The Impact of Sharia Supervisory Decisions on the Financial Performance of Islamic Banks: -A Case Study of Al Baraka Bank Algeria-

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Abstract:

This study explores the conceptual framework of Islamic banking, focusing on the role of Sharia governance in ensuring the alignment of banking activities with Islamic principles and its impact on financial performance. The study highlights the distinctive features of Islamic banks, such as the prohibition of usury and the adoption of Sharia-compliant financing modes like Mudaraba and Murabaha. It also examines the global position of Islamic banking, with a practical analysis of Sharia governance decisions at Al Baraka Bank Algeria as a case study.

The analysis findings indicate that Sharia governance decisions have contributed to strengthening trust among clients and investors, leading to asset growth and increased banking revenues. Despite the limited impact of allocating non-compliant revenues to charitable purposes on net profits, these decisions have reinforced Sharia compliance and reduced operational and compliance risks. The study underscores the significance of Sharia governance in achieving a sustainable balance between adherence to Islamic values and attaining financial goals.

Keywords: *Islamic Banking ; Sharia Supervision ; Al Baraka Bank.*

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1. INTRODUCTION

The global financial system is witnessing a diversity of banking business models, among which Islamic banking stands out as a response to the aspirations of Muslim communities to establish a banking system reflecting values and principles derived from Islamic Sharia. Islamic banking is based on unique economic foundations, such as the prohibition of usury, the pursuit of economic justice, and the encouragement of risk-sharing, making it a distinctive model for providing financing solutions that balance profitability with social responsibility.

Islamic banks are characterized by multiple features that make them an attractive alternative to conventional banks. They rely on innovative financing modes such as Murabaha, Mudaraba, and Ijara, which aim to stimulate economic activity through real investments while avoiding unlawful financial speculation. In addition, Sharia supervision constitutes a fundamental pillar to ensure compliance with Sharia principles in all banking operations, enhancing the credibility of these institutions and increasing the trust of clients and investors.

With the growing demand for Sharia-compliant banking products and services, Islamic banks have become pivotal in supporting economic and social development, while facing ongoing challenges in balancing Sharia compliance with sustainable financial performance.

Research problem: Accordingly, we pose the following main question:

How do Sharia supervisory decisions affect the financial performance of Islamic banks?

Sub-questions: To answer this question, we pose the following sub-questions:

- What role does Sharia supervision play in regulating banking operations?
- How do Sharia supervisory decisions affect the financial indicators of Islamic banks?
- What challenges arise in implementing Sharia supervisory decisions?

Research hypotheses:

- The first hypothesis: Sharia supervision plays a fundamental role in regulating banking operations and ensuring compliance with Islamic law
- The second hypothesis: supervisory decisions improve financial performance by enhancing trust and increasing assets;
- The third hypothesis: Implementing Sharia supervisory decisions faces challenges that require solutions to balance compliance with financial objectives.

Research objectives: This study seeks to achieve a number of objectives, including:

- Analyze the role of Sharia supervision at Al Baraka Bank Algeria.
- Evaluate its impact on financial performance indicators.
- Identify challenges in implementation and suggest solutions.
- Highlight its role in enhancing customer and investor trust.
- Provide recommendations to balance Sharia compliance with sustainable financial

Importance of the research: his study is significant as it highlights the role of Sharia supervision in ensuring compliance with Islamic principles in banking operations, thereby enhancing trust and credibility. It also emphasizes the impact of Sharia supervisory decisions on the financial performance of Islamic banks by improving and sustaining financial indicators. Moreover, it proposes solutions to implementation challenges, contributing to a balance between Sharia compliance and financial objectives.

The research methodology: The study relies on the descriptive method to analyze the theoretical framework of Islamic banking and the role of Sharia supervision, the analytical method to assess the impact of Sharia supervisory decisions on the financial indicators of Al Baraka Bank Algeria, and the inductive method to derive factors that enhance the effectiveness of Sharia supervision and identify the challenges it faces. The study is based on secondary data such as annual reports and relevant previous studies.

2. The Conceptual Framework of Islamic Banks and Sharia Supervision

2.1 General Overview of Islamic Banking

Islamic banks are financial institutions that adhere to the principles of Islamic Sharia in all their banking activities, relying on interest-free financing and investment instruments and avoiding activities prohibited by Sharia. These banks aim to achieve a balance between profitability and social responsibility by offering innovative financial services that meet customers' needs in compliance with Sharia rules.

.2.11 The Concept of Islamic Banks

It is a financial institution that collects, invests, and grows funds for the benefit of participants, with the aim of rebuilding the Muslim community and fostering Islamic cooperation in accordance with Sharia principles. Its main foundations include avoiding usurious transactions and prohibited contracts, distributing all profits based on mutual agreement without exploiting the needs of the distressed or disadvantaged, supporting those in need through Qard Hasan (benevolent loans), and promoting Islam economically and socially. (Marabti & Saaidia, 2022)

2.1.2 Characteristics of Islamic Banking

Islamic banking is distinguished by a set of characteristics that differentiate it from conventional banking, including: (Marabti & Saaidia, 2022)

- **Prohibition of interest (Riba):** This is the primary and defining feature of Islamic banks, aimed at purifying wealth. Therefore, Islamic banks do not deal with interest in any form—whether giving or receiving, deposit or investment, acceptance or discount, directly or indirectly, fixed or variable.
- **Commitment to Halal transactions:** Since Islamic banking derives its legitimacy from Islamic thought, it strictly adheres to the principle of Halal and Haram in all its dealings.
- **Sharia supervision:** Unlike conventional banks, Islamic banks have an additional layer of oversight—Sharia supervision—alongside financial, administrative, and banking controls. This is a key distinguishing feature, ensuring that all banking operations comply with Islamic rulings, whether through prior or subsequent supervision.

It is noteworthy that Sharia auditors must be both religiously and academically qualified to provide informed judgments.

Additional characteristics include:

- **Correcting the role of capital in society:** Islamic thought views money solely as a medium of exchange. Hence, Islamic banks reject the idea of trading in money. They neither lend nor borrow it as conventional banks do; instead, they utilize it to stimulate economic activity through real investments and partnership-based contracts rather than interest-based loans.
- **Developmental role:** Islamic banks are inherently developmental institutions. They contribute not only to achieving the community's economic development goals by maximizing benefits—directly or indirectly—but also extend to moral and psychological development, as investing in human beings is regarded as the best investment for societal progress and advancement.

2.1.3 Financing Modes in Islamic Banking (Summary):

According to Regulation 20-02 on Islamic banking, the main financing modes are:

- Murabaha: The bank purchases a commodity at the client's request and sells it at cost plus an agreed profit margin, with payment either upfront or in installments. Commonly used for goods, housing, and equipment.
- Musharaka: A joint venture between the bank and other parties to provide capital for a project. Profits are shared as agreed, while losses are borne according to each party's share. Encourages partnership and cooperation.
- Mudaraba: The bank provides capital, while the entrepreneur provides work and management. Profits are shared as agreed, but losses are borne by the bank unless negligence occurs.
- Ijara: The bank leases an asset (e.g., property, vehicle) to a client for a fixed rent, with the option to transfer ownership at the end of the contract.
- Salam: Full payment is made in advance for goods to be delivered later. Often used in agricultural and industrial projects.

- Istisna: A contract for manufacturing or producing a specific item requested by the client, to be delivered later. Common in industrial and real estate projects.
- Deposit Accounts: Funds deposited with the bank to be returned on demand or under agreed terms, mainly for safekeeping.
- Investment Accounts: Funds deposited for investment in Sharia-compliant projects, with profits and losses shared between the bank and the depositor.

2.1.4 The Difference Between Conventional Banks and Islamic Banks

The key differences between Islamic and conventional banks can be summarized in the following table, which outlines both similarities and distinctions:

Table N (01): Similarities and Differences Between Islamic and Conventional Banks

Comparison Between Islamic and Conventional Banks		
Similarities		
Source of funds.		
There is always a return for money taken or given.		
Investment of various types in multiple sectors.		
Subject to financial and accounting audits, whether internal or external.		
Supervised and regulated by the central bank, with adherence to its decisions.		
Differences		
Aspect	Islamic Banks	Conventional Banks
Principle of Work	Islamic economic system based on the prohibition of usury (Riba).	Conventional economic system based on interest.
Nature of Work	Partner between the supplier and demander of funds.	Intermediary between the supplier and demander of funds.
Methods of Work	Interest-free financing, Sukuk, and profit-and-loss sharing.	Loans, borrowing, bonds.
Characteristics of Work	Religious and economic characteristics within the framework of Islamic principles.	Purely economic characteristics.
Objectives of Work	Both economic and social.	Purely economic.
Responsibility of Work	Both legal and religious responsibility.	Legal responsibility only.
Relation with Central Bank	Does not benefit from such interest; redirected to solidarity accounts.	Benefits from the interest of funds deposited at the central bank.
Organization of Work	Subject to an organizational structure that includes a Sharia Supervisory Board.	Subject to a conventional organizational structure.
Risks of Work	Both economic and religious risks.	Economic risks only.

Fields of Work	Limited to Sharia-compliant fields.	All fields.

Source: Prepared by the researchers based on a doctoral thesis entitled "A Specific Standard Model for Financing Choices Between Islamic Banks and Conventional Banks: A Case Study of Banque Extérieure d'Algérie and Al Baraka Bank Algeria (elaziz, 2018)

2.1.5 Position of Islamic Banks in Islamic Financial Assets

Table N (02): Distribution of Islamic Financial Assets Worldwide (Billion Dollars)

Region	Banks	Sukuk	Funds	Takaful	Total	%
GCC	1342.9	356.6	24.1	16.7	1740.4	53.6
SEA	307.2	411.4	32.8	6.0	757.4	23.3
MESA	478.3	57.8	62.9	5.9	604.9	18.6
Africa	49.6	2.9	1.9	0.8	55.2	1.7
Others	71.2	1.0	14.9	0.6	87.7	2.7
Total	2249.2	829.7	136.6	30.0	3245.5	100.0

Source: Prepared by the researchers based on the Annual Report of Islamic Financial Services. (Annual Report of Islamic Financial Services, 2024)

regions The Gulf Cooperation Council (GCC) countries lead with 53.6% of total assets, amounting to 1,740.4 billion dollars, indicating a clear dominance of this region in the Islamic finance sector, particularly in Islamic banks' assets, which reached 1,342.9 billion dollars. This is followed by the South-East Asia (SEA) region with 23.3%, totaling 757.4 billion dollars, driven largely by significant activity in issued sukuk, which amounted to 411.4 billion dollars. The Middle East and South Asia (MESA) region ranks third with 18.6%, with notable contributions from Islamic funds' assets totaling 62.9 billion dollars. In contrast, Africa and other regions record very modest shares, at 1.7% and 2.7% respectively, with total assets not exceeding 55.2 billion dollars and 87.7 billion dollars. This disparity highlights the importance of developing Islamic financial markets in the less contributing regions to promote equity and global growth in the sector.

2.2 Concept of the Sharia Supervisory Board

To understand the theoretical aspects of Sharia supervision, its structures, and its role in Islamic financial institutions, we will address the following elements

2.2.1 Definition of the Sharia Supervisory Board: Sharia supervision is an oversight process aimed at ensuring that the activities of Islamic financial

institutions comply with the provisions of Islamic law and the rulings of recognized Sharia councils and committees. This supervision is implemented through precise mechanisms and controls to achieve transparency and adherence to Islamic values, thereby enhancing trust in financial products and ensuring their sustainability. (Mohamed Adnan & Abir, 2020, p. 16)

2.2.2 Sharia Supervisory Bodies in Islamic Financial Institutions: Sharia supervisory bodies in financial institutions generally consist of: (Mohamed Adnan & Abir, 2020)

- **Fatwa Board:** This board includes a group of Sharia scholars specialized in financial transactions, all qualified to issue fatwas in this field. The number of scholars is not less than three to ensure that the fatwa is issued collectively, as in the case of disagreement between two scholars, neither opinion is preferred over the other. This board issues fatwas and focuses on the theoretical aspect, such as proposing Sharia-compliant alternatives and providing practical solutions to financial issues within Islamic financial institutions.
- **Sharia Compliance Department:** This department comprises Sharia auditors who are knowledgeable about Sharia rules. They are not necessarily scholars; they may be accountants, lawyers, or other professionals. This department is essential to safeguard the operations of Islamic financial institutions from Sharia violations and to ensure the correct implementation of the Fatwa Board's decisions. Its presence is obligatory because what cannot be fulfilled without it becomes necessary. A fatwa without monitoring may at best be subject to the interpretation or errors of employees, who may misunderstand or misapply its content. Therefore, this department focuses on the practical side of supervision, ensuring that the institution adheres to its defined boundaries and follows the directives of the Fatwa Board.
- **Supreme Sharia Supervisory Board:** This is a higher-level Sharia authority, often affiliated with the central bank, which supervises Islamic financial institutions at the national level in coordination with the Sharia supervisory bodies of each institution. Its primary objective is to monitor and follow up on the compliance of the

internal Sharia supervisory boards in Islamic financial institutions with the application of Sharia-compliant financial structures.

2.2.3 Role of Activating the Sharia Supervisory Board: The activation of the role of the Sharia Supervisory Board in Islamic financial institutions is manifested through the following measures: (Meshawri, 2019, p. 95)

- **Restructuring the Sharia Supervisory Board:**
  - The board must be independent or function as a dedicated Sharia authority within banks, companies, or institutions.
  - The board should have full authority to perform its duties and supervise transactions.
- **Coordination with Relevant Parties:**
  - Enhance coordination between the Sharia board and all parties involved in Islamic banking and finance.
  - Ensure that all operations comply with Islamic law.
- **Enhancing Competence and Expertise:**
  - Ensure that the board comprises members with expertise in Sharia and banking sciences.
  - Focus on continuous academic and jurisprudential training for board members.
- **Issuing Clear Rules and Regulations:**
  - Develop a system clarifying the powers and responsibilities of the Sharia Supervisory Board.
  - Establish a clear framework for Sharia supervision mechanisms in accordance with Islamic law.
- **Reviewing Activities and Decisions:**
  - Conduct regular reviews to ensure that activities comply with Sharia principles.
  - Provide reports that indicate the level of adherence to Islamic law.
- **Communication with Financial Institutions:**
  - Build an integrative relationship between the board and institutions to ensure compliance.
  - Provide continuous Sharia support in financial decision-making.

3. Analysis of the Sharia Supervisory Board's Decisions at Al Baraka Bank

3.1 Al Baraka Bank Algeria:

Al Baraka Bank Algeria is one of the leading Islamic banks in the country and is part of the Al Baraka Banking Group, which is considered one of the largest Islamic banking groups worldwide. Established in 1991, Al Baraka Bank Algeria operates in accordance with Islamic law, meaning it provides banking products and services that comply with Islamic principles, which prohibit interest-based transactions. (bank, al baraka bank, 2025)

3.2 Key Products of Al Baraka Bank Algeria:

Bank Accounts: (bank, al baraka bank, 2025)

- **Islamic Current Account:** Allows customers to manage their funds easily, with the ability to deposit and withdraw at any time.
- **Islamic Savings Account:** Offers customers the opportunity to save their money with Sharia-compliant returns, free of interest.
- **Islamic Investment Account:** Designed for investors who wish to grow their funds through Sharia-compliant investments.

Financing Products:

- **Murabaha Financing:** Used to purchase goods such as cars or houses, where the bank buys the asset and sells it to the customer at an agreed profit margin.
- **Ijara Financing:** Used for leasing equipment or property, with an option to own it at the end of the contract.
- **Musharaka Financing:** Based on profit and loss sharing between the bank and the customer in a specific project.
- **Istisna Financing:** For funding industrial or real estate projects through an Istisna contract.

Card Services:

- Debit and ATM Cards: Enable customers to access their funds conveniently.
- Sharia-Compliant Electronic Payment Cards.

Investment Services:

- Offering various investment products, such as Sharia-compliant investment funds.
- Portfolio Management Services.

International Trade Services:

- Issuance of Letters of Credit.
- Issuance of Bank Guarantees.
- Facilitation of export and import operations in accordance with Sharia principles.

3.3 Analysis of Sharia Supervisory Decisions on Financial Performance for 2022–2023

3.3.1 2022 Report: (bank, Annual Report of the Sharia Supervisory Board of Al Baraka Bank – 2022, 2022)

- **Decision 1:** The procedures implemented by the bank during the year ending 31/12/2022 were reviewed and found to comply with Islamic Sharia principles and established rules.
- **Decision 2:** Revenues generated from non-permissible sources were transferred to the "Sabil Al-Khairat" fund and spent on charitable purposes and areas of public benefit.
- **Decision 3:** The distribution of profits and allocation of losses to the investment account is consistent with the approved basis, in accordance with Islamic Sharia principles.
- **Decision 4:** We have decided to rectify the executed operations, as the recorded violations do not affect their validity from a Sharia perspective, being mere procedural errors; except for two operations whose profits were set aside and will be transferred to the "Sabil Al-Khairat" fund.
- **Decision 5:** A small number of aid disbursements from the "Sabil Al-Khairat" fund were recorded that do not fall under areas of public benefit, and some beneficiaries were not classified among the eligible recipients.

3.3.2 2023 Report: (bank, Annual Report of the Sharia Supervisory Board of Al Baraka Bank – 2023, 2023)

- **Decision 1:** The procedures implemented by the bank during the year ending 31/12/2023 were reviewed and found to comply with Islamic Sharia principles and established rules.

- **Decision 2:** Revenues generated from non-permissible sources will be transferred to the "Sabil Al-Khairat" fund and spent on charitable purposes and areas of public benefit.
- **Decision 3:** The distribution of profits and allocation of losses to the investment account is consistent with the approved basis, in accordance with Islamic Sharia principles.
- **Decision 4:** We have decided to rectify the executed operations, as the recorded violations do not affect their validity from a Sharia perspective, except for one operation whose profits were set aside and will be transferred to the "Sabil Al-Khairat" fund.

3.3.3 Financial Indicators of Al Baraka Bank from 2022 to 2023

The following table highlights the key financial indicators of Al Baraka Bank for the years 2022 and 2023. (Bank, 2023)

Table N 03: Financial Indicators of Al Baraka Bank Algeria

Financial Indicator	2022 (Thousand DZD)	2023 (Thousand DZD)	Change (%)
Cash, Bank of Algeria	127,478,107	150,804,407	+18.3%
Financing Granted to Customers	131,506,406	137,661,979	+4.7%
Other Assets	3,364,009	7,804,297	132%
Customer Receivables	180,922,659	208,838,578	+15.4%
Net Income for the Year	4,022,156	3,953,172	-1.7%
Granted Liabilities	41,431,936	80,174,815	+93.5%
Received Liabilities	6,680,646	3,643,262	-45.5%
Net Banking Income	8,301,152	9,067,868	+9.2%
Operating Result	4,406,956	4,899,428	+11.2%
Result Before Tax	5,144,733	5,331,978	+3.6%
Result After Tax	4,022,156	3,953,172	-1.7%

Source: Prepared by the researchers based on the Annual Report of al baraka bank (bank, al baraka bank, 2025)

Impact of Sharia Decisions on Financial Performance

- **Decision 1:** Reflects the bank's compliance with Islamic Sharia principles in all procedures. This enhances trust and credibility, positively affecting the attraction of deposits and investments. This decision is part of Sharia risk management, as it reduces the likelihood of violations. Its impact is evident in the increase of assets (an increase in "Cash, Bank of Algeria" by +18.3% and in

"Financing Granted to Customers" by +4.7%), reflecting the growth of Sharia-compliant banking activity.

- **Decision 2:** Represents the transfer of non-permissible revenues to the "Sabil Al-Khairat" fund. This decision reflects the bank's commitment to social responsibility, though it leads to a reduction in net profits. It contributes to managing reputational risk, as evidenced by the slight decrease in net income for the year (-1.7%).
- **Decision 3:** Represents the distribution of profits and losses according to the principles established in Islamic Sharia. This decision ensures fairness and transparency in profit and loss distribution, enhancing trust in the bank. It is part of managing risks related to profit distribution and contributes to attracting investors who prioritize fairness.
- **Decision 4:** Entails rectifying the executed operations, as the recorded violations do not affect their validity from a Sharia perspective, being mere procedural errors, except for two operations whose profits were set aside and will be transferred to the "Sabil Al-Khairat" fund. This decision aims to correct procedural errors and results in setting aside profits in certain cases, which negatively affects net profits in the short term but strengthens Sharia compliance and reduces risks. It may contribute to the slight decline in net income for the year (-1.7%), while enhancing Sharia risk management.
- **Decision 5:** A small number of aid disbursements from the "Sabil Al-Khairat" fund were recorded that do not fall under areas of public benefit, and some beneficiaries were not classified among eligible recipients. This decision helps improve the aid disbursement process and reduces operational and reputational risks. It aims to organize the functioning of the "Sabil Al-Khairat" fund and positively impacts the integrity of operations.

Conclusion:

The study of Al Baraka Bank's Sharia supervisory decisions demonstrates a consistent commitment to Islamic Sharia principles, which enhances customer and investor confidence and contributes to the growth of assets and revenues, despite the impact of setting aside non-permissible profits on net income. The importance of these decisions is evident in managing Sharia, operational, and reputational risks, while highlighting the need for more comprehensive quantitative analyses to measure their actual impact on financial performance.

Based on the above, we concluded the following results:

- **Continuous Compliance with Adjustments:** The decisions in both years demonstrate a focus on continuous adherence to Sharia principles, with some adjustments in procedures and controls aimed at improving performance and compliance, such as the decision to organize the "Sabil Al-Khairat" fund in 2022.
- **Balanced Financial Impact:** The decisions help achieve a balance between financial growth and Sharia compliance. Although decisions related to setting aside non-permissible profits may lead to a slight decrease in net income, they enhance credibility and contribute to attracting customers and investors.
- **Integrated Risk Management:** Sharia decisions contribute to managing Sharia, operational, and reputational risks by ensuring that operations comply with Sharia, correcting errors, and properly allocating funds.
- **Indirect Impact:** Sharia decisions indirectly affect financial performance by enhancing trust and attractiveness, which leads to increases in assets and deposits.
- **Sustainable Growth Amid Challenges:** The bank's financial performance shows sustainable growth, but it faces challenges in balancing Sharia and financial objectives, particularly regarding the costs of complying with Sharia decisions.
- **Increase in Revenue:** Despite the slight decrease in net income, net banking income increases, indicating the soundness of the bank's operational process.

Based on the above results, we can confirm or disconfirm the hypotheses as follows:

- Hypothesis 1: ....; (Confirm/Disconfirm the Hypothesis)
- Hypothesis 2: .....; (Confirm/Disconfirm the Hypothesis)
- Hypothesis 3: ..... (Confirm/Disconfirm the Hypothesis)

Accordingly, we conclude the following set of recommendations:

- **Enhancing Transparency**: The bank should work on including clearer details in the Sharia supervisory reports, specifying the applied Sharia standards, details of violations, and how they were addressed, in order to increase trust and facilitate monitoring and evaluation.
- **Developing Quantitative Performance Indicators**: It is recommended to develop quantitative indicators to measure the bank's compliance with Islamic Sharia, such as the proportion of Sharia-compliant operations, Sharia compliance costs, the number of corrected violations, and the share of financing granted to socially impactful projects. This will enable the bank to objectively assess its performance.
- **Analyzing Causes of Violations**: The Sharia supervision should focus on analyzing the causes of discovered Sharia and operational violations and propose root-cause solutions to prevent recurrence, thereby reducing long-term risks.
- **Focusing on Substantive Aspects**: Sharia supervision should pay greater attention to substantive aspects related to the objectives of Islamic Sharia and the impact of the bank's operations on society, to ensure the achievement of Sharia goals.
- **Developing Products and Services**: The bank should invest in developing innovative Sharia-compliant banking products and services to meet diverse customer needs and enhance its competitiveness in Islamic banking.
- **Enhancing Communication and Collaboration**: It is recommended to strengthen communication and collaboration

between the bank management and the Sharia supervisory board to ensure proper understanding and effective implementation of Sharia decisions, achieving the bank's shared objectives.

- **Periodic Review of Decision Effectiveness**: Periodic reviews of the effectiveness of Sharia decisions should be conducted, assessing their impact on financial and operational performance, with adjustments made when necessary to ensure the achievement of intended objectives.
- **Analyzing the Nature of Other Assets**: It is recommended to analyze the nature of other assets, which saw a significant increase in 2023 (+132%), to determine their Sharia compliance and assess the impact of Sharia decisions on them.
- **Analyzing the Nature of Liabilities**: The nature of granted and received liabilities should be analyzed to understand the reasons for significant changes and evaluate their impact on the bank's financial risks, ensuring effective risk management.

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