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# THE IMPACT OF SHARIAH GOVERNANCE, RISK MANAGEMENT AND FINANCIAL INNOVATION UPON PERFORMANCE: ORGANIZATIONAL AGILITY AS MEDIATOR

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KEYWORDS
Shariah Governance, Risk Management, Financial Innovation, Performance of Islamic Financial Institutions, Organizational Agility

ABSTRACT
This study examined the impact of Shariah governance, risk management, and financial innovation on performance of Islamic financial institutions (IFIs) in Pakistan, with a specific focus on mediating role of organizational agility. A quantitative research design was employed, and data were collected through structured questionnaire from 300 managers of Islamic banks across Pakistan. The findings, analyzed using the Partial Least Squares Structural Equation Modeling (PLS-SEM), revealed that Shariah governance and risk management had a significant effect upon IFI performance, while financial innovation exhibited moderate yet positive impact. Moreover, organizational agility partially mediated relationships, indicating that agility played crucial role in enhancing effectiveness of governance, risk management & innovation in driving performance. These results offer valued insights for policymakers and Islamic financial institutions, emphasizing the need for robust Shariah governance frameworks, proactive risk management strategies & continuous financial innovation to sustain and enhance institutional performance. This study donates to literature by integrating organizational agility as mediator, offering novel perspective on how Shariah governance, risk management, and financial innovation collectively enhance performance of Islamic financial institutions.



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## INTRODUCTION

Islamic financial institutions (IFIs) have become an important part of today's global financial system, which provides ethical and Shariah compliant banking to their clients. With the basis of the risk sharing, asset backed financing and prohibition of interest and other principles, IFIs have evolved considerably, especially in Muslim majority countries (Rashid, Akmal & Shah, 2024). Islamic banks have received a great attention from both policymakers and researchers for their resilience during financial crisis and their potential for economic stability. However, there are regulatory intricacies, financial technology evolution & risk management constraints that continue to linger and impede IFIs on their way to attain sustainable performance despite their growing market shares and business expansion (Ferdinand, 2024). Combining Shariah governance, the risk management and Islamic upload financial innovation as the fundamental determinant in the performance of Islamic bank, the interaction among these variables needs further investigation. Previous studies upon these variables have been conducted, nonetheless, their combined effect has not been studied extensively, especially as it relates to organizational agility, can serve as a mediating variable in improving IFI performance (Abdul, Shahar & Suki, 2024).

Shariah governance is key to guarantee Islamic financial institutions work accordant to Islamic law, thereby enhance stakeholder faith & institutional eminency. Shariah supervisory boards, compliance and internal controls, which guide the financial decision making process in the IFIs are all part of it. Governance structures, therefore, play an effective part in mitigation of risks and steering the firm towards sustainable growth by making finances transparent and ethical financial practices (Alhammadi, 2024). However, risk management has, and will continue to be, a paramount challenge for IFIs as they are undertaking the service primarily through profit and loss sharing contracts i.e. Mudarabah and Musharakah which inherently expose the IFIs to higher financial risks. Unlike conventional banks, that use interest-based hedging mechanism, IFIs must come up with their Shariah compliant hedging frameworks with purpose of ensure the institution performance (Sari & Hussien, 2024). The development of new Islamic financial products, including Sukuk (Islamic bonds) and Takaful (Islamic insurance) as part of financial innovation are correspondingly factors that increase the competitive edge of IFIs in dynamics of ever-changing financial market influence performance of institutions, particularly financial institutions.

The success of these mechanisms in refining IFI’s performance may depend on organizational agility as IFI’s ability to react fast to changes in market, regulations and technology (Sarwar, 2024). Hence, in this study organizational agility is studied as a mediating factor in enhancing link between Shariah governance, risk management, financial innovation and Islamic financial institution performance. Still, mechanisms causing such relationships amid risk management and financial innovation, IFI performance have not been fully investigated. The organizational agility is incorporated as a mediating factor to offer a novel viewpoint on how IFIs can increase their ability to respond to outside challenges under condition of Islamic principles compliance (Mohd, Rahman & Ghazali, 2024). Rapid growth of Pakistan’s Islamic banking sector, with competitive pressure coming from other conventional, and lately fintech driven institutions, in addition to demands of practical improvements, necessitate understanding of these dynamics (Touti & Taïb, 2024). The research problem is to address pertains to persistent performance problems of IFIs emanating from governance inefficiencies, risk exposure & over constraining the financial innovations (Prawati, Wulandari, Wahyuningsih, Rosadi, Setiawan & Mardiana, 2025).

Still, Islamic banks face operational complexity, regulatory barriers and difficulty in adapting to the market. These challenges are further exacerbated by a lack of comprehensive framework that links governance, risk management, innovation to performance, so hindering the sector from competing with conventional banking institutions (Irawan, 2024). Therefore, this study seeks to bridge by this gap by developing integrated model incorporating the organizational agility as the mediating mechanism to enable more extensive understanding about the factors that determine IFI performance. Therefore, the present study is of significance to academics, to the policymakers, and to the practitioners in Islamic finance industry. From a practical vantage point, this research combines the key empirics of organizations that are more agile into a single interaction model and, as such, yields managerial guidance on how to respond to the disparate and heterogeneous situations in which organization must operate (Judijanto, Mokodenseho, Birah, Mamonto & Mokodongan, 2024). This study is grounded theoretically in Agency Theory and Resource Based View (RBV). The findings not only would fill existing research gaps but also refine the policy and management practices for the long-term growth of IFIs in Pakistan and beyond.

## LITERATURE REVIEW

The specific financial investigation needed for Islamic financial institutions stems from their commitment to Islamic legal governance standards in the regulatory frameworks (Tumewang, Supriani, Dewi & Alam, 2025). Agency Theory together with Resource-Based View (RBV) form basis of this research for understanding institutional achievement mechanisms (Nuri, 2025). The Jensen and Meckling (1976) version of Agency Theory demonstrates how organizations develop conflicts between owners who act as principals and managers functioning as agents so strong governance becomes crucial for shareholder AIM alignment. Shariah governance serves Islamic finance as oversight mechanism to enforce compliance with religious values leading to reduced agency conflicts (Farooq & Zaheer, 2015). The competitive benefit from firms stems from the utilization of valuable, rare, inimitable and non-substitutable resources according to the RBV (Barney, 1991). The core competitive and sustainable resources of IFIs include risk management strategies along with financial innovation and agility as agility can affect how well organizations adapt to these challenges and changes in the market (Ali, Zaman & Bashir, 2022).

Performance outcomes from Islamic Financial Institutions result from the effective integration between governance mechanisms and risk management strategies and financial innovation which depends upon institutional capacity to adapt to market changes through organizational agility (Alam, Nugroho, Isman & Ahmi, 2025). Numerous empirical studies demonstrate that Shariah governance serves as a catalyst to boost Islamic bank performance and most research findings support this conclusion. Almutairi and Quttainah (2019) demonstrated through their research that effective Shariah supervisory boards boost profits and institution reputation in countries with strict oversight requirements. Mollah and Zaman (2015) showed that Islamic banking performance is superior when Shariah governance follows well-structured guidelines. Scholarly investigation into risk management practices in Islamic finance increases due to distinctive risk features found in Shariah-compliant instruments. Traditional banks use interest rates for lending while Islamic Financial Institutions utilize Islamic contracts like Mudarabah and Musharakah but these agreements create market risk exposure for them (Ahmed & Khan, 2021).

Risk management frameworks of Islamic banks are described as robust by Hassan, Paltrinieri, Dreassi, Miani and Sclip (2020) and Iqbal and Mirakhor (2019) lead to better financial stability and resilience in times of economic uncertainty. The research on the relationship between risk management approach and other institutional factors like governance and financial innovation for shaping IFI performance remains poorly documented. The analysis of how organizational agility contributes to risk mitigation capacity has not been fully explored which requires the researchers to use integrated research method for better understanding connections between these elements (Alam et al., 2025). Islamic financial institutions can both boost market standing and achieve performance results through product development and market expansion enabled by financial innovation. The creation of Sukuk Islamic bonds along with the Takaful Islamic insurance and fintech-based Shariah-compliant solutions enables IFIs to reach more customers in markets where regulations are strictly followed (Laldin & Furqani, 2022). Research carried out by Kammer et al. (2015) and Bakar et al. (2023) reveals financially innovative Islamic banks to exceed conventional banks in asset expansion as well as customer base addition and market expansion.

Regulatory challenges and compliance requirements act as barriers to quick implementation of new products in Islamic financial institutions (Dusuki & Abdullah, 2017). The critical standing of organizational agility emerges since it allows Islamic financial institutions to find solutions through regulatory obstacles while implementing profitable financial innovations for long-term expansion. According to theory of agency, effective governance mechanisms can reduce the conflict between shareholders and management and, in turn, improve performance in the financial institutions (Iqbal & Mirakhor, 2019). As an additional layer of oversight in the case of IFIs, shariah governance sets additional controls on financial activities so that they conform to Islamic principles, minimizes agency conflicts and improves institutional credibility. Thus, the Resource Based View (RBV) is relevant to firms with superior resources and capabilities, which develop a competitive advantage in the different circumstances. The development of the risk management frameworks, financial innovation plans & organization agility are key resources to IFI performance in study (Rahman, 2024). Though these factors are important theoretically, evidence of how they work alongside each other from an Islamic finance perspective remains scant.

While existing research has focused largely on individual aspects of performance of Islamic banks like financial stability, profitability and compliance, it has ignored combining it together along with governance, risk management and innovation in overall framework which includes organizational agility as mediating mechanism. In this linking, relating to IFI performance are the critical research gaps, including how these variables interact to impact these performance variables in context of Pakistan's Islamic banking sector that operates with a unique regulatory and economic environment for realizing desired and leading outcomes. There has been much research on Shariah governance frameworks, but little research on effectiveness in shaping risk management practices and fostering financial innovation (Alghamati, Azam & Khatibi, 2024). The individual contribution of Shariah governance, risk management and financial innovation to Islamic Financial Institution (IFI) performance have received robust research-based evidence yet the integration between these components is insufficiently studied. In this drive, theoretical significance of organizational agility between the institutional development and adaptability (Teece, Peteraf & Leih, 2016), that remains under-investigated although it should be a critical focus.

The complex Islamic financial sector requires research into how governance elements jointly impact performance together with risk management and innovation mechanisms and which control variable agility plays to strengthen relationship between these elements. Surrounding research primarily examines the global and Middle Eastern Islamic financial institutions while neglecting Pakistan's dual banking system which necessitates additional strategic adaptability according to Khan and Bhatti (2022). Also, it yields empirical validation of Agency theory and RBV in the context of Islamic banking and further enhances the existing literature with new insights (Islam et al., 2025). In this drive, the findings will provide strategic recommendations for regulators, policy makers and providers of financial product for regulatory frameworks, governance policy and the financial product development that are 'Shariah driven' without compromising the institution's sustainability. This study investigates the interplay in Shariah governance, risk management, financial innovation and performance with an organization's agility as a mediator. Thus, using an activity theory, this study develops a comprehensive and actionable framework to enhance the sustainability as well as resilience of Islamic financial institutions.

## RESEARCH METHODOLOGY

The quantitative research design is used in study to examine impact of Shariah governance, risk management, and financial innovation on the performance of Islamic financial institutions (IFIs) in Pakistan, where organizational agility acts as a mediating variable. In accordance with the objective of study to analyze causal relationships among variables, quantitative approach is justified on the basis that analysis calls for empirical validation through statistical modelling. Meanwhile the research questions and hypotheses are structured, deductive approach is used appropriate with the positivism underlying research philosophy. It assumes that social reality can be objectively studied and that empirical data and statistical analysis be used to measure such things as financial performance, institutional governance and yield 'hard' generalizable findings that yield to general body of research of Islamic financial research. The study inducted the managers of Islamic banks in Pakistan in the target population because as they are at the forefront of the decision making with regard to governance, risk management and financial innovation. In Pakistan, Islamic banking has grown tremendously and institutions like Meezan Bank, Al Baraka Bank (Pakistan), Dubai Islamic Bank, et cetera are a major part of the financial sector.

In light of rapid expansion, regulatory development of Islamic finance in Pakistan, managerial views should be understood so as to measure effects of the internal governance structures, risk frameworks and innovation strategies of ICB to its overall institution performance. For reasons of representativeness of the sample, the probability sampling strategy is implemented, namely stratified random sampling. This is a way of including managers from different Islamic banks proportionately so that there are not likely to be biases in responses from particular institution or level of hierarchy in banking sector. However, Hair (2019) recommendation for PLS - SEM is to select a sample size of 300 managers based on the recommendation that when a study has multiple constructs, 10 times number of highest number of indicators is the minimum sample size. Keep in mind that study in case includes multiple latent variables which require sample of 300 for it to enable reliable statistical power of model. The collection of data uses structured survey questionnaire that is disseminated over online and physical channels to raise response rate.

Using validated scales from past literature, questionnaire designed to measure reliability and construct validity. In this linking, respondents must evaluate variables, for instance Shariah governance, risk management, financial innovation, organizational agility and institutional performance using a Likert scale with five points scale, which vary from 1 (strongly disagree) to 5 (strongly agree). The questionnaire is pre-tested with a small group of the Islamic bank managers to gain finer details of clarity and ascertain that items correctly represent intended constructs. Data analysis uses Partial Least Squares Structural Equation Modeling (PLS-SEM) employing the SmartPLS software. The preferred approach here is PLS-SEM because it is able to deal with more complex models with many latent variables especially where study hopes to examine both direct and mediating effect in order to extract additional information towards the knowledge contribution (Hair, 2021). The analysis process consists of two stages. In the first stage, it will be based on measurement model assessment for purpose of assessing construct reliability, convergent validity and discriminant validity. In the second stage, model will be based on structural model analysis for the purpose of testing the hypothesized relations among variables.

Statistical significance of path coefficients is assessed based on bootsrapping techniques using 5,000 resamples in order to check robustness of findings. Variance inflation factor (VIF) tests are carried out to check for the multicollinearity problem and further $R^2$ values and effect sizes ($f^2$) are examined to see explanatory power of the model. The testing of the mediation effects of organizational agility is performed using the Preacher and Hayes (2008) method for indirect relationships in mediation models. Throughout the research process, rigorously adhered to is ethical considerations. In this connection, before contracting the inaccessible types of research, prior approval from appropriate ethical review boards is acquired to ensure compliance with academic and professional ethical standards. Similarly, informed consent forms are given to all respondents in which consent to participate in the study, with details of the purpose of study, confidentiality and voluntary application are employed. This study aims to offer the empirical insights regarding governance-performance nexus in the Islamic finance by using the rigorous research design, a well conceptualized sampling strategy and employing the robust analytical techniques, thus contributing both theoretically as well as practically to the concerned field in research.

## DATA ANALYSIS

**Table 1**
*Reliability and Convergent Validity Analysis*

| Construct | CA | CR | AVE |
|---|---|---|---|
| Shariah Governance (SG) | 0.89 | 0.92 | 0.68 |
| Risk Management (RM) | 0.86 | 0.90 | 0.65 |
| Financial Innovation (FI) | 0.87 | 0.91 | 0.66 |
| Organizational Agility (OA) | 0.85 | 0.89 | 0.63 |
| Institutional Performance (IP) | 0.90 | 0.93 | 0.71 |

The measurement tool achieved satisfactory internal consistency based on both the Cronbach's Alpha results (≥0.85) as well as composite reliability (≥0.89) for every construct. The calculated Average Variance Extracted scores surpass 0.50 which proves the adequate construct validity because it demonstrates that measurement variables correctly represent the main constructs in study.

**Table 2**
*Discriminant Validity (HTMT - Heterotrait-Monotrait Ratio)*

| Construct | SG | RM | FI | OA | IP |
|---|---|---|---|---|---|
| Shariah Governance (SG) | | | | | |
| Risk Management (RM) | 0.67 | | | | |
| Financial Innovation (FI) | 0.55 | 0.60 | | | |
| Organizational Agility (OA) | 0.52 | 0.58 | 0.63 | | |
| Institutional Performance (IP) | 0.61 | 0.66 | 0.57 | 0.59 | |

The assessment of discriminant validity succeeds because all HTMT values remain under 0.85 (Henseler et al., 2015). All constructs prove statistical clarity from each other thus validating the model.

**Table 3**
*Variance Inflation Factor (VIF) for Multicollinearity Assessment*

| Construct | VIF |
|---|---|
| Shariah Governance (SG) | 2.34 |
| Risk Management (RM) | 2.10 |
| Financial Innovation (FI) | 1.98 |
| Organizational Agility (OA) | 2.45 |

All VIF values in analysis demonstrate no signs of multicollinearity since they remain under 5.0. Each predictor variable offers unique information to explain model because the evaluation reveals no overlapping contributions in the variables as discycssed in the existing research for conclusion.

**Table 4**
*Model Fit Indices*

| Fit Measure | Recommended Value | Obtained Value |
|---|---|---|
| SRMR (Standardized Root Mean Square Residual) | ≤ 0.08 | 0.063 |
| NFI (Normed Fit Index) | ≥ 0.90 | 0.91 |
| $R^2$ (Institutional Performance) | ≥ 0.50 | 0.64 |

The model shows proper fit because the SRMR value (0.063) remains under 0.08, value of NFI (0.91) surpasses 0.90 so model proves effective in representing analyzed data. The $R^2$ statistical value explains how performance variables reveal 64% of variance when observed against the predictors.

**Table 5**
*Structural Model Results (Path Coefficients and Hypothesis Testing)*

| Hypothesis | Path Relationship | Path Coefficient (β) | t-Value | p-Value | Decision |
|---|---|---|---|---|---|
| H1 | SG → IP | 0.34 | 4.12 | 0.000 | Supported |
| H2 | RM → IP | 0.29 | 3.87 | 0.001 | Supported |
| H3 | FI → IP | 0.26 | 3.55 | 0.002 | Supported |
| H4 | SG → OA → IP | 0.22 | 3.41 | 0.003 | Supported (Mediation) |
| H5 | RM → OA → IP | 0.18 | 3.12 | 0.004 | Supported (Mediation) |
| H6 | FI → OA → IP | 0.20 | 3.25 | 0.003 | Supported (Mediation) |

Statistical analysis supports significance of all hypotheses (H1 to H6) because p-values remain below 0.05, proves positive relationships amid Shariah governance, risk management, financial innovation and performance, OA acts as a mediator amid all established relationships because flexible institutions can maximize governance along with risk strategies financial innovation effectiveness.

## DISCUSSION

The research analysis shows Shariah governance practice together with the risk management mechanism and financial innovation as direct determinant of Islamic financial institution (IFI) performance in Pakistan. We confirm reliable results showing that Shariah governance systems are what have the biggest impact on institutional performance as religious principles on which the stability of any business is based on are centered on ethical standards and transparency. It is seen from numerous earlier studies including Farooq and Zaheer (2020) and Ahmed and Mollah (2018) that rigorous governance protocols hold the effect of effective trust levels and operational excellence in Islamic finance, which further leads to enhance performance. In the study, Shariah compliant adherence shows that both the religious authenticity and stakeholder trust are derived from which result in superior financial performance. Governance has been found to be very important towards the Islamic finance performance but this is only possible through the addition of the strategic capabilities in the forms of risk management and financial innovation.

The risk management has significantly affected the performance of Islamic financial institutions because the Islamic financial sector, such as financial sector in general, places more and more emphasis on the dynamic risk assessment strategies and regulatory compliance. Islamic banks can attain the better performance results since they manage their operational and market risks actively in view of positive and statistically significant relationship ($\beta = 0.29$, $p < 0.001$). These findings were confirmed by Hussain et al. (2021) because they established that risk governance frameworks that benefits the financial organization by addressing uncertainty and preventing occurrence of financial distress. Islamic banks well established in risk policies make financial turbulence more bearable and investors have maximum confidence while long term growth becomes a long term viable. Islamic banks proved to be getting better performance through the innovation in financial products and by utilizing the digital technologies and therefore fintech elements, which was proven through research. The results of the research ($\beta = 0.26$, $p = 0.002$) suggest that the technology adoption along with development of Shariah-compliant financial tool contribute towards enhancement of the competitiveness of the IFIs in the modern banking sector.

Alam et al. (2022) research have shown that financial innovation is beneficial for Islamic banks as they grow better market potenial along with the product exchanges and attracting the wide type of customers in the banking industry. Financial innovation is a very important component but has to be within Islamic principles in order to gain stakeholders' acceptance and safeguard institutional reputation. An important discovery made in this research is that organizational agility acts as mediator between governance systems and risk management, respectively amid financial innovation and the business performance outcomes. The notion of organizational agility is beneficial for Islamic banks insofar that it allows them to attain outcomes successfully converting governance structures and risk frameworks as well as strategic innovations into positive outcomes. Flexible and adaptive organizational structures that are well suited to the relationships of these relationships bring IFIs readiness towards market shifts and regulatory changes and technology advancement (SG → OA ← IP, $\beta = 0.22$; RM → OA ← IP, $\beta = 0.18$; FI → OA ← IP, $\beta = 0.2$, $p < 0.05$). The findings are in line with Tariq et al. (2021) who concluded that for financial institutes to be strategic, they are to have operational resilience that is powered by agility.

The study also demonstrates that Islamic banks can achieve both superior performance in the face of unpredictable circumstance, and can do so through the improvement in the adaptability of decision process and market as well as the resource management approaches. The outcome of the study implies various significant implications. By indicating how governance links with risk management and innovation and organizational agility, the reported findings form a part of theoretical studies about Islamic financial governance and performance. This will be useful to IFIs practitioners including bank managers, risk analysts and so on who will find practical strategies for enhancing agility; mitigating financial risks; and promoting innovation in order to achieve competitive performance. Organizational agility inspection serves as intermediate, by offering new insights into the utilization of the internal capability that enhances financial sustainability for Islamic financial institution. Also, it is proved that in the case of properly governed innovative institutions, fundamental agency theory and dynamic capability theory conjoin through dynamic organizational design, as these organizations succeed in performing well.

## CONCLUSION

The research delivers research findings which prove that by considering all three risk factors of Shariah governance and risk management and financial innovation together there is significant performance growth in the Pakistan's Islamic financial institutions. Both strong risk mitigation plan and proper governance are proved vital joint factors with financial innovation being the other required factor for each Islamic financial institution success. The role of organizational agility is to mediate how flexibility of Islamic banks translates its governance and innovation efforts into better financial performance. It also provides many new theoretical understandings and practical guidelines and policy recommendations which support view that Islamic finance should pursue the governance-oriented innovation which has agility. To remain relevant and financially viable for the future, the progress of a culture wrought of the symbiosis between the fundamentals of compliance and of strategic risk management and the principle of agility born out of human creativity and innovation that will be necessary for the global Islamic banking industry.

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