



THE EFFECT OF CORPORATE GOVERNANCE
STRUCTURE ON CORPORATE SOCIAL AND
FINANCIAL PERFORMANCE OF MALAYSIAN
ISLAMIC BANKS

BY

HAMIDAH BINTI BANI

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ABSTRACT

Social responsibility is incumbent in the foundation of corporate governance of Islamic banks (IBs) and positioned as one of the bank's objective world widely. This research uses stakeholder and agency theories in search of empirical evidences on the achievement of the social objective in Malaysian Islamic banks. It investigates the issue via a questionnaire survey and content analysis of the IBs' annual reports. The survey is carried out with 152 IBs managers aimed to gain insight on the important corporate social performance (CSP) indicators and salient stakeholder groups from the managers' perspective. In general, Islamic bank managers perceived that there were 47 important CSP indicators while different stakeholder interest groups were significantly different in salience for CSP consideration. New stakeholder groups, the government, investment account holder and Zakat were recognized in Islamic banking with the government interest group being the most salient. The content analysis aimed to gauge the actual CSP's /achievement) for various stakeholder interest groups of 11 IBs in Malaysia from 2003 to 2008 and to examine the relationship and effect of corporate governance structures with CSP and the banks' performance. CSP (scored based on the presence of the CSP indicators in the banks' annual report weighted by its perceived importance) in IBs was still marginally low with an average of 52% of the expected performance. Controlling the cultural and national differences, this study found significant improvement in CSP particularly in 2007 and 2008 (years after the issuance of CSR framework for public listed companies (2006) and after the issuance of specific Code of Corporate Governance for Islamic Financial Institutions in Malaysia (2005). However, the significant improvement was neither across all stakeholder groups nor across the time series. CSP in the full-fledged IBs (FFIB) was inactive compared to the Islamic subsidiary banks (ISB). Though generally the CSP in IBs was not encouraging, EGLS regression analysis empirically provided evidences that the board structures particularly the board size and *Shari'ah* governance structures (size and roles) were significant factors to the banks' CSP (social functions). Only Government ownership (GOwn) had significant effect to ROA while the size of *Shariah* Committee (ScSize) and the concentrated ownership (IOWN) had significant effect to Tobin Q. Though general analysis found that CG had significant effect on CSP and CSP had significant effect on financial performance, Barron and Kenny (1985) mediating test procedure found that CSP was not a mediating variable in the CG and financial performance relationship.

ملخص البحث

المسؤولية الاجتماعية حتمية في تأسيس حوكمة الشركات للمصارف الإسلامية وتعتبر كأحد أهم أهداف البنوك على مستوى العالم، هذا البحث يستخدم نظريات المساهمين والوكالة لإستقصاء الأدلة التجريبية على تحقيق الهدف الاجتماعي في المصارف الإسلامية الماليزية، تستخدم هذه الدراسة الاستبيان وتحليل محتوى التقارير السنوية للبنوك الإسلامية، تم تطبيق الاستبانة على 152 من مدراء البنوك بهدف معرفة أهمية مؤشرات الأداء الاجتماعي للشركات ومجموعة المساهمين البارزين من وجهة نظرهم، ويرى المدراء أن هناك 47 مؤشرا مهما من مؤشرات الأداء الاجتماعي للشركات بينما كانت مجموعات فوائد المساهمين البارزين دالة إحصائيا باختلاف الأداء الاجتماعي للشركات. وكانت الأكثر أهمية في البنوك الإسلامية مع مجموعة الفوائد الحكومية: مجموعات المساهمين الجدد، وأصحاب الحسابات الاستثمارية والزكاة، ويهدف تحليل المحتوى إلى قياس الأداء الفعلي للمسؤولية الاجتماعية للشركات لمختلف مجموعات مصالح المساهمين والمكونة من (11) من مدراء البنوك الإسلامية في ماليزيا في الفترة 2003-2008 لإختبار العلاقة بين بنية حوكمة الشركات والمسؤولية الاجتماعية للشركات وأداء البنوك، إن المسؤولية الاجتماعية للشركات في البنوك مازالت هامشية ومنخفضة بمعدل 52% من الأداء المتوقع، وللتحكم في الإختلافات الثقافية والوطنية فقد وجدت هذه الدراسة تحسنا ملحوظا في المسؤولية الاجتماعية للشركات وخاصة في عامي 2007 و 2008 وهي السنوات التي أعقبت إقرار الإطار العام للمسؤولية الاجتماعية للشركات الوطنية المدرجة لعام 2006 وبعد صدور القانون المحدد لحوكمة الشركات للمؤسسات المالية الإسلامية في ماليزيا لعام 2005. وعموما لم يكن التحسن الكبير في جميع مجموعات المساهمين ولا عبر سلسلة زمنية، إن إكتمال المسؤولية الاجتماعية للشركات في البنوك الإسلامية غير مفعّل مقارنة مع فروع البنوك الإسلامية. وبالرغم أن المسؤولية الاجتماعية للشركات في البنوك الإسلامية لم تكن مشجعة، وتحليل الإنحدار أثبت عمليا بالأدلة أن هياكل المجالس وخصوصا حجم الهياكل وبنية حوكمة الشريعة (الحجم والأدوار) كانت عوامل هامة للبنوك في وظائفها الاجتماعية، إن ملكية الحكومة له تأثير مهم على (RAO) بينما حجم الهيئة الشرعية والملكية المركزة كان له تأثير على العائد على الأصول، وأثبتت التحليلات العامة أن (CG) له تأثير مهم على (CSP) وأن (CSP) له تأثير مهم على الأداء الاقتصادي، كما أن إجراءات إختبار المتوسطي لبراون وكيني (1985) وجدت أن (CSP) ليس بالعامل المتوسطي في العلاقة بين (CG) والأداء المالي.

APPROVAL PAGE

The dissertation of Hamidah Bani has been approved by the following:

.....
Noraini Mohd Ariffin
Supervisor

.....
Abdul Rahim Abdul Rahman
Co-Supervisor

.....
Syed Musa Syed Jaafar AlHabshi
Internal Examiner

.....
Asyraf Wajdi Dusuki
External Examiner

.....
Nasr El-Din Ibrahim Ahmed
Chairman

DECLARATION

I hereby declare that this dissertation 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.

Hamidah Bani

Signature.....

Date

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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ON CORPORATE SOCIAL AND FINANCIAL PERFORMANCE
OF MALAYSIAN ISLAMIC BANKS**

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In the name of Allah the Most Compassionate and the Most Merciful

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LIST OF ABBREVIATIONS

AAIOFI	Accounting and Auditing International Organization for Financial Institution
Amet	Number of Audit Committee meeting
BAFIA	Banking and Financial Institution Act
BIMB	Bank Islam Malaysia Berhad
BMet	Number of board meeting
BMMB	Bank Muamalat (Malaysia) Berhad
BNM	Central Bank of Malaysia
BNM CCG	Guideline of corporate governance for licensed IBs (revised BNM/GP1-i)
BSize	Board Size
CG	Corporate governance
CSP	Corporate Social Performance
EPF	Employee Provident Fund
FFIB	Full fledge Islamic Banks
GDP	Gross Domestic Product
GOwn	Government agency share ownership
IAH	Investment Account Holders investment
IBA	Islamic Banking ACT
IBs	Islamic banks
IFI	Islamic Financial Institutions
IIIB	Institute of Institution of Islamic Banking
IOwn30	30 Substantial owners share ownership
ISB	Islamic Subsidiary banks
KLSE	Kuala Lumpur Stock Exchange (Bursa Malaysia)
MCCG	Malaysian Code of Corporate Governance
MESRA	Malaysian Environmental and Social Report Award
MIA	Malaysian Institute of Accountant
NEP	New Economic Policy
PauInd	Percentage of auditors independent
Pbisi	Percentage of independent board
PNB	Permodalan National Berhad
ROA	Return on Assets
RWCR	Risk-Weighted Capital Ratio
SAC	<i>Shari'ah</i> Advisory Board
ScRoles	Number of Roles of <i>Shari'ah</i> Committee
ScSize	Size of <i>Shari'ah</i> Committee
SPI	Skim Perbankan Islam
Tobin Q	Approximate Tobin Q
TOwn	Board of directors and top management team share ownership
VIF	Variance Inflation Factor

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The role of corporate governance (CG) in banking is vital. In fact, the recurring financial crisis in the year 1997 and 2009 that affected the banking industry globally, has attracted the attention on the effectiveness of the CG of the banks in ensuring safe and sound banking system. Effective and efficient CG in banking industry is important because the industry contributes to the economic system significantly. In Malaysia for example, banking and finance industry has significant contribution to the national economic system or Gross Domestic Product (GDP) of 9.2% in 2000, 11% in 2008 and 17% in 2011 (BNM, 2009; 2012)

CG is also important in the fast growing Islamic finance industry. All over the world, Islamic finance industry operates in 75 countries with over 500 Islamic financial institutions (IFIs) with total assets of nearly USD 1 trillion and is expected to capture half of the savings of the Muslim world (Austay, 2010: pg. 41-42). In Malaysia, the industry has shown a tremendous growth over the last five years. The total assets in the system increased from RM156, 810.8 million in 2007 to RM334, 982.6 million in 2011 (BNM Monthly Statistical Bulletin, 2012).

Consistent to the growth of the Islamic finance industry, the CG of Islamic banks is expected to play greater role in ensuring business success in fulfilling the responsibilities of the banks to shareholders and other stakeholders (Hakim, 2002) and to act as a mechanism to mitigate agency problems involving various stakeholders of

the business namely the shareholders, creditors, management, employees, consumers and the public at large (Abu-Tapanjeh, 2009).

The term CG in the Islamic perspective is referred to as *Howkomat al Sharikat* (حوكمة الشركات) in Arabic which literally means the governance of companies (Adwam, World Bank Group 2013). It refers to the manner of directing , managing affairs , controlling, engineering , steering, marshaling, regulating , be in charge , managing well, economizing , devising, planning and conducting the course of business. In Al Quran it is termed as *Tadbir* (تَدْبِيرِي) (Al Burey, 1985). It refers to rational act of examining the consequence (s) of an affair so that a creditable result may be worked out and thus obtained. In the Malaysian Code of CG (MCCG, 2000 pg. 2) CG is defined as “the process and structure to direct and manage the business and affairs of the institution towards enhancing business prosperity and the corporate accountability with the ultimate objective of realizing long term shareholders value, whilst taking into account the interest of other stakeholders”.

In the context of Islamic banks (IBs) in Malaysia, CG involves the manner in which the business and the affairs of individual banking institutions are being governed by their board of directors and senior managers. CG assures generation of economic returns to the owners and day-to-day operations, and acknowledges the interests of recognized stakeholders including depositors. This is to ensure that the banking business is safe and sound and in compliance with the applicable laws and regulations with an aim to maximize shareholders’ return and protect the interest of all stakeholders (BNM/RH/GL 001-1 (GP-i), 2005 pg.1)

The comparison among few definitions above provide basic understanding that CG of IBs has the responsibility to integrate social responsibility in their banking business by taking into account the interests of all stakeholders. In other words, it

means that other than ensuring business success; the CG of IBs is expected to be more socially responsible. This is because, according to the Islamic law (*Shari'ah*), faith-based institutions and business entities with wealth (the wealthy) are required to; contribute to social and humanitarian works (Kahf, 2004), emphasize the promotion of *adl* (fair) and just (justice) operation to customers, society and the needy and promote social benevolence in their business operations for example through prohibiting *Riba* (interest) and *Gharar* (gambling) and upholding the payment of *Zakat* (Chapra, 1985; Chapra and Khan, 2000; Munawar, Iqbal and Llywellyn, 2002; Munawar and Philip, 2005; Acher and Abdel Karim, 2007). Due to those expectations, IBs are expected to place a greater concern on the accounting, accountability and transparency in their business operation in comparison to conventional banks.

The definition of CG in context of IBs also appreciates the stakeholders' relations in the systems and processes which requires the management to act in a socially responsible way in all areas of their business activities. The aim of social responsibility activities, policies or programs is to discharge accountability to various stakeholders through optimizing their CG system so that it can maximize the IBs' performance over a long term. Theoretically, this resembles the application of stakeholder theory (Iqbal and Mirakhor, 2004; Hasan, 2008; Hasan and Harahap, 2010). The theory specifies that decision makers utilize resources efficiently, to manage them in the best interest of their principal stakeholders and to maintain good relationship between different stakeholders (Grais and Pellegrini, 2006). Indirectly, CG also covers decision-making activities; who make the decision on CG, who will benefit from CG and what resources to use to materialize CG (Lewis, 2005), in order to meet the objectives of the decision based on the principle of accountability, transparency and trustworthiness.

In general, an efficient CG from the Islamic perspective is the mechanism, which has the capability in ensuring good relationship and protecting the interests of various stakeholders. Philosophically (in *Tawhidic* paradigm), efficient governance primarily needs to ensure efficient relationship with the ultimate stakeholder that is the resource owner (Allah) through compliance of *Shari'ah*. The *Tawhidic* paradigm (Unity of God) conceptually provides illustrations of the link between the spirit of *Tawhid* with all management functions (planning, organization, leading, and controlling) and ensures harmony between the other worldly (*Al-Akhirah* - the Hereafter) and the worldly (*Al Duniya*). The banks' mission and objectives will be achieved through continuous enforcement in promoting goodness (*amr bil ma'aruf*) and prevention of evil (*wannaha anil munkar*). Based on this paradigm, harmonized management approach, in accordance to the requirements of the religion (*ad-din*), is an important ingredient to achieve the objective of *Shari'ah* (*Maqasid Shari'ah*) of Islamic banks successfully.

Economically, effective CG must be able to achieve its commercial objective to generate profit that will protect the economic interest of the shareholders and in return increase the value of the banks.

Ethically, CG requires banks to provide interest-free goods or services to customers (depositors and borrowers) and socially IBs need to be efficient in protecting the interest of affected parties or entities (stakeholders) such as employees, the general community and environment surrounding the corporations.

The capability of Islamic banks in fulfilling the interests of various stakeholders through providing interest-free products and services, performing welfare activities, installing appropriate policies and program in compliance to *Shari'ah* is known as corporate social performance (CSP) in this study. As such, the Islamic

perspective on CSP in Islamic banks is defined as the fulfillment of *Al Tawhidic* philosophy (*servant (al-abd)* and vicegerancy (*khalifah*) paradigm). This is based on firstly, the principles of accountability, transparency, justice and fair and trust, which motivates action taken (*akhlaq*) by the cooperated individuals (on behalf of the company) on various stakeholders (who are affected and affecting the business). Secondly, the basis is the degree to which firms make use of social responsiveness processes and finally, the existence and nature of policies and programs designed to manage the societal relationships and the social impact (that are observable outcomes). In brief, corporate social performance is not limited to donating money but more on integrating philosophical, economic, social and ethical foundations of corporate governance into the business practices. (This study uses CSP and CSR interchangeably because CSR denotes social activities)

A number of Islamic scholars criticized the incapability of IBs to emphasize economic and social objectives fairly and adequately. Chapra (2009), Siddiqi (2009) and El Gamal (2006) claimed that IBs do not have genuine business operations. This is because they are in the opinion that most of IBs activities are similar to any conventional finance where activities are market and profit driven and they neglect their responsibility to serve and engage with the communities (Asutay, 2010).

The stakeholder theory and the philosophical perspective (*Tawhidic* paradigm) of CG in Islam place stakeholders' interest as an important aspect in Muslims' daily activities in maintaining the relationship with Allah (*hablum minallah*) and fellow man (*hablum minannas*) for example, shareholders, investors, fellow workers, customers, supplier, debtors, community, the needy, and competitors and the environment (nature and universe) surrounding them. Nonetheless, the specific indicators of social responsibility for various stakeholders have not been adequately