

CORPORATE GOVERNANCE, INTELLECTUAL
CAPITAL EFFICIENCY AND PERFORMANCE OF
ISLAMIC BANKS: EVIDENCE FROM ISLAMIC
COUNTRIES

BY

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ABSTRACT

Islamic banking and finance industry has been growing exponentially, especially in recent decades. The rapid growth witnessed by this industry demands well-trained human resources at board or management level to play leadership roles under a good corporate governance structure. To address this issue, the current study has made a threefold contribution to the examination of Islamic banking performance. First, this study investigates the relationship between corporate governance and intellectual capital efficiency of Islamic banks. Second, it examines the impact of intellectual capital efficiency on Islamic banks' performance. Third, it determines the relationship between corporate governance and Islamic banks' performance using intellectual capital efficiency as a mediating variable. The sample size of this study consisted of 129 Islamic banks from 29 Islamic countries, from 2008 to 2017. The data sourced were analysed via 2SYS-GMM to assess the influence of corporate governance and intellectual capital efficiency on the Islamic banks' performance. The results show that board structures, particularly board size, non-executive directors, and audit committee, have positive and significant relationships with intellectual capital efficiency. These findings lending support to the resource dependence theory, where boards were enhancing the intellectual capital efficiency to detain a competitive advantage in the market. Similarly, the study finds that intellectual capital efficiency, mainly structural capital efficiency and relational capital efficiency, has a positive and significant relationship with Islamic banks' performance. Thus, the finding highlights the importance of intellectual capital efficiency for the rapid growth of Islamic banks. Moreover, the study provides evidence that corporate governance measure, particularly board size, has a negative and significant relationship with banks' performance; whereas, non-executive director, CEO duality, Shariah board, and audit committee have positive and significant relationships with banks' performance. Barron and Kenny's (1986) mediating test procedure reveals that intellectual capital efficiency mediates the relationship between corporate governance and Islamic banks' performance. Based on the findings of this study, it is envisaged that this study will benefit the research community, having incorporated different areas or research into one model. This study suggests that management and other regulatory bodies must recognise the effectiveness of corporate governance mechanism, along with the intellectual capital efficiency, in improving the performance of Islamic banks.

خلاصة البحث

نالت الصناعة المصرفية والمالية الاسلامية نمواً هائلاً، خاصة في السنوات العشر الأواخر. النمو السريع في هذه الصناعة يتطلب وجود الموارد البشرية المدربة تدريباً جيداً على مستوى مجلس الإدارة أو الإدارة للقيام بأداء دور قيادية وفي ظل هيكل جيد لحوكمة الشركات. أقدم هذه الدراسة لمعالجة هذه المشكلة كمساهمة ثلاثية لفحص الأداء والانجازات في المصارف الاسلامية. أولاً، تبحث هذه الدراسة عن العلاقة القائمة بين حوكمة الشركات وكفاءة رأس المال الفكري للمصارف الإسلامية. ثانياً، تبحث هذه الدراسة عن تأثير رأس المال الفكري على أداء وانجاز البنوك الاسلامية. ثالثاً، تحدد هذه الدراسة العلاقة بين حوكمة الشركات وأداء البنوك الاسلامية مستخدماً كفاءة رأس المال الفكري كمتوسط المتغير. تألفت حجم عينة هذه الدراسة من بين 129 مصارف الاسلامية وأيضاً من 29 دولة اسلامية محيطاً على عام 2008 إلى عام 2017. لقد تم تحليل البيانات التي تم الحصول عليها من خلال SYS-GMM22 لتقييم تأثير حوكمة الشركات وكفاءة رأس المال الفكري على أداء البنوك الاسلامية. تأكدت النتائج أن هياكل مجالس الإدارة، بالخصوص حجم مجلس الإدارة والمدراء غير التنفيذيين ولجان التدقيق، لها علاقة إيجابية ومهمة مع كفاءة رأس المال الفكري. هذه النتائج تدعم نظرية الاعتماد على الموارد، حيث تعمل المجالس للاحتفاظ بميزة تنافسية في السوق على تعزيز كفاءة رأس المال الفكري. وكذلك، وجدت الدراسة أن فعالية رأس المال الفكري، وبشكل رئيسي كفاءة رأسمال الهيكلية وكفاءة رأس المال العلائقي، لها أثر إيجابي ومهم بأداء البنوك الاسلامية. ومن ثم، يكتشف أن سبب هذا النمو السريع للبنوك الاسلامية هو أهمية كفاءة رأس المال الفكري. بالإضافة الى ذلك، تقدم هذه الدراسة أدلة كافية على أن تفعيل حوكمة الشركات، خصوصاً حجم مجلس الإدارة، له علاقة سلبية وهامة بإنجاز البنوك الاسلامية؛ حيث أن المدير غير التنفيذي والرئيس التنفيذي للشركة والمجلس الشرعي ولجنة التدقيق لديها علاقات إيجابية وهامة على سير العمل في البنوك. قام بارون وكيني (1986) بكشف إجراء اختبار الوساطة بأن كفاءة رأس المال الفكري يتوسط في العلاقة بين حوكمة الشركات وأداء البنوك الاسلامية. بناءً على نتائج هذه الدراسة، ومن المتصور أن هذه الدراسة ستفيد مجتمع البحث، حيث قامت بدمج مجالات أو ابحاث مختلفة في نموذج واحد. تقترح هذه الدراسة، أن الإدارة والهيئات التنظيمية الأخرى يجب أن تعترف بفعالية آلية حوكمة الشركات مع كفاءة رأس المال الفكري، في تحسين وتعزيز أداء وإنجاز البنوك الاسلامية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organizations of Islamic Financial Institutions
ARCEIFI	Arbitration and Reconciliation Center for Islamic Financial Institutions
AUDC	Audit Committee
ATO	Asset Turnover
BCBS	Basel Committee on Banking Supervision
BCCI	Bank of Credit and Commerce
BM	Number of Board Meetings
BS	Board Size
CIMA	Chartered Institute of Management Accountants
CPI	Consumer Price Index
DE	Debt to Equity
ETD	Equity to Customer Deposit
FSB	Financial Stability Board
GEN	Gender
GDP	Gross Domestic Product
IAHs	Investment Account Holders investment
IBs	Islamic Banks
IFIs	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IIRA	International Islamic Rating Agency
IIFM	International Islamic Financial Market
IFS	Islamic Financial Services
IMF	International Monetary Fund
LAR	Loan to Asset Ratio
LTD	Loan to Deposit Ratio
MENA	Middle East and North Africa
NEXD	Non-Executive Directors
NPF	No-Performing Financing
NPM	Net Profit Margin
OECD	Organisation of Economic Co-operation and Development
OIC	Organisation of Islamic Cooperation
ROA	Return on Asset
ROE	Return on Equity
SA	South Asia
SBC	Shariah board committee
SEA	South-East Asia
SG	Shariah Governance
SB	Shariah Board
UK	United Kingdom
USA	United State of America
VIF	Variance Inflation Factor

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Islamic banking and finance is one of the fastest-growing sectors in the global financial industry. According to the 2017-2018 World Islamic Banking Competitiveness report,¹ Islamic banking and finance is growing at 15-20 per cent and the total assets held by the Islamic Banks (IBs) was valued US\$2.1 trillion at the end of 2017. Based on the contemporary literary sources, the Islamic finance industry has remained stable (Chapra, 2011; Hasan & Dridi, 2011; Hussien, Alam, Murad, & Wahid, 2019), efficient (Al-Khazali, Lean, & Samet, 2014; Bourkhis & Nabi, 2013; Rosman, Wahab, & Zainol, 2014), with better asset quality (Mwamba, Hammoudeh, & Gupta, 2017), and lower loans default rates (Baele, Farooq, & Ongena, 2014; Mollah, Hassan, Al Farooque, & Mobarek, 2017).

Since the last few decades, Islamic financial institutions have experienced substantial growth, especially in Muslim countries. The financial stability of Islamic financial institutions, even during the recent 2007-2008 global financial crisis, has attracted a great deal of attention throughout the world. These institutions are less susceptible to insolvency due to their unique structure of investment and contracts. According to Rosman et al. (2014), Islamic financial institutions outperformed the conventional banks during the financial crisis due to their unique activity and funding structures, such as risk-sharing principles and real economic transactions that are backed by tangible assets (Ajili & Bouri, 2018; Beck, Demirgüç-Kunt, & Merrouche, 2013).

¹ world-islamic-banking-competitiveness-report-2017.pdf

The recent subprime crisis of 2007-2008 arises as a result of several issues, but lack of governance and intellectual capital deficiency are among the major issues (Chazi, Khallaf, & Zantout, 2018; Mollah et al., 2017; Nawaz, 2017). Although Islamic banks are different from their conventional counterparts and have been showing strong resilience during the financial crises, there is a need for them to be more focused on a good governance structure to avoid uncertain shocks. This is so since good corporate governance structure plays a significant role in banking operations, particularly as it improves the ability of Islamic banks to withstand external shocks, including exterior financial distress (Berger, Imbierowicz, & Rauch, 2016). A structure of good corporate governance includes board members, discipline, accountability, fairness, independence, responsibility, transparency, social responsibility, and shareholders' rights (AlSagr, Belkhaoui, & Aldosari, 2018; Farag, Mallin, & Ow-Yong, 2018; Zagorchev & Gao, 2015).

Meanwhile, continuous growth in the Islamic financial institutions has increased their competitiveness in the global financial industry, and as such, there is need for them to focus more on their intellectual capital assets because high intellect can greatly contribute to the static and dynamic efficiency of the economic system of organisations (Makki & Lodhi, 2014; Nawaz, 2019). On this basis, Al-Musalli, Karem and Ismail (2012) note that knowledge-based intellectual capital is the primary factor that creates to value and achieve competitive advantage for the organisations as compared to the financial and physical capital. Today, the world financial economy is knowledge-based (Rochmadhona, Suganda, & Cahyadi, 2018) and organisations must create value through intangible sources rather than depending on physical sources only (Duho & Onumah, 2019; Khairiyansyah & Vehtasvili, 2018; Tahir, Shah, Khan, & Afridi, 2018).

Nowadays, organisations are in dire need to increase their intellectual capital efficiency to obtain a competitive advantage by extending trained human capital as a unique asset to enhance the performance (Basyith, 2016; Duho & Onumah, 2019; Nawaz, 2017; Rochmadhona et al., 2018). In the financial sector, banks generally require massive number of relational capital and human capital for their endurance (Belal & Ali, 2013; Khairiyansyah & Vehtasvili, 2018; Nawaz, 2019) because these are highly skill-based, knowledge-intensive, and relationship-rich industry (Alhassan & Asare, 2016). Thus, the typical operations of banking sector closely involve direct customer interaction at a more substantial extent for the amalgamation of information about the development of new products and services (Arifin, 2016; Rochmadhona et al., 2018; Yalama, 2013).

Furthermore, intellectual capital is one of the vital principal components of corporate governance, and it behoves organisation that comply with corporate governance policies to disclose it. The disclosure of intellectual capital increases the shareholders' confidence and reduces uncertainty about the future projection of the organisation (Al-Musalli, Karem & Ismail, 2012; Khairiyansyah & Vehtasvili, 2018). Moreover, intellectual capital disclosure can accurately assist in the assessment of the organisational value that will ultimately help to improve the organisation performance (Mention & Bontis, 2013; Purnomo, 2018). Hence, intensive competition, both nationally and internationally in the financial industry, demands that board should be more efficient in the utilisation of their tangible and intangible resources to generate profit since intellectual capital viewed as one of the significant assets of an organisation. Thus, organisations with high intellectual capital may attract more investors that may increase their yield (Grove, Patelli, Victoravich, & Xu, 2011; Jetmiko, 2018; Nawaz, 2019).

In addition, corporate governance and intellectual capital are related due to their significant roles in attaining the objective and assuring survival and growth of the organisation (Saeed, Rasid, & Basiruddin, 2015). As such, it is part of the responsibilities of the board to constitute strategies towards efficient utilisation of human and structural resources to improve the organisation performance (Nawaz, 2017). Thus, combining intellectual capital and corporate governance is important for Islamic Financial Institutions (IFIs) to generate good profit and sustainable growth (Basyith, 2016; Nawaz, 2019). Based on this, the current study utilises intellectual capital as a mediating variable in the relationship between corporate governance and Islamic banks' performance.

1.2 STATEMENT OF THE PROBLEM

Over the past few decades, the field of banking and finance has experienced the evolution of Islamic mode of banking, particularly with its rapid growth in the Muslim world. Islamic finance has also seen substantial expansion in the non-Muslim countries in term of global financial assets and market share (Chazi et al., 2018). The financial assets of the Islamic financial sector totaled US\$2.1 trillion in 2017, growing at 50% faster than the overall banking sector with an average annual growth rate of 15% from 2010 to 2017. The value of Islamic banks' assets is expected to reach US\$3.4 trillion by 2020 (Čihák & Hesse, 2010). Despite the significant progress made by Islamic banks, but Islamic banking industry as increasingly been found with asset deficient Nawaz (2017) as a result of inadequate skilled workforce, proper training, research, and human infrastructure. This suggests that this industry is clearly dependent on research and training to be able to grow from strength to strength (Jetmiko, 2018).

As we look ahead to the future, the Islamic finance industry is shifting from what it is today to a more Shariah-compliant industry. This industry has initially adjusted to the reality of conventional banking framework, but has been shifting towards a more Shariah-based banking framework. However, shifting towards Shariah-based industry will be successful only if there are more trained and well-qualified Shariah professional Islamic bankers (Alhassan & Asare, 2016). This is the area where human resources, whether at board or management level, should play a leadership role under the corporate governance principles. Thus, strong corporate governance principles provide the world with a more equitable and fairer place for all (Nawaz, 2019).

Apart from the substantial growth of Islamic finance, some Islamic financial institutions (IFIs) are reported to have experienced financial crises, such as Dubai Islamic Bank in 1998, Ihlis Finans in Turkey in 2001, and Bank Islam in Malaysia in 2005 (Chazi et al., 2018; Fakhrunnas & Ramly, 2017). These Islamic financial institutions experienced financial crises because of mismatch management (right person for the right position) that give a big picture of the importance of corporate governance for the performance of Islamic banks. Based on various circumstances confronted by the organisations, it can be considered that corporate governance is an urgent matter for the banks, especially Islamic banks, to manage their operations appropriately.

While the failure of IFIs could arise due many issues, but bad governance and lack of intellectual capital are considered as significant issues that attract the attention of researchers, policymakers, regulatory bodies, and investors both from developed and developing countries. Although corporate governance was effective and intact in IFIs at the time of crises, but they failed to perform (Fakhrunnas & Ramly, 2017).

Gupta, Krishnamurti, and Tourani-Rad (2013) documented that IFIs are failed because of their board of directors unable to serve for the purpose which they were hired in the institutions. Thus, IFIs needs a strong governance structure that can be formed by putting the right people in the right positions, which can benefit from reducing agency cost as well (Mwamba et al., 2017; Nawaz, 2019).

Banking industry is playing a pivotal role in the development of economic growth and it is considered as the backbone of every economy. To effectively play their roles, it is essential for banks to close attention to the issue of governance since banks have been categorised as a highly regulated industry by the Basel Committee on Banking Supervision (1999). Failure to do so may, therefore, jeopardise the performance of the banks. Hence, there is need to ensure excellent governance mechanism that is well structured, adequate, appropriate, and sufficient, particularly by the Islamic banks. Therefore, this study empirically investigates corporate governance mechanism of Islamic banks as a banking system with two-layers of organisational governance structures, which make them unique from their conventional counterparts. First, Islamic banking and finance is based on Shariah law, suggesting that Islamic banks must undertake their businesses in accordance with Islamic principles (Hassan, Rizwan, & Sohail, 2017). Second, Islamic banks are characterised by a high presence of investment deposits, which can lead to a principal-agent problem and conflict of interest between investment deposit holders, shareholders, and managers (Frag et al., 2018). Also, this has raised unresolved corporate governance issue regarding the protection of rights of investment deposit holders versus shareholders. Third, the institutional environment in which Islamic banks operate is characterised by less transparency, weaker market forces, and sometimes, inadequate government oversight (Elshandidy & Neri, 2015).

Islamic banking is a new area in the financial sector around the world, and they are facing high competition. For sustainable growth, Islamic banks significantly need to focus on the value of intellectual capital efficiency under the structure of good corporate governance.

1.3 RESEARCH OBJECTIVES

The main objective of this study is to investigate the connection between corporate governance mechanism and intellectual capital efficiency, and their combined effects on Islamic banks' performance in the Islamic countries.

This study has four sub-objectives as follows:

1. To identify the measures of corporate governance mechanism in Islamic banks.
2. To investigate the impact of corporate governance mechanism on intellectual capital efficiency.
3. To examine the relationship between intellectual capital efficiency and Islamic banks performance.

To determine the relationship between corporate governance mechanism and Islamic banks performance when intellectual capital efficiency is functioned as a mediating variable.

1.4 RESEARCH QUESTIONS

The study aimed to achieve the following research questions:

1. What are the measures of corporate governance mechanism in Islamic banks?

2. What is the relationship between corporate governance mechanism and intellectual capital efficiency?
3. How does corporate governance mechanism affect the performance of Islamic banks?
4. How does intellectual capital efficiency affect the performance of Islamic banks?
5. Does intellectual capital efficiency mediate the relationship between corporate governance mechanism and Islamic banks' performance?

1.5 MOTIVATION AND SIGNIFICANCE OF THE STUDY

There are several motivating factors for conducting this research. The primary motivating factor is the financial failures of the Islamic financial institutions as seen in Dubai Islamic Bank, Ihtas Finan's House, and Bank Islam (Chazi et al., 2018). Many researchers believe that weak corporate governance is one of the reasons for these failures (Chazi et al., 2018; Fakhrunnas & Ramly, 2017). Although Islamic banking sector is growing substantially, their failures may result in a lack of investors' confidence. As such, there is a need to develop a sound corporate governance system to rebuild the trust of investors as well as to sustain the advancement in Islamic financial institutions. Therefore, the researcher is motivated to study the impact of corporate governance on Islamic banks' performance. This study uses panel data from 2008 to 2017 across all Muslim countries. The sampled period is one of the main contributions of the study because most of these countries have developed code of corporate governance and follow it in their banking system. This study examines the post effect of corporate governance at the time when it is considered as a crucial factor for the growth of Islamic financial institutions. Furthermore, this study uses data of