# THE INFLUENCE OF CORPORATE AND *SHARĪ'AH* GOVERNANCE MECHANISMS ON THE ISLAMIC ECONOMIC AND FINANCIAL PERFORMANCE OF ISLAMIC BANKS IN MALAYSIA

BY

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# ABSTRACT

The responsibility and accountability of boards of directors and its effectiveness as part of governance mechanisms are important in assessing corporate performance. In the context of banking industry, corporate scandals and failures have attracted considerable amount of public attention. Hence, the need to understand the essentials of governance mechanisms have emerged. These mechanisms are crucial to ensure adequate accountability from the key players to protect not only the interests of shareholders but other stakeholders, in achieving performance. For Islamic banks, there is an emerging issue of inadequate, inappropriate and insufficient performance measurements. This study measures the acceptance of elements and ratios for the new performance measurement as well as develops a new performance measurement which is Islamic economic performance (IEP) as derived from Islamic economic objectives. This study also examines the influence of both corporate and *Sharī'ah* governance mechanisms on the Islamic economic and financial performance. In order to produce a reliable research, qualitative and quantitative research techniques have been used; via primary and secondary data collection methods, which covers interview (structured survey), questionnaire, annual reports and financial database. The sample of this study is 13 Islamic banks in Malaysia. The data had been gathered for three years since the start of the *Sharī'ah* governance Framework (SGF) full implementation in 2012, until 2014. The data has been analysed via SmartPLS SEM to assess the influences of corporate and *Sharī'ah* governance mechanisms on Islamic bank performance. This study adopts the Islamic governance and accountability perspective which was developed by Abdul Rahman (1998) in deriving the theoretical framework and hypotheses. The IEP measurement has been accepted and developed in three elements such as need fulfilment and equitable distribution, economic growth and economic stability and seven ratios to represent the achievement of Islamic banks in Islamic economic objectives. The corporate governance mechanisms (CGM) and *Sharī'ah* governance mechanisms (SGM) were found to have a positive effect on the financial performance (FP) for Islamic banks in Malaysia. Not only that, SGM also has a positive effect on IEP. However, CGM brings no effect on IEP at all. The results indicated that the practices of corporate and Shari'ah governance mechanisms of Malaysian Islamic banks are considered to be sufficient as majority of the practices are aligned with most recommendations made by the relevant authorities. The findings of this study signify the importance of Islamic rules and regulations, moral values and ethics in enhancing Islamic economic and financial performance of the Islamic banks. This study also offers new measurement which can assist top management of Islamic banks to develop new strategies to further improve their banks' performances. It is hoped that this research can positively impact the policies and regulations in scrutinizing the roles, duties and responsibilities of board and Shari'ah committee in enhancing accountability, moral values and ethics matters. This study contributes to the body of knowledge as it develops and provides a set of new performance measures in measuring Islamic economic performance, which is also known as the *M Score*.

# ملخص البحث

إن مسؤولية ومساءلة مجالس الإدارة وفعاليتها كجزء من آليات الحوكمة أمر مهم للغاية في تقييم أداء الشركات. وقد جذبت فضائح الشركات والاخفاقات المختلفة قدراً كبيراً من الاهتمام العام ضمن سياق الصناعة المصرفية. ونتيجةً لذلك، ظهرت الحاجة لفهم جوهر آليات الحوكمة. تلك الآليات ضرورية لإنجاز التقييم الكافي في تحقيق الأداء الأمثل من الجهات الفاعلة الرئيسية بغية حماية مصالح حملة الأسهم بالإضافة الى أصحاب المصالح الآخرين. أما فيما يخص المصارف الإسلامية، فهناك قضية ناشئة عن عدم كفاءة وفعالية وملائمة تقييم الأداء. وبالتالي، فإن هذا البحث يقيس ملائمة العناصر والنسب لإجراءات الإنجاز الجديدة. ليس هذا فحسب، بل تطور هذه الدراسة أيضًا قياس أداء جديد وهو أداء الاقتصاد الإسلامي (IEP) المستمد من أهداف الاقتصاد الإسلامي. لذلك، يمكن أن تساعد هذه الدراسة في فحص تأثير آليات حوكمة الشركات والحوكمة الشرعية على الاقتصاد الإسلامي والأداء المالي. تم استخدام تقنيات البحث النوعية والكمية من خلال جمع البيانات الأولية والثانوية، وقد تنوعت مصادر جمع المعلومات والبيانات من مقابلات الشخصية والاستبيانات والتقارير السنوية وقواعد البيانات المالية وذلك بهدف الحصول على بحث موثق. تمت دراسة ثلاثة عشرة مصرف إسلامي في ماليزيا كعينة مستخدمة في هذا البحث من خلال جمع بيانات لفترة ثلاث سنوات منذ بدء التنفيذ الكامل لـ SGF في عام ٢٠١٢ وحتى عام ٢٠١٤. وتم تحليل البيانات عبر Smart PLS SEM لتقييم تأثير آليات حوكمة الشركات والحوكمة الشرعية على أداء المصارف الإسلامية. يعتمد هذا البحث على نظرية الحوكمة والمساءلة الإسلامية التي طورها عبد الرحمن (١٩٩٨) في استخلاص الإطار النظري والفرضيات. لقد تم قبول وتطوير مقياس IEP في ثلاثة عناصر مثل تحقيق الحاجة والتوزيع العادل والنمو الاقتصادي والاستقرار الاقتصادي وسبعة نسب تمثل إنجاز المصارف الإسلامية في أهداف الاقتصاد الإسلامي. وقد خلص البحث إلى أن هناك علاقة ايجابية بين آليات حوكمة الشركات (CGM) وآليات الحوكمة الشرعية (SGM)على الأداء المالي (FP) للمصارف الإسلامية في ماليزيا. ليس هذا فقط، فان آليات الحوكمة الشرعية لها تأثير إيجابي على الأداء المالي. ومع ذلك، لا يوجد أي تأثير لآلية حوكمة الشركات على مقياس IEP على الإطلاق. استناداً إلى النتائج، نود الاشارة إلى أن ممارسات آليات حوكمة الشركات والحوكمة الشرعية في المصارف الإسلامية الماليزية تعتبر كافية لأن غالبية الممارسات المستخدمة تتماشى مع معظم التوصيات التي تقدمها السلطات المختصة. كما تشير نتائج هذه الدراسة إلى أهمية القواعد والأنظمة الإسلامية والقيم الأخلاقية وأخلاقيات المهنة في تعزيز الأداء الاقتصادي والمالي الإسلامي للمصارف الإسلامية. تقدم نتائج هذه الدراسة أيضاً قياسًا جديدًا يمكن أن يساعد الإدارة العليا للمصارف الإسلامية على تطوير استراتيجيات جديدة لزيادة تحسين أداء هذه المصارف.ومن المؤمل أن يؤثر هذا البحث إيجابياً على السياسات والأنظمة للتدقيق في أدوار وواجبات ومسؤوليات مجلس الإدارة واللجان الشرعية لتعزيز المساءلة والقيم الأخلاقية وأخلاقيات العمل. يمكن لهذا البحث أن يساهم في تكوين المعرفة، لكونه اعتمد على مجموعة من مقاييس الأداء الجديدة المستخدمة لقياس أداء الاقتصاد الإسلامي والذي يُعرف أيضًا باسم درجة M، وعمل على تطويرها وتفعيلها في هذه الدراسة.

# APPROVAL PAGE

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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 degree at IIUM or other institutions.

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| | |
|---|---|
| AAOIFI | Accounting and Auditing Organizations of Islamic Financial Institutions |
| BAFIA | Banking and Financial Institutions Act 1989 |
| BNM | Bank Negara Malaysia |
| BCBS | Basel Committee on Banking Supervision |
| BC | Board Competency |
| BS | Board Size |
| BOD | Board of Director |
| CGM | Corporate Governance Mechanism |
| CTI | Cost to Income |
| EG | Economic Growth |
| ES | Economic Stability |
| FMM | Formative Measurement Model |
| FP | Financial Performance |
| IEP | Islamic Economic Performance |
| IFIs | Islamic Financial Institutions |
| IFSB | Islamic Financial Services Board |
| IIUM | International Islamic University Malaysia |
| KPI | Key Performance Indicator |
| MCCG | Malaysian Code of Corporate Governance |
| NED | Non-Executive Directors |
| NFED | Need Fulfilment and Equitable Distribution |
| OECD | Organization of Economic Cooperation and Development |
| PLS | Partial Least Squares |
| ROA | Return on Assets |
| ROE | Return on Equity |
| SBS | *Sharī'ah* Committee Size |
| SBM | *Sharī'ah* Committee Meeting |
| SC | Social Contribution |
| SEM | Structural Equation Modelling |
| SGF | *Sharī'ah* Governance Framework |
| SGM | *Sharī'ah* Governance Mechanism |
| SM | Structural Model |
| SPSS | Statistical Package for Social Science |
| UKM | Universiti Kebangsaan Malaysia |
| UM | Universiti Malaya |
| UPM | Universiti Putra Malaysia |
| UUM | Universiti Utara Malaysia |
| VIF | Variance Inflation Factor |
| WIS | Weighted Importance Score |
| WRIGA | Weighted Ratio of Income Generation over Assets |
| WRIGE | Weighted Ratio of Income Generation over Equity |
| WRIRES | Weighted Ratio of Investment in Real Sector over Assets |
| WRERA | Weighted Ratio of Employee Remuneration over Assets |
| WRTFA | Weighted Ratio of Total Financing over Assets |
| WRTPA | Weighted Ratio of Tax Paid over Assets |
| WRZPA | Weighted Ratio of Zakat Paid over Assets |

# CHAPTER ONE

# INTRODUCTION

## 1.1 BACKGROUND OF STUDY

Generally, the development of Islamic banking started with the endeavour for social obligation-based initiatives. The efforts made were based on social obligation, such as in Malaysia via the Pilgrimage Fund in the mid-1940s, in Pakistan in the late 1950s by means of the Indian Jama'at Islami in 1969, in Egypt through the Mit Ghamr Saving Banks between 1963 and 1967, and the Naseer Social Bank in 1971.

The development of the Mit Ghamer Saving Bank and the Nasser Social Bank in Egypt were the pioneers of the Islamic banking system in 1963. Nevertheless, at that particular time, they only collected small savings and made direct investment in agricultural and industrial activities, and small local businesses. Twelve years later, in order to foster the economic development and social progress among the member countries and their Muslim communities to comply with the principles of *Sharī'ah*, the Organisation of Islamic Conference (OIC) inaugurated an inter-governmental Islamic bank, known as the Islamic Development Bank (IDB). The Islamic banks have been monitored by special enactments, legislation, and infrastructure. Many Muslim countries adopted Islamic banking practices alongside conventional banking. A summary of the international development in Islamic finance can be referred to in Appendix 1.

Meanwhile, the growth of Islamic finance in Malaysia has been developed via four distinct phases (Dusuki & Abdullah, 2011). The first phase was the establishment of Islamic Financial Institutions (Islamic banks), the second phase was the Islamic windows; the third phase was the Islamic subsidiaries, and the fourth was the liberalization of Islamic finance. The development of Islamic finance in Malaysia can be referred in details in the Appendix 2.

Corporate governance is essential to ensure the smooth running of any business, and it has been seen as a mechanism to improve accountability and performance. However, there is a critical debate on the governance and performance based on the increasing number of corporate/bank closures and difficulties. The people comprising the management of the institution are the key players that bear the ultimate responsibility and accountability to run the business properly. However, there were cases around the world involving senior persons in the business operations who were not acting in the best interests of shareholders and other stakeholders.

In 1999, the Malaysian Finance Committee Report defined corporate governance as "the process and structure used to direct and manage the business and affairs of the institution toward enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholders' value, whilst taking into account the interests of other stakeholders".

Moreover, the Organisation for Economic Co-operation and Development (OECD) in the Principles of Corporate Governance (2000, revised April 2004) defines corporate governance as the "…set of relationship[s] between a (company's) management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of (the company) are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the Board and management to pursue objectives that are in the interests of (the company) and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy." It is emphasized that corporate governance involves a set of relationships between an institution's management, its board, shareholders and other stakeholders.

In fact, the code also further explains that corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Therefore, from the definition itself, corporate governance can be illustrated as a mechanism for managing and monitoring a corporation to achieve its objectives, and, at the same time, to ensure that the interests and welfare of the shareholders and stakeholders are protected. Indeed, Bank (2009) also highlights that good governance is an effective mechanism for protecting stakeholders, whilst poor governance puts all parties at risk. By having the best practices of governance in place, the interests of shareholders and other stakeholders are guaranteed by the proper running of the business, which is handled by the appropriate and responsible individuals.

In the financial services sector, the principal-agent relationship carries the same definition as is applied in the corporate sector. However, the additional requirements of governance for Islamic banks need to be understood by the persons responsible when making decisions for Islamic banks. As highlighted by Chapra (2004), there are three groups of internal key components in Islamic banks involving decision-making – the board of directors, the *Sharī'ah* and key *Sharī'ah* compliance functions, and the majority shareholders. They are in the position to make sound decisions and realign the direction of the business for the sake of shareholders and other stakeholders in Islamic banks. The International Financial Services Board (IFSB) (2006) defines corporate governance “as a set of relationships between a company’s management, its BOD, its shareholders, and other stakeholders that provide the structure through which the objectives of the company are set; and the means of attaining those objectives and monitoring performance are determined.” This definition has been adopted from OECD (2000 and revised 2004).

In the context of Islamic banks, good corporate governance should encompass “a set of organizational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders; provision of proper incentives for the organs of governance such as the BOD, *Sharī’ah* Committee, and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging Islamic banks to use resources more efficiently; and compliance with Islamic *Sharī’ah* rules and principles” (IFSB, 2006).

Based on the description as discussed, corporate governance cannot be seen solely as a set of relationships amongst directors, shareholders and other stakeholders in an institution. An institution should set up its strategic objectives and ensure that the objectives can be achieved, whilst, at the same time, the monitoring mechanism must be in place. Hence, corporate governance in the context of Islamic banks has been defined by Hasan (2011) as, firstly, a set of relationships among the key players and stakeholders. Secondly, these banks should have clearer strategic objectives of their existence. Thirdly, they should also have a proper monitoring mechanism in terms of the checks and balances of the business operations and activities.

At present, in Malaysia, the Central Bank, i.e., Bank Negara Malaysia (BNM), has developed the *Sharī’ah* governance framework for Islamic banks, effective beginning 1$^{st}$ January 2011 with the ultimate objective being to enhance the role of the board, the *Sharī'ah* Committee and the management in relation to *Sharī'ah* matters. Indeed, the *Sharī'ah* Governance Framework was the first guideline on *Sharī'ah* governance matters to be issued and applied in Islamic financial institutions in Malaysia.

The definition of *Sharī'ah* governance in the *Sharī'ah* Governance Framework for Islamic Financial Institutions guideline has been adopted from the definition in the Islamic Financial Services Board (IFSB) (2009). The IFSB (2009) defines the *Sharī'ah* governance system as "a set of institutional and organizational arrangements through which Islamic banks ensure that there is effective independent oversight of *Sharī'ah* compliance over the issuance of relevant *Sharī'ah* pronouncements, dissemination of information and an internal *Sharī'ah* compliance review." Besides the corporate governance requirements as prescribed by other codes at the international level and locally, Islamic banks are also required to comply with the *Sharī'ah* governance requirements to ensure *Sharī'ah* compliance.

The agency problems in Islamic financial institutions are unique to other financial institutions and corporation, and different ways of examining and solving the issues are needed. As highlighted by Bukhari (2013); Darmadi (2013); Safieddine (2009); Grais and Pellegrini (2006); Archer and Karim (1998), and Sarker (1999), the need to comply with *Sharī'ah* rules and regulations makes a huge difference between Islamic finance and other modes of financing.

This study aims to fill the research gap by identifying the performance measurement from the Islamic economic objectives and use them as indicators for measuring Islamic banks' performance other than financial performance. This research also examines how the monitoring and control mechanism of the corporate and *Sharī'ah* governance in the form of the board of directors and *Sharī'ah*

Committees can better contribute to Islamic economic and financial success. Hence, this study highlights the sufficient practices from corporate and *Sharī'ah* governance monitoring and control mechanisms that are expected to be able to reduce or minimize agency and accountability problems in Islamic banks.

## 1.2 PROBLEM STATEMENT

There is inadequate, inappropriate and insufficient performance measurement for Islamic banks (Qasim, Mohamad & Ibrahim, 2017; Siswanti, Salim & Sukoharsono, 2017; Mohammed, Tarique & Islam, 2015; Nadia, Sonia & Jaleleddine, 2014; Ajlouni & Omari, 2013; Mohamed, 2010; Badeldin, 2008; Rosly & Bakar, 2003; Samad & Hassan, 1999). The measurement for assessing the performance of Islamic banking is still lacking due to the fact that Islamic banks require a broader measurement rather than one of simply profit maximization. They are not only expected to make a profit but also to fulfil the *Sharī'ah* rules and principles. Their objectives should also consider the Islamic economic system in designing their achievements. Therefore, the performance measurement for Islamic banks could differ from corporations and conventional banks.

Nienhaus (2007), Chapra and Ahmad (2002), Adams and Mehran (2012) have contended that banks clearly appear to have different governance attributes than non-financial firms to ensure sound business practices in the banking industry. There is a lack of understanding of governance attributes due to the higher demand by the higher authority in governing the financial institutions (bank). The governance in banks is crucial as they have been categorized as a highly regulated industry by the Basel Committee on Banking Supervision (1999). Failure to do so, may jeopardise the performance of the banks. Thus, they need to ensure the governance mechanisms that structured in the bank must be adequate, appropriate and sufficient particularly for Islamic banks.

There are three reasons for the different governance structure. Firstly, in Islamic banks, the ultimate concern is compliance with the Islamic *Sharī'ah* rules and principles (*Sharī'ah* requirements). Besides the banking Acts, they are also required to fulfil Islamic rules and regulations, moral values and ethics. Therefore, the board of directors, *Sharī'ah* Board and key *Sharī'ah* compliance functions are involved in *Sharī'ah* audit, *Sharī'ah* review, *Sharī'ah* risk management and *Sharī'ah* research. These are the key players responsible for making decisions and implementation and must be well-versed in both the *Sharī'ah* requirements and the conventional banking Acts. They have primary accountability to Allah (S.W.T), and, at the same time, have secondary accountability to all the stakeholders. The people involved in planning and making decisions in Islamic banks must have the capacity for monitoring and control of the institutions. This has been proven by the corporate failures of Islamic banks, which attracted attention from around the world and the demand for a good and efficient governance system.

Secondly, Islamic banks have a broader base of stakeholders compared to corporations and conventional banks. 'Stakeholders' in Islamic banks include employees, customers, suppliers, investment account holders and the community. Due to the unique role of banks, the supervisors and government are also stakeholders (BNM/GP1-I, 2007; IFSB, 2006). Nienhaus (2007) highlights and suggests that the scope of corporate governance for Islamic banking is wider than conventional banking for Islamic depositors, i.e., investment account holders (IAHs). The Investment Account Holders (IAHs) are exposed too much higher risks than in conventional banks. It was referring to the different nature of depositors as debt or partnership arrangement.

The fundamental problem concerning the conflict of interest between Islamic depositors and shareholders is that both parties share substantial parts of the bank's profits, which implies a distribution conflict. Clearly, the profit share based on a ratio is not numerically defined in the Islamic deposit contracts. This ratio will be decided by the management decision, which is an issue that may lead to a conflict of interest. In addition, the requirement for proper internal guidelines for managing investment account holders (IAHs) was suggested by the IFSB (2006), and highlighted in the International Financial Services Act (IFSA, 2013).

Thirdly, Islamic banks are heavily regulated. The role of the board of directors differs in the banking industry in the sense that they have greater responsibility and accountability in discharging their duties. The duties and responsibilities of the key players in the Islamic banks (boards, *Sharī'ah* Boards, key *Sharī'ah* compliance, i.e., *Sharī'ah* Audit, *Sharī'ah* Review, *Sharī'ah* Risk Management and *Sharī'ah* Research) are more demanding, in that they must ensure both legal and *Sharī'ah* compliance as well as take into account the Islamic moral and ethical values. They are required to be accountable to the broader group of stakeholders. Ultimately, they are accountable to Allah (S.W.T) Hence, they are expected to be knowledgeable and skillful in managing, monitoring, and controlling banking institutions to ensure *Sharī'ah* compliance.

There is also a lack of appropriate theories in governance from an Islamic perspective to address the issue of accountability, and a governance structure to protect shareholders and other stakeholders as a whole. Stakeholders must be assured that their welfare will be taken care of properly by the authorized party, as suggested by Iqbal and Mirakhor (2004), and the Financial Sector Master Plan (BNM, 2012). This is due to the lack of a 'shareholder model' of corporate governance, particularly for Islamic banks. As suggested by Archer, Ahmed and Karim (1998), a proposed model for Islamic corporate governance is necessary to overcome the lack of a Western or conventional model of corporate governance to cater for Islamic banks, especially in protecting IAH rights; for instance, in the case of default and the investment strategy. Even though in the IFSB (2009) the procedure for minimizing the risk has been outlined it is worth studying how the top key players in the Islamic banks are able to enhance performance, which, indirectly, contributes to the stakeholders' protection.

The problem that arises as a result of this system of corporate ownership is that agents do not necessarily make decisions in the best interests of the principal, as both the principal and the agent have their own interests, which results in a conflict. This is also known as the agency problem. The assumption underlying this theory is that the goals of the principal and the agent are often in conflict. Whereby, the primary objective of the corporation is to maximize the shareholder's wealth. In practice, this does not necessarily happen, as it is normal for managers to pursue their own personal objectives; for instance, to get a bonus every year, which constitutes individual wealth maximization. They may concentrate on projects and company investments that would provide high short-run profits as the short-term returns would benefit them via their pay. In addition, managers are also tempted to gain extra benefits, such as salaries with other supplements; for example, holiday packages through the company, and office equipment, etc. This leads to a reduction in shareholder value and is termed according to the agency theory as 'residual loss'.