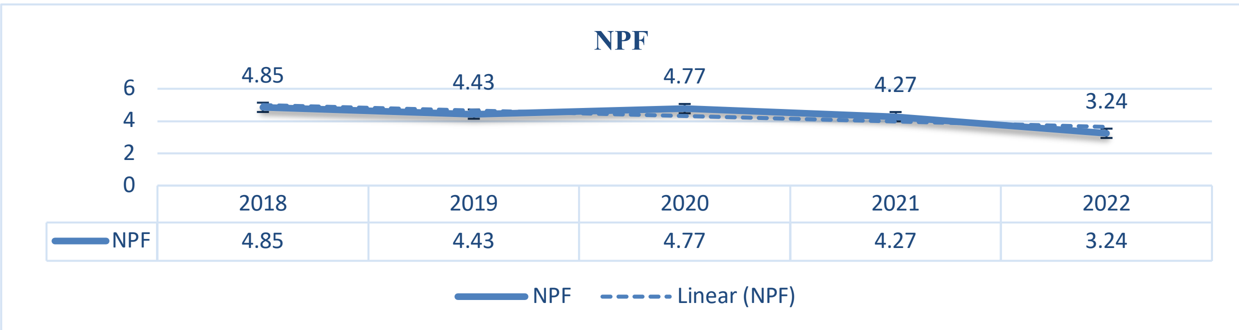


Source: **Financial services evidence 2022.**

The aforementioned data suggest that IBs in Pakistan are expected to increase their assets, equity, and investment between 2018-2022. It has become increasingly imperative for researchers to examine the risk relationship with IBs financing in Pakistan as the market divide for IBs financial services has risen to generate larger profits. Sobarsyah et al. (2020) The relationship between lending growth, investment by IBs, and financial risk in IBs is examined. Ultimately, the study of financial risk in Islamic banking is a crucial area of research that can inform policymaking and risk-management strategies. The study was conducted as a result of the economic disaster, & the results revealed that Islamic banks' commercial and operational environments had matured since the pre-crisis period between 2018 and 2022. Banks must develop regulations to ensure Islamic financial system expansion and sustainability. All in all, Islamic banks have matured significantly since the financial crisis, but further regulations are needed to sustain their growth and development.

Financial Services Authority Circular Letter No. 11/PakSBP.04/2015 and Financial Services Authority Regulation No.9/PKSBP.04/2015 require that a bank's soundness level be assessed independently and correlated with a hazard-based method (Risk-Constructed Bank Score). NPF (non-performing financing) is utilized in this study to assess the risk profile, one of the evaluations utilizing the RBBR technique. A measure called NPF quantifies how difficult banks face in obtaining finance (Rassizal et al., 2021; Iqbal et al., 2025). As a result, it is a critical component of evaluating a risk profile. NPF is a significant aspect of risk profiles. Between 2018 and 2022, Islamic banks' NPF will progress as follows:

Figure 2: based on the growth of Islamic banks' NPF between 2018 and 2022, Figure 2 can be viewed as follows.



Sources of SPS from 2018 to 2022

Based on the data, it may be concluded that Islamic bank and NPF has remained healthy over time. However, health levels have been less consistent, increasing and decreasing annually. As a result, the bank can effectively manage problematic funding. Accordingly, an NPF value of less than 6% may be considered suitable in accordance with PKSBP value 9/PKSBP.04/2015, which concerns the reliability rating of Islamic banks & Shari'ah corporate components, or PKSBP amount 5/PKSBP.04/2017, which concerns commercial banks' rating. BUS is performing well, as evidenced by its average NPF ratio of 2.10%. According to Rizal et al. (2021); Wahasusmiah et al. (2018), a bank's performance and operations are higher the lower its NPF. Consequently, BUS is well-positioned to continue its growth and development in the Sharīʿah banking industry. As an indicator of financial system stability, financial risk is often used by international organizations and policymakers (Tekathen et al., 2013). Banks and the global financial system depend on effective financial risk management. According to Greuning et al. (2003), financial risk is defined as a borrower's inability to repay the loan on the agreed-upon terms. Financial risk, according to some experts, is a bank's biggest financial risk (Campbell, 2007). Risking misappropriated funds might result in an ineffective government. In order to promote excellent corporate governance and generate value for all stakeholders, effective risk management is therefore essential (Greuning & Bratanovic, 2020). Banks need proper risk management to avoid unnecessary losses and ensure sound corporate governance.

Using agency theory, which addresses agency issues arising from conflicting interests, we can understand financial risk. In their paper, Jensen and Meckling (1976) examine agency issues, discussing profit, data irregularities, and the ensuing expenses associated with these conflict situations. There is no doubt that these costs are substantial. Therefore, some scholars believe they can be minimized through the establishment of governance structures that effectively regulate management behaviour. There is a specific place in these procedures for the commissioner’s board. The board of directors is critical in a complicated industry like banking since administrators are answerable to shareholders, depositors, and regulators. There is a need for a uniform risk management policy across all complex sectors (Pathan, 2009; Iqbal et al., 2023). Thus, the board of commissioners sets risk management policies for all banking operations.

Bank governance systems include rules and internal controls. Effective implementation of a risk management strategy helps control managerial behaviour and ensure bank rules are properly followed while affecting the methods of risk management. Hence, the banking governance system appears to be the best way to decrease bank risk. In the banking industry, the board of directors is the effective control mechanism because the industry is connected with complexity. Banks should implement an efficient risk management strategy system to decrease the risk of bank failure. Companies are responsible for meeting the demands of all stakeholders. This includes shareholders, authorities, and managers. Therefore, parties are required for effective governance. To sum up, it is apparent that the banking system of governance must be properly run for banks to mitigate risk and fairly consider all stakeholders (Andres & Vallelado, 2008).

This study explores corporate governance with respect to financial risk and Pakistan Islamic banks. The following are reasons why banking should finance risk research. To begin with, financial risk is one of the criteria used to judge bank business performance. Haniifah, (2015); Iqbal et al. (2023) say high NPF levels hurt bank earnings and continuous operations. Therefore, the banking sector should invest in risk research to increase stability and profitability. Additionally, high NPF ratios have negative effects on the country's economy and banks. Abdul-Rahman et al. (2017) argue that if NPF is not well-managed numerous instances of bank collapse and financial collapse will occur. At the same time, other scholars have conducted research on the impact of board governance on financing risk. Furthermore, the NPF ratio is an effective instrument to stabilize the country's economy and the banking sector. In 2020, Rafay conducted research on corporate governance and the size of boards of directors. Aside from the NPF ratio, the independent commissioner board was the first. Islamic banks are the variable or subject of this study. The researcher asserts that the Sharīʿah Supervisory Board plays this role. Corporate governance mitigates financing risk. Therefore, the Sharīʿah Supervisory Board is a fundamental instrument in reducing financial risk in Islamic banking (Farag & Mallin, 2015).

Aslam and Haron (2021) argue that board size may influence banks risk-taking. Other studies have shown that bank risk and board size are positively related. This is because each director’s experience and skill lead to a better risk management process and decreased financial risks. It is clear that the optimum size of a board of directors is required for effective risk management in banks. The audit committee is considered one of the most significant committees in banks and the banking sector as a whole. This is because of its control over bank operations and the potential to improve internal and external audits. Banks must ensure banks' long-term survival by appointing a competent audit committee. As a result of improved efficiency and effectiveness of audit committees, one of corporate governance standards, the danger of extensive business losses has fallen. In conclusion, the audit committee’s role and importance are indispensable to effective financial management and risk mitigation in the banking sector (Al et al., 2019). A Sharīʿah Supervisory Board composed of Sharīʿah scholars well-versed in Fiqh Muamalat, should exist within Islamic banking institutions. The SSB is vital to the Islamic banking sector. Although they operate separately, they are selected by Board of Directors recommendations. In the end, the Sharīʿah Supervisory Board is essential in ensuring the responsible and ethical functioning of the Islamic banking sector. SSB is mainly responsible for approving financial products and services and inspecting operations so as to ensure that business practices are consistent with Sharīʿah law. This is for shareholders and stakeholders. As a result, the Sharīʿah Supervisory Board is crucial to the efficient functioning of the Islamic banking sector (Khan et al., 2022).

SSB is viewed as a complementary layer of corporate governance to reinforce the Board of Supervisors' general surveillance function (Nomran et al., 2016; Mollah et al., 2015). Therefore, SSB serves as a reliable method for corporate governance. Islamic institutions display high levels of disclosure and symptoms and consequences. At present, SSB is a valuable tool for Islamic banks to preserve compliance and reduce financial risks (Nomran et al., 2016; Rana et al., 2024). Ultimately, with increased disclosure and transparency, Islamic banks also take fewer risks, which creates investor confidence and profitability. In conclusion, SSB is a valuable instrument for Islamic banks to follow Sharīʿah law and reduce financial risks. Also, SSBs are dedicated to seeking not personal gain but basic virtues and principles, as well as fighting against growing social inequality (Mollah et al., 2017). Therefore, SSB can be said to further Islamic banking. SSB authority serves as an independent operating tool, enabling senior finance administrators to avoid financial risks. The SSB is a critical tool for Islamic banks' core business.

Consequently, the banking sector can only have stability through investment in risk research. There was a previous study that examined the relationship between board governance structure and financing risk: (Farag & Mallin 2015). However, there is hardly any research available specifically to investigate the role of Sharīʿah Supervisory Boards (SSB) in Islamic banks. This paper aims to provide research and develop empirical studies on how SSB may minimize financial risk, and bring better corporate governance through Islamic banking. Corporate governance and risk management are at the core of bank sustainability and growth, as well as survival. It is the job of the Sharīʿah Supervisory Board, as agreed by them, to ensure that Sharīʿah principles are adhered to. It reduces financial risk and encourages ethical banking practices. The paper emphasizes the importance of governance systems in reducing financial risks and making Islamic banking growth in Pakistan sustainable (Haniifah, 2015; Iqbal et al., 2023).

2. Literature Review

2.1 Agency Concept

Agency theory is a result of the conflict between ownership and control. It emphasizes that to maximize efficiency and performance in an organization there must be a clear distinction between ownership and management. The concept of agency, historically speaking, comes from ownership, which divides investors and instruments or boards of directors (Eisenhardt et al., 1989). Agency theory is a key concept in understanding how ownership and control combine to shape organizational behavior. The controlling of a corporation splits and management is accepted by both the holders (the investors) and the agents (the officials) because of this agency conflict (Hendrastuti et al., 2023). Agency theory is a central concept in understanding ownership and control dynamics shaping organizational behavior. According to Farag et al. (2015) included in corporate governance is the evolution of policies and rules that confirm responsibility, liability and neutrality. In addition, policies and rules maintain standards of equity and public obligation for investors. This approach can be taken forward into future practices. These policies and rules form the foundation of corporate governance, and must be implemented in a ethical and sustainable business environment. The system of corporate governance has played a significant role in Islamic banks' operations to withstand exogenous shocks, especially external economic tests (Berger et al., 2016). Therefore, corporate governance is central importance to the construction of a sustainable and ethical Islamic banking sector.

With their expertise and qualifications, commissionaires play a pivotal role in overseeing and advising on bank governance. In this way, they are a positive resource for the banking industry. Corporate governance is essentially a tool used by shareholders to defend their capital from management and retain return on investment. Aslam et al. (2021) commissions, because of their knowledge and experience are crucial to ensuring corporate governance works well in the banking industry. With financial risk exposures, we will look at the audit committee, the Sharīʿah Supervisory Board, and the Board of Directors. These are the three main issues under corporate governance examined in this study. In short, these three elements are essential for the proper functioning and corporate governance of the banking industry.

Table 1: Encapsulates the primary elements discussed in the context of agency theory and corporate governance in Islamic banking.

Concept	Description	References
Agency Theory	Result of conflict between ownership and control. Emphasizes the need for clear distinction between ownership (investors) and management (agents).	Eisenhardt et al. (1989)
Ownership and Control	Ownership (investors) and control (boards of directors) are divided, leading to agency conflict.	Hendrastuti et al. (2023)
Corporate Governance	Policies and rules to ensure responsibility, liability, neutrality, and maintain standards of equity and public obligation for investors.	Farag et al. (2015)
Ethical Business Environment	Corporate governance must be implemented in an ethical and sustainable manner, forming the foundation for future practices.	Berger et al. (2016)
Islamic Banks Operations	Corporate governance helps Islamic banks withstand exogenous shocks, especially external economic tests.	Berger et al. (2016)
Role of Commissionaires	Experts who oversee and advise on bank governance, ensuring effective corporate governance and protecting shareholders' capital.	Aslam et al. (2021)
Corporate Governance Tools	Shareholders use corporate governance to defend their capital and retain return on investment.	Aslam et al. (2021)
Main Issues in Corporate Governance	Audit Committee, Sharīʿah Supervisory Board, and Board of Directors are essential for proper functioning and corporate governance in the banking industry.	-

Source: Authors' Own

2.2 Financial Risk and Board of Supervisors Size (SSB)

Agency theory says a bank's decision to accept risk may be influenced by its board size. Therefore, when making risk management decisions, you must consider board size. Consequently, a number of studies have revealed there is a positive correlation between bank risk and the size of board members. In sum, financial risk is shaped by the board of director's size. Because of this, diversity and experience among directors all contribute to improved risk management and financial risk reduction (Iqbal et al., 2023 and Rasli et al., 2017). Banks realized the right to authority in 1984, when it established a board of directors and let parliament alone conduct its affairs. Banks should carefully select their board of directors and allocate resources corresponding to the degree of risk they wish to manage. As a consequence of shareholder moral hazard, a small board size is also equated with a high level of risk. This is because shareholders promote excessive risk-taking at the expense of other stakeholders. Banks should therefore maintain the right board size and allocate resources to manage risk effectively.

Pakistani banks, they found that the smaller the board size, the lower bankruptcy and overall risk of failure. Their results, taken as a whole, show that smaller boards can be much more productive than commonly thought in preventing economic crisis. Likewise, Switzer (2013) declare that larger boards will lessen the impact of unusual events, bankruptcy, systemic risk and overall risk in American banks. Thus, one can argue that larger boards save financial institutions money on bankruptcy protection and financial risk management. So based on my overview of the preceding paragraphs, the following hypothesis can be formulated:

H1: The size of Islamic bank supervisory boards (SSB) is negatively related to financial risk.

2.3 Financial Risk and Sharīʿah Supervisory Board (SSB)

In addition to being an independent unit of Islamic banks, the Sharīʿah Supervisory

Board consists of Sharīʿah scholars knowledgeable about Fiqh Muamalat, the Islamic law governing commercial transactions. Therefore, what they operate on is tantamount to the Islamic banking system's safety. The Board's mission is to provide guidance and assistance to ensure compliance with Islamic law among IBs. Although working independently, they are nominated by the BOD. Ultimately then, the Sharīʿah Supervisory Board is of significant importance in upholding the Islamic banking system rules and regulations. SSB Provides support for financial statements of products and services, archival data on these operations and actions and confirmation that Sharīʿah law is followed. There can be no exaggeration about the importance of the Sharīʿah Supervisory Board for the Islamic banking system. SSB is seen as adding another layer of corporate governance to support the responsibility of directors in supervising a company, as quoted by (Mollah et al., 2015; Nomran et al., 2016). In the end, the Sharīʿah Supervisory Board upholds ethical and professional business standards for a financial institution. On the whole, an SSB is crucial to guarantee ethical and Sharīʿah -compliant operations of IBs.

Islamic banks follow Sharīʿah principles and boast high transparency levels, incurring high financial risk. However, with careful management over a period of time, such risks can be eliminated. In light of further major breaches of these regulations, it has led to self-regulation by the Islamic banking industry and increased transparency. Finally, Islamic banks are stabilized and the overall financial system is safer. Moreover, Mollah et al. (2017) found that instead of greed and egalitarianism, SSB guides IBs in pursuing noble virtues and basic ethics. With increased transparency and disclosure Islamic banks remain stable, ethical and profitable. SSB's multi-layer governance system functions as an independent monitoring and control mechanism against unnecessary risks. This governance system assures SSB's financial stability and is risk-free. Therefore, the SSB is critically significant for Islamic banks to be profitable. Based on the above description, the hypothesis on the impact of financial risk in Islamic banks by the Sharīʿah supervisory board (SSB) is offered as follows:

H2: The Sharīʿah supervisory board (SSB) negatively impacts financial risk in Islamic banks.

2.4 Financial Risk and Audit Committee

A review of audit committee members has already been conducted by BW (Oussii et al. 2020; Pillai et al. 2017 and Iqbal et al., 2023). The intention is to offer some insight into audit committee surroundings and bank governance in general. When a team audits you, Rafay (2020) says it reinforces responsibility and openness. Audit committees play a crucial role in effective banking governance. Real estate investment trusts (The University of Chicago Press) committed serious errors and were redeemed in 1984. Agency theory posits that when a manager's selfish pursuits do not match stockholder desires, agency costs accrue (Khan, 2017). This negative sum dividend makes some shareholders' interests improve the majority. Audit committees protect shareholders' interests by creating an institutional safety net. Audit committees play an integral role in maintaining discipline and confidentiality. Corporate governance, as we understand it today and some bankers will appreciate this, simply would not exist but for the audit committee. It is this institution of representatives in an organization that unites all contracting parties together. Audit committees also act as a kind of good governance tool for a period of 10 years. Organizations with established audit committees might be operating, unsurprisingly, based on agency theory - one that was hierarchical based on the perceived need to maintain social order inside the organization. Business can improve decision making and risk management processes by having an audit committee. A more extensive audit committee can exercise more judgment about banking operations. Abdeljawed et al. (2020); Iqbal et al. (2017) and Qamar et al. (2023) If its widely distributed capabilities are considered. And so, the size of audit committees really defines school organizational effectiveness. All in all, an organization's governance structure is better off with an audit committee, it has more chance of success that way. To preserve its integrity, size and composition should be reviewed regularly. Thus, it is a must to ensure the audit committee is staffed adequately and well supported, as completing its task responsibly is largely achieved by having it properly maintained.

Abdeljawad et al.'s (2020) findings revealed that audit committees are negatively correlated with risk-taking propensities, implying that these oversight bodies must be more vigilant in their supervision and guidance relating to dangers. Likewise, Jermias et al. (2013) uncovered that hazard proclivities and audit committees are markedly negatively interrelated. Taken together, these results emphasize the necessity of the audit committee monitoring and directing risks proactively. Consequently, the following hypothesis is postulated: Namely, that audit committees reduce fiscal vulnerabilities in Islamic banking institutions through diligence and foresight. The audit committee must be cognizant of balancing monitoring risks whilst allowing the institution to prudently pursue its objectives.

H3: The audit committee (AC) negatively impacts financial risk in Islamic banks.

This paper reviews the relationship between corporate governance elements and Islamic banks' financial risk between the SSB, SSB2, and audit committees. The paper's review area is agency theories, Islamic finance, corporate governance, and financial risk. Agency theories are based on the relationship between an agent and a principal. Corporate governance processes and mechanisms involve organizational directors' selection and execution. Auditors, organizational accounting controllers, and audit committees are superior to firms' decisions. Financial risk is described as the uncertainty or effect of monetary decisions made not only in relation to the firm's shareholders but also to other stakeholders.

According to Sharīʿah law, Islamic banks adhere to banking decrees. As a result, financial risks have been affected by these funds' adherence to moral and legal standards. At the same time, the design of the process and interactions among the firms that deliver banking services, the auditors involved in the firm, and the stakeholders served have affected risk. The paper reviews Islamic banks' financial risk and the interaction between agency theories, corporate governance, and financial risks. The hypothesis of the paper examines the relationship between corporate governance elements and Islamic banks' financial risk. As a contribution to the literature and as a basis for future research or practical application, the paper is valuable.

Table 2: summarizes the key authors, their country of research, the purpose of their studies, the type of source (theoretical or empirical), and the main summary points related to agency theory, corporate governance, and financial risk in Islamic banks.

Authors	Purpose	Type Source	Summary Points
Eisenhardt et al. (1989)	Establish agency theory's foundation in organizational behavior	Theoretical	Agency theory–conflict between ownership and control in organizations; stresses separation for efficiency.
Farag et al. (2015)	Define corporate governance, its components, and its role in business ethics	Review	Dimensions aiding proper corporate governance in Islamic banks: responsibility, accountability, transparency and fairness.
Berger et al. (2016)	Examine corporate governance's role in enhancing Islamic banks' resilience to economic challenges	Empirical	Smaller boards–lower bankruptcy and financial risk in banks
Rachdi et al. (2011)	Investigate the impact of board size on financial risk in Pakistani banks	Empirical	Larger boards–better risk management capabilities
Switzer et al. (2013)	Explore the relationship between board size and risk management in American banks	Empirical	Larger boards are associated with better risk management capabilities in banks.
Mollah et al. (2015); Nomran et al. (2016)	Analyze the role of Sharīʿah Supervisory Boards in Islamic banking governance	Empirical	Sharīʿah Supervisory Boards uphold ethical and Sharīʿah compliant standards in Islamic banks.
Iqbal et al. (2023)	Discuss the importance of transparency and governance in reducing financial risks in Islamic banks	Review	Transparency and governance practices mitigate risks and enhance stability in Islamic banking.
Mollah et al. (2017)	Examine how SSBs contribute to ethical standards and risk management in Islamic banks	Empirical	SSBs act as independent controls to prevent excessive risk-taking in Islamic banks.
Oussii et al. (2020); Pillai et al. (2017); Iqbal et al. (2023)	Investigate the role of audit committees in banking governance	Empirical	Audit committees enhance accountability and transparency, crucial for effective governance.
Abdeljawad et al. (2020); Qamar et al. (2023)	Analyze the impact of audit committee size on risk management in organizations	Empirical	Larger audit committees are associated with better risk management outcomes.
Jermias et al. (2013)	Study the relationship between audit committees and risk-taking in organizations	Empirical	Effective audit committees mitigate risk-taking behaviors in organizations.
Rafay (2020); Connelly et al. (2011)	Explore the role of audit committees in enhancing organizational decision-making	Review	Audit committees improve decision-making processes by mitigating agency costs.

3. Research Methodology

In this study, statistical methods were used to conduct research. The study provided valuable insights through data analysis. According to Iqbal et al. (2023) the quantitative approach is a positivist-based research methodology used to examine certain populations or samples. Therefore, the quantitative approach was an effective research methodology for this research. Data is collected using research tools, analyzed qualitatively or statistically, and hypotheses are tested. The study's panel data came from Islamic banks' financial reports from 2018-2022. Ultimately, the quantitative approach provided a reliable set of data points to analyze the research hypotheses.

3.1 The measuring methodology for each factor is as results

Table 3: Measurement of Factors

Variables	Measurements
Financial Risk & Sharīʿah Banks	NPF – (Aslam et al., 20221; Iqbal et al., 2023).
Corporate Governance	**Measurements**
Size Supervisory Board (SSB1)	No. Supervisory Board – (Aslam et al., 2021).
Sharīʿah Supervisory Board (SSB2)	Overall SSB2 – (Arifin et al., 2021).
Audit Committee (ADC)	No. of Audit Committee – (Azhar et al., 2021).

Demonstration of results in support of the hypothesis:

NPF= α+β1SSB1it+β2SSB2it+β3ADit+ROAit+e

Source: Authors' Own

4. Results and Discussion

This study, conducted from 2018 to 2022, examined Islamic banks' financial performance and corporate governance. Descriptive statistics and regression analyses provided valuable insights into financial risks and corporate governance structures within these institutions.

Table 4: Descriptive Analysis

	(NPF)	SSB1	SSB2	ADC
Mean	3.910973	3.337779	2.361112	2.469445
Median	1.555001	1.000001	2.000001	2.000001
Maximum	11.53001	5.000001	5.000001	5.000001
Minimum	1.330001	1.000001	1.000001	2.000001
Dev-Std.	2.042111	0.481262	0.877025	0.801872
Skewness	2.070775	1.368267	2.006826	0.102192
Kurtosis	9.617899	3.730279	6.426051	3.321444
Obs*	75	75	75	75

Source: Statistics analyzed with E-Views-10 (2023)

From the descriptive statistics table above, the descriptive statistical test results are explained below. The study is, in summary, a one-tailed hypothesis. Descriptive statistics for the NPF demonstrate a range of financial risk as the maximum value is metaphorically 11.53% and the minimum value is literally 1.33%. The mean is metaphorically 3.91 and in conclusion, regarding the results, according to these results, a typical Islamic bank in Pakistan is doing satisfactorily economically, with an NPF score of 5%. The maximum is 11.53% and the minimum is 5.83%. To sum up, this study provides significant information concerning Pakistani Islamic banks' financial risks.

There are separate variables for supervisory board size and supervisory board size. For each variable, the values are as follows. A board of supervisors' value of $ =3.33 $ supervisors, $ =1 $ on a SSB1, $ =5 $ on a board of supervisors of any size. Thus, the SSB1 variable will have a range of possible values independently of the other variables. This means that the two variables can be examined independently, which represents a step forward in understanding corporate governance structures.

On the basis of the value of this variable, there should be a minimum of two board members, a maximum of six members, and an average of 2.4 members on the audit committee. Therefore, considering the variable's value, a minimum number of board members should be required. The value of the variable Sharīʿah Supervisory Board implies there must be a minimum of two members of the SSB2. There must also be a maximum of five members, and an average of 3.9.

Interpretation: An average NPF of 3.91% suggests Islamic banks in Pakistan have healthy finances. Consequently, these banks are relatively capable of managing financial risks. Interpretation: The average value of 3.34 suggests a certain degree of variability in the size of the supervisory board. Interpretation: The average value of 2.36 suggests considerable Sharīʿah compliance significance. Interpretation: The average of members of the audit committee is around 2.47 which suggests that auditing functions are significant.

4.1 Selection Test Model

The results of the panel data regression tests are below; therefore, the model can be used to predict future outcomes. Panel data are observed statistics that integrate both cross-sectional statistics and time series. Therefore, it is imperative to note that the panel data regression test is very useful, and roots the most definitive model to ascertain future outcomes. Cross-sectional and time series data indicate several data pieces are available. Panel regression includes three models: the common effect model, fixed effect model, and random effect model. The model results include, model selection results from Chow test, Hausman, and LM test:

Table 5: Tests of LM, Chow, and Hausman

Model Selection	Test of Chow	Test of Hausman	Test of L-M
Common-Effect-Model	-	-	0.000
Fixed-Effect-Model	0.000	-	-
Random-Effect-Model	-	0.854	-
Choice of greatest model	*F-EM of respect of probability* 0.000 < 0.5*		

Source: Statistics analyzed through E-Views-10 2023

The Chow experiment shows H0 should be rejected since the FEM p-value of 0.000 < 0.005. Therefore, an employee should conclude that the FEM gives results. As shown by the results, a fixed-effect model was used. From this information, a fixed-effect model is the most appropriate model. One should apply a standard assumption test to test FEM results. Therefore, using Chow assessment results, an EFM should be chosen for statistical completion. According to Chow test p-value of 0.000, it shows that the fixed-effect model is the most appropriate model, and thus, a supplier should reject the null hypothesis in favor of FEM.

4.2 Results of Multicollinearity Test

Table 6: Test of Multicollinearity

Variables	(NPF)	SSB1	SSB2	ADC
(NPF)	1.0001	-	-	-
SSB1	-0.095	1.0001	-	-
SSB2	0.1516	0.2779	1.0001	-
ADC	-0.232	0.2263	-0.0162	1.0001
ROA	-0.221	0.0538	-0.0877	0.2037

Source: Statistics analyzed through E-View-10 2023

From the table findings, it is clear that there is no multicollinearity in this model for Islamic banks, the Board of Supervisors, Sharīʿah Supervisory Boards, and Audit

Committees. This is because for each of the variables, the correlation value is lower than 0.8. These results imply that each of the substantive variables, as well as the independent variables and the dependent variables have only moderately strong relationships. In conclusion, this result means that the independent variables and the dependent variables are not related in any way. The R>s generally indicates no multicollinearity among the variables.

Table 7: under indicates the findings of panel data regression test

Variables	Coefficients	Error-Std.	Statistic-t	Prob.
Constant	39.47386	14.25163	2.913331	0.0054
SSB1	-0.120888	0.147690	-0.977894	0.3838
SSB2	0.409977	0.284761	1.650636	0.1045
ADC	-0.199454	0.057994	-2.918731	0.0052
ROA	-10203638	0.449976	-2.675495	0.0099
Squared-R				*0.573660*
Squared-R Adjust				*0.459475*
Statistic-F				*5.023562*
Statistic-F Prob.				*0.000004*

Source: Data Analyzed

The regression analysis indicates significant negative impacts of audit committee size (ADC) and ROA on NPF, with p-values of 0.0052 and 0.0099 respectively. SSB1 and SSB2 do not show significant relationships.

4.3 Discussion

4.3.1 Supervisory Board Size (SSB1) and Financial Risk

This study finds that the size of the Supervisory Board (SSB1) does not have a significant impact on financial risk in Islamic banks, as indicated by a coefficient of -0.120 and a p-value of 0.3838. The small size of supervisory boards in Islamic banks limits their ability to oversee financial management and mitigate risks effectively. Descriptive statistics reveal that the average size of SSB1 is 3.34 members, which suggests insufficient diversity and expertise to address the complexities of financial risk management. Alipour et al. (2019) argue that larger boards are more effective at monitoring management, making informed decisions, and controlling assets, ultimately reducing business risks. Although some research, such as Marinova et al. (2016), suggests that board size may not directly influence financial risk-taking, the results of this study indicate that the current supervisory board size in Islamic banks may not be sufficient to address financial risks effectively. The hypothesis (H1) that supervisory board size negatively influences financial risk is not supported, but increasing board size could strengthen oversight functions. Future research should explore the relationship between board size, diversity, and decision-making quality to determine whether larger supervisory boards can improve risk management outcomes.

4.3.2 Shari'ah Supervisory Board (SSB2) and Financial Risk

The findings also show no significant relationship between the Sharīʿah Supervisory Board (SSB2) and financial risk, as demonstrated by a coefficient of 0.409 and a p-value of 0.1045. The average size of SSB2, according to descriptive statistics, is 2.36 members, which is relatively small for fulfilling the critical role of ensuring compliance with Sharīʿah principles. The primary responsibility of SSB2 is to oversee Sharīʿah -compliant banking practices rather than directly engaging in risk management. This aligns with Mollah et al. (2017), who described SSB2 as a compliance-focused governance mechanism rather than one that directly impacts financial risk. While SSB2 ensures transparency and compliance, its role in mitigating financial risks remains limited. Nomran et al. (2012) suggest that SSB2 can reduce financial risks by providing an additional layer of governance, but this study's findings do not support such a relationship. Instead, it highlights the need for future research to examine the potential interactions between SSB2's compliance role and its impact on financial risk. The hypothesis (H2) that SSB2 negatively affects financial risk is not supported by this study. However, strengthening SSB2's capacity and increasing its size may enhance its governance role.

4.3.3 Audit Committee (ADC) and Financial Risk

The audit committee (ADC) emerges as a critical governance element for reducing financial risk in Islamic banks. Regression results show a significant negative relationship between ADC size and financial risk, with a coefficient of -0.199 and a p-value of 0.0052. Descriptive statistics reveal that the average size of the audit committee is 2.47 members, indicating room for improvement in size and capacity. Larger audit committees can provide better oversight, greater expertise, and a more diverse set of perspectives, which enhance their ability to mitigate risks. Abdeljawad et al. (2020) and Jermias et al. (2013) found that larger audit committees are associated with reduced risk-taking and stronger governance practices. This study corroborates these findings, supporting the hypothesis (H3) that audit committees negatively influence financial risk. Moreover, audit committees act as a safeguard against financial mismanagement, fraud, and agency problems. Increasing the size and capacity of audit committees could further strengthen financial stability in Islamic banks.

The findings indicate that while SSB1 and SSB2 have limited impact on financial risks, audit committees play a significant role in mitigating these risks. Increasing the size and diversity of both supervisory boards and audit committees may enhance their effectiveness in financial risk management. These results align with the hypotheses and suggest that corporate governance elements must be optimized to address the evolving challenges in Islamic banking. Future research should further investigate the interplay of governance structures and their impact on financial risk reduction.

5. Conclusion

This study highlights the financial performance and governance structures of Islamic banks in Pakistan from 2018 to 2022, providing critical insights into financial risk management. The average non-performing financing (NPF) score of 3.91% indicates a stable financial standing, demonstrating the banks' capacity to manage financial risks effectively. Regression analysis shows that audit committee size (ADC) and return on assets (ROA) significantly and negatively influence NPF, with coefficients of -0.199 (p-value = 0.0052) and -10.2036 (p-value = 0.0099), respectively. This underscores the pivotal role of profitability and audit committee effectiveness in reducing financial risks.

Conversely, the supervisory board size (SSB1) and Sharīʿah Supervisory Board (SSB2) variables do not exhibit statistically significant relationships with NPF, with p-values of 0.3838 and 0.1045, respectively. These findings suggest that while these governance components are integral to overall bank operations, their current structures may require further refinement to enhance their impact on financial risk.

Descriptive statistics expose variability across governance structures, with an average of 3.34 members on supervisory boards (SSB1), 2.36 members on Sharīʿah Supervisory Boards (SSB2), and 2.47 members on audit committees (ADC). The fixed-effect model, determined as the most suitable based on the Chow test (p-value = 0.000), validates the robustness of the analysis. The absence of multicollinearity among variables (correlation values < 0.8) further strengthens the reliability of the findings.

While the study provides valuable insights, its reliance on a limited set of governance proxies (SSB1, SSB2, ADC) and financial indicators highlights the need for future research. Expanding the scope to include independent supervisory boards, risk committees, and ownership structures could provide a more comprehensive understanding of governance and risk management in Islamic banking, contributing to enhanced financial stability and operational effectiveness.

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تأثير لجان التدقيق في البنوك الإسلامية: حوكمة الشركات والمخاطر المالية في إطار الالتزام الشرعي في باكستان

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المستخلص. لاستكشاف تأثير حوكمة الشركات خاصة لجان التدقيق على المخاطر المالية في البنوك الإسلامية في باكستان الخاضعة لأحكام الشريعة الإسلامية. استخدمت الدراسة بيانات اللوحة خلال الفترة (٢٠١٨-٢٠٢٢) للبنوك الإسلامية في باكستان. لتسهيل تحليل البيانات، استخدمت الدراسة نموذج التأثير الثابت في انحدار بيانات اللوحة. تسلط الدراسة الضوء على أن البنك الإسلامي في باكستان يحافظ على وضع مالي مناسب، بمتوسط صافي رأس مال متعثر يبلغ ٣,٩١٪، مما يشير إلى أن هناك إدارة قوية للمخاطر. يؤكد تحليل الانحدار على التأثيرات السلبية الكبيرة لحجم لجنة التدقيق (*ADC*) والعائد على الأصول (*ROA*) على صافي رأس المال المتعثر، بمعاملات -٠,١٩٩ (ص = ٠,٠٠٥٢) و-١٠,٢٠٣٦ (ص = ٠,٠٠٩٩) على التوالي. تؤكد هذه النتائج على أهمية الربحية ودور لجان التدقيق الفعال في الحد من المخاطر المالية. ومع ذلك، لا يظهر *SSB1* و*SSB2* أي علاقات مهمة، بقيم ***p*** تبلغ ٠,٣٨٣٨ و٠,١٠٤٥ على التوالي. ويضمن نموذج التأثير الثابت، الذي تم التحقق من صحته بواسطة اختبار تشاو (ص = ٠,٠٠٠)، قوة التحليل. إن القيود الرئيسية التي تواجه البحث هي الوقت والموارد وتوافر جودة وكمية البيانات. ويُستنتج مما سبق أنه بسبب الحاجة القصوى إلى الحد من المخاطر المالية، يجب أن يقوم المدققون بدورٍ مهمٍ في البنوك بشقيها الإسلامي والتقليدي. تشير نتائجنا إلى أن البنوك الإسلامية بحاجة إلى ضمان عمل لجان التدقيق بكفاءة. إن وجود نظام فعال في البنوك الإسلامية يعزز المساءلة والشفافية وتعزيز إدارة المخاطر المالية بشكل فعال.

الكلمات الدَّالة: البنوك الإسلامية، حوكمة الشركات، المخاطر المالية، الشريعة الإسلامية

تصنيف JEL: K10, G34, G32, G21

تصنيف KAUJIE: E23, E2