DUAL BOARD GOVERNANCE, OWNERSHIP STRUCTURE AND PERFORMANCE OF ISLAMIC BANKS: A COMPARATIVE ANALYSIS ON SELECTED COUNTRIES

BY

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ABSTRACT

Islamic banks (IBs) must guarantee that all of their products and operations are *Shari'ah* compliant, and therefore, IBs have unique agency issues which give rise to different agency conflicts. For that, IBs have unique board governance structure, i.e. *Shari'ah* supervisory board (SSB) besides board of directors (BoD). Given there is a noticeable lack of empirical studies that examine the unique dual board structure and ownership structure in IBs vis-a`-vis their performance, this study aims to fill this gap in the literature. A sample of 78 IBs is employed from the GCC countries, Southeast Asian countries, Bangladesh and Pakistan over the period 2007-2015 while the Generalized Method of Moments (GMM) -First Difference (2-step) was used to analyze the panel data. The study contributes to the literature by providing empirical evidence across jurisdictions on the impact of dual board structure on IBs performance. Furthermore, the study provides evidence on how SSB affects IBs performance by considering the differences across jurisdictions in SG structure models ((Centralized SG model (CSGM) vs. decentralized SG model (DSGM)) and SG regulatory models (Pro-active vs. Minimalist), as well as the impact of the financial crisis of 2008. The study also examines the moderating effect of ownership concentration on the relationship between SSB and IBs performance. Lastly, the study examines whether IBs with larger SSBs size outperform their counterparts with smaller boards, besides as whether there is any optimal SSB size that can enhance IBs performance and can be recommended to the IBs across jurisdictions. The results show that strong BoD is negatively related to performance while effective SSB is positively related even during crisis period. It is also found that effective SSB positively moderates the relationship between strong BoD and performance of IBs. The results indicate that the IBs with more effective SSBs demonstrate higher levels of performance when they are located in jurisdictions that adopt CSGM and Pro-active models. The results also present that ownership concentration and effective SSB are segmented in IBs in terms of performance as measured by accounting ratios and integrated in IBs in terms of performance as measured by the market-based measurement and Islamic performance measurement (Zakat ratio). The findings highlight the importance of small SSB size in enhancing the performance of IBs as compared to large board size, besides that the optimal SSB size is between three and seven, more specifically, the optimal SSB size seems to be four or five. The findings confirm the need for SSB scholars in IBs with higher doctoral qualification and reputation and with less cross-membership during crisis and non-crisis periods.

خلاصة البحث

يجب أن تكون منتجات وأعمال المصارف الإسلامية متوافقة مع أحكام الشريعة الإسلامية، وبالتالي، فإن هذه المصارف عُرضة لمشاكل وكالة فريدة والتي تؤدي إلى ظهور مشاكل التعارض في المصالح. لهذا، تمتاز المصارف الإسلامية بهيكل حوكمة يحتوي على مجلس الرقابة الشرعية إلى جانب مجلس الإدارة. نظراً لوجود نقص ملحوظ في الدراسات التجريبية فيما يخص تأثير هيكل الحوكمة المزدوج وهيكل الملكية في المصارف الإسلامية على أدائها، تهدف الدراسة إلى سد هذه الفجوة البحثية. تكونت عينة الدراسة من 78 مصرفاً إسلامياً تعمل في دول مجلس التعاون الخليجي ودول جنوب شرق آسيا وبنغلادش وباكستان خلال الفترة 2007-2015، وقد تم تحليل بيانات (بانل) باستخدام طريقة العزوم المعممة (GMM). قدمت الدراسة أدلة تجريبية حول كيفية تأثير هيكل الحوكمة المزدوج على أداء المصارف الإسلامية مع الأخذ بعين الاعتبار الاختلافات بين الدول من حيث نماذج هيكل الحوكمة الشرعية ((نموذج مركزي (CSGM) مقابل نموذج لامركزي (DSGM))، ومن حيث نماذج البيئات التنظيمية للحوكمة الشرعية ((تدخل تنظيمي قوي (Pro-active) مقابل تدخل طفيف (Minimalist)). أشارت النتائج إلى وجود تأثير تفاعلي إيجابي لمجالس الرقابة الشرعية على العلاقة بين مجالس الإدارة وأداء المصارف الإسلامية. كذلك أظهرت النتائج أن المصارف الإسلامية التي لديها مجالس رقابة شرعية فعالة وتعمل في الدول التي تتبنى أنظمة حوكمة شرعية مركزية وبيئات تنظيمية قوية، تتمتع تلك المصارف بأداء مرتفع. أشارت النتائج أيضاً إلى أن تركز ملكية المصارف الإسلامية يعيق مجالس الرقابة الشرعية في تعزيز أداء المصارف بحسب نسب السيولة، في حين أن هذا التركز يساعد تلك المجالس على تعزيز الأداء بناءً على مقاييس قيمة المصارف السوقية، ونسبة الزكاة. أكدت الدراسة على أن حجم مجلس الرقابة الشرعية الأمثل لا يتجاوز أربعة أو خمسة أعضاء. أخيراً أوصت الدراسة بضرورة وجود أعضاء في مجالس الرقابة ممن لديهم مؤهلات عالية، وسمعة طيبة، مع تقليص عدد الأعضاء ممن لديهم عضوية في أكثر من مجلس رقابة شرعية.

APPROVAL PAGE

The thesis of Naji Mansour Naji Nomran has been approved by the following:

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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.

Naji Mansour Naji Nomran

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This thesis is dedicated to my late father, my mother, my wife, and all my family.

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In the name of Allah, the Most Compassionate, the Most Merciful. All praise is for Allah *subbahÉnahu wa ta'ÉlÉ* and blessings and salutations of peace be upon His Messenger Muhammad *ṣallā llāhu ʿalayhi wasallama* and his companions and those who follow them in upholding the cause of the right religion. I am really grateful to Allah (S.W.T) for the health, wealth, strength and opportunity to complete my PhD Degree without any obstacles and difficulties, particularly in conducting this work which cannot be done without His will.

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for IFIs
AGT	Agency Theory
BoD	Board of Directors
BoDs	Boards of Directors
CB	Conventional Bank
CBs	Conventional Banks
CG	Corporate Governance
CSGM	Centralized *Shari'ah* Governance Model
DSGM	Decentralized *Shari'ah* Governance Model
IAHs	Investment Account Holders
IB	Islamic Bank
IBs	Islamic Banks
ICLR	Islamic Commercial Law Report
IFIs	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
RDT	Resource Dependence Theory
ROA	Return on Assets
ROE	Return on Equity
SEM	Structural Equation Modeling
SG	*Shari'ah* Governance
SKT	Stakeholder Theory
SSB	*Shari'ah* Supervisory Board
SSBs	*Shari'ah* Supervisory Boards
STD	Stewardship Theory
UIA	Unrestricted Investment Account
GMM	Generalized Method of Moments
OLS	Ordinary Least Square
CEO	Chief Executive Officer
COPER	Conventional Performance
ISPER	Islamic Performance
GCC	Gulf Cooperation Council
CSR	Corporate Social Responsibility
OIC	Organization of Islamic Cooperation

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

The importance of corporate governance (CG) concept has attracted attention from researchers and businesses especially after the global financial crises of 1997 and 2008. This is due to weak CG in financial institutions leads to weak performance, which in turn would affect the financial system as a whole (Minton et al., 2010). Recently, there is a noticeable increase in the literature that highlights the CG and their impact on performance and risk in the banking industry, particularly in developing countries (see, e.g., Mahmood and Islam, 2015; Liem, 2016; Alobaidi et al., 2017). More specifically, there is an absence of empirical studies on the Islamic banks' (IBs) CG. Thus, this study contributes to the literature by offering an empirical study concerning the impact of *Shari'ah* supervisory board (SSB), board of directors (BoD), and ownership structure on IBs performance across jurisdictions.

1.2 BACKGROUND OF THE STUDY

There is no doubt that good CG has a positive impact on performance, where most of the studies confirm that good governance would improve companies' profitability, productivity, competitiveness and decreases risk (Todorovic, 2013). This impact would be reflected in improving the financial system and then the economies especially for the developing economies (Abdurrouf, 2011). For both, the developing and underdeveloped economies, banks play a significant role in enhancing the economic development since they are the main source of finance and investment (Zulkafli et al., 2010). This explains why countries are keen on the stability of their financial institutions. There is a belief that this requires promoting stakeholders' value, which will not be achieved only by strengthening their confidence in the financial institutions such as banks.

The Islamic banking industry has grown rapidly since the early 2000s (Safiullah and Shamsuddin, 2018) and become most competitive to the conventional banking (Kamarudin et al., 2014). This growth is due to many reasons, led by the religious aspect that encourages Muslims to use banks that comply with *Shari'ah* rules particularly in a Muslim majority country (Ashraf et al., 2015; Ullah and Khanam, 2018). Further, many industry players have shifted their interests towards the Islamic financial system as a viable alternative to the conventional one after the series of failures of several conventional financial institutions due to the crisis of 2008 (Kassim and Majid, 2010).

IBs differ from its conventional counterparts in their functions, structure, and objectives (Mohammed and Muhammed, 2017a). The main difference distinguishing the IBs from conventional banks (CBs) is the absolute prohibition of interest (*riba*) (Ghayad, 2008), business concerning alcohol, gambling, and excessive speculation (Zirek et al., 2016). IBs should guarantee that all their products and operations are compliant with *Shari'ah* rules and principles (Grais and Pellegrini, 2006a). Accordingly, IBs have unique agency issues which give rise to different agency conflicts that might exist in IBs as compared to the CBs (Farag et al., 2017). Besides the common agency problems that occur between managers and shareholders, IBs are also likely to encounter additional agency problem, e.g., in any case managers deviate from their duty, to ensure *Shari'ah* implementation (Zainuldin et al., 2018).

Thus, the governance structure of IBs requires them to establish SSBs besides the usual BoDs (Alnasser and Muhammed, 2012; Nomran et al., 2018). This extra layer of governance, as represented by SSB, aims to approve and report on IBs' compliance with moral values (Abdelsalam et al., 2016; Shibani and De Fuentes, 2017). As Al-Malkawi and Pillai (2018) state, SSB serve as the governance cockpit for certifying IBs transactions.

In other words, IBs have "multi-layer" governance structure, i.e. SSB besides BoD instead of "singlelayer" structure (Mollah and Zaman, 2015; Bukair and Rahman, 2015; Abdelsalam et al., 2016; Almutairi and Quttainah, 2017; Rafay et al., 2017; Farag et al., 2017; Shibani and De Fuentes, 2017; Safiullah and Shamsuddin, 2018). As Farag et al. (2017) argue, there is an ongoing debate in the the CG literature about the advantages and disadvantages of single-tier boards versus the dual board structure. The decision-making process is much faster in single-tier boards as the frequency of meetings is higher compared with the dual board structure, while in contrast, the separation of control and managerial tasks was regarded as one of the major advantages of the dual board structure (Jungmann, 2006).

This discussion requires us to initially understand the meanings of important terms such as "Corporate Governance (CG)", "CG system" and "CG mechanism". CG is "the set of mechanisms that induce the self-interested controllers of a company to make decisions that maximize the value of the company to its owners" (p.1) (Denis and McConnell, 2003). According to Weimer and Pape (1999) and Aljifri and Moustafa (2007), a CG system is defined as "a more-or-less country-specific framework of legal, institutional and cultural factors shaping the patterns of influence that shareholders (or stakeholders) exert on managerial decision-making" (p.1) (p.72). Also, CG is the system which directs and controls companies (Gitman et al., 2010).

In contrast, CG mechanisms are defined as "the methods employed, at the firm level, to solve corporate governance problems" (p.73) (Aljifri and Moustafa, 2007). Literature indicates that internal CG mechanism includes BoD and ownership structure whilst external focuses on the market and legal regime (Abdullah and Muhammed, 2012).

Therefore, on that basis, *Shariʿah* governance (SG) is defined as "the internal mechanism which helps to ensure that an Islamic financial institution complies with the *Shariʿah* in its operations and activities which helps it to achieve the objectives of *maqāṣid al-Shariʿah*", and hence, SG system is "the system by which the SSB is controlled and directed for the purpose of *Shariʿah* compliance" (p.176) (Grassa, 2013a). The SSB, in this case, is the most important CG mechanism that ensures compliance with *Shariʿah* rules in IBs (Besar et al., 2009). It acts as a key internal control mechanism (Haniffa and Hudaib, 2007) that increases the stability and therefore the profitability of IBs (Ajili and Bouri, 2018a). SSBs add great value to IBs as a CG mechanism by overseeing managers' behaviour and minimizing the probability of unethical practices (Quttainah and Almutairi, 2017).

Given that such system and mechanism, as represented by SG and SSB, do not exist in the CBs, therefore, they are the main governance features of IBs that distinguish them from the CBs (Mollah and Zaman, 2015). Despite SG is relatively new, it was known during early modern Muslim societies as the institution of *Hisbah*[1]. Currently, SSB is therefore the ideal institution to play the role of *Hisbah* in IBs (Hakimi et al., 2018).

[1] "*Hisbah* is referred to enjoining of evidently abandoned good and forbidding what is indecent and evil. The *Hisbah* system is run by *Muhtasib* (supervisor) whose responsibilities are to control the unethical actions in society's economic affairs. Thus, board members who are the trustees of shareholders might play important roles as *Muhtasib* by monitoring and instructing the bank's management in ensuring that the business activities are parallel with *Shari'ah*" (Zainuldin et al., 2018).

Figure 1.1[2] provides a clear explanation for the CG framework of IBs and the interactions between a bank's various actors (i.e., management, BoD, SSB, and shareholders). As the Figure 1.1 shows, both boards (BoD and SSB) are appointed by the shareholders in order to monitor management. The reason is that the operation mechanism of IBs are mainly based on the Islamization in all their activities and operations (Grassa, 2013a; Grassa, 2013b), for this, IBs operate based on a profit and loss and (risk-sharing) model instead of interest-based (*riba'*) as in the CBs (Mollah and Zaman, 2015).

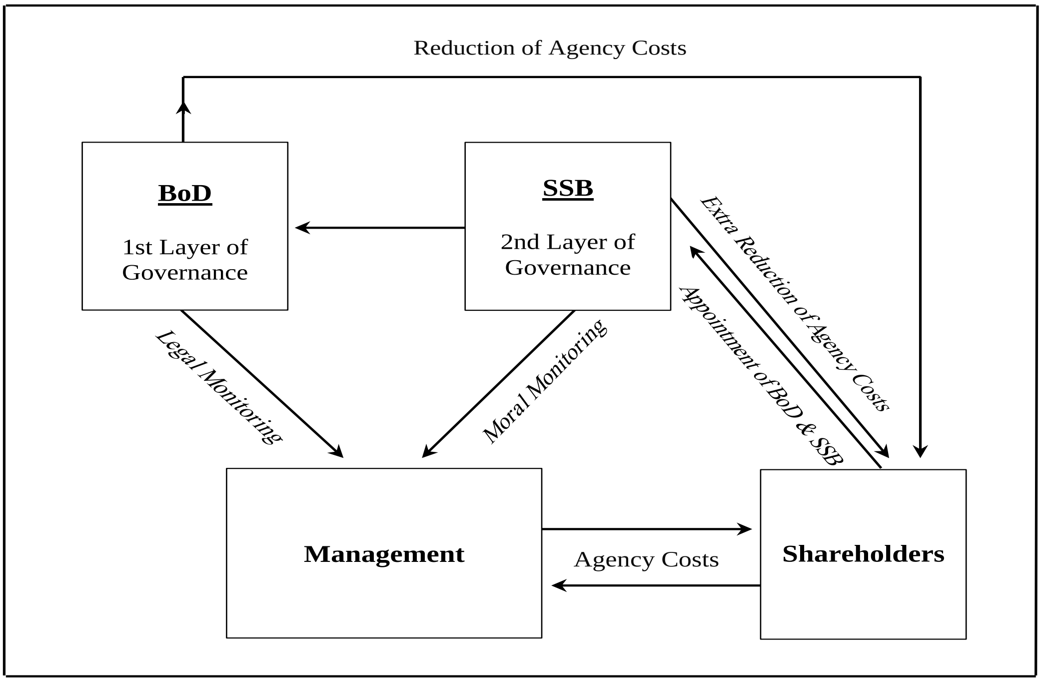

Figure 1.1 Corporate Governance Structure for IBs

As BoD is a powerful internal governance mechanism affecting IBs performance, SSB is also an important stakeholder that affects their performance besides BoD and the ownership structure (Mohammed and Muhammed, 2017a). The decision-making of management in the IBs is indeed constrained by an SSB that

[2] Figure 1.1 adapted from: (Abdelsalam et al., 2016; Shibani and De Fuentes, 2017).

rejects any proposals in the light of the *Shari'ah* principles (Ghayad, 2008); therefore, BoD is obliged to obey the SSB decision (Alnasser and Muhammed, 2012). The nature of the SSBs decision may influence the acceptance of one product over another, hence; the SSB certification of approval could increase or decrease the volume of banking business especially there is no rights are given for the management to involve in the SSB decision (Mohammed and Muhammed, 2017a). In addition, the SSB role means that products are likely to be *Shari'ah* compliant and less risky, and then, it ameliorates the negative effects of excessive risk-taking and contributes to better performance of IBs (Mollah and Zaman, 2015).

Also, some shareholders or the senior management may blame the SSBs for any operating loss, e.g., in dealing with calculation of actual expenses of the penalty arising from late payments to be recorded as an income in the profit and loss statement or even in Zakat accounting or in making recommendations for the profit qualification reserve provisions, which may affect the bank's profitability (Bakar, 2016). Although economic calculation and the profit concerns of the IBs are allocated to the BoD, the appreciation of the licit character of this profit is allocated to the SSB (Ghayad, 2008). Further, effective SSB members with diverse professional backgrounds may enable juristic *Shari'ah* decision-making and greater conformity to *Shari'ah* principles and as such influence the level of IBs' risk (Safiullah and Shamsuddin, 2018). Thus, as a result, the establishment of an SSB for IBs is very essential (Amin et al., 2013; Mohammed and Muhammed, 2017a).

However, the BoD effectiveness is determined by its characteristics such as independence, size, and composition (John and Senbet, 1998). Similarly, a multitude of variables relating to the SSB characteristics may determine how effective the SSB conducts its task. The variables include SSB size, cross-membership, doctoral qualification, reputation, expertise and change in the board composition (Farook and Lanis, 2007; Farook et al., 2011; Rahman and Bukair, 2013; Nomran et al., 2017; Almutairi and Quttainah, 2017; Nomran et al., 2018, Hakimi et al., 2018).

According to Grais and Pellegrini (2006a), Grassa (2013a), Bukhari et al. (2013), and Ben Bouheni and Ammi (2015), there are five issues of CG resulted from the SSBs function. First, the independence of SSBs opinions and decisions as IBs management appoints these boards' members and suggests their reward which in turn may have a negative effect on the SSBs independence. Under such conditions, IBs management may tend to affect SSBs decisions (*fatwas*) by using the management authority, thereby promoting "*fatwa* shopping"[3]. Second, the confidentiality of SSBs members especially when some of them holding multiple board appointment in different IBs which may be reflected negatively on their independence. The third and fourth issues are respectively the competence of SSBs members and the consistency of opinions (*fatwas*) across IBs, time, and across countries. Finally, the fifth issue is the disclosure practices regarding SG function as IBs should provide clear information about their SSB responsibilities, *fatwas*, and members (Grais and Pellegrini, 2006a; Grassa, 2013b; Ben Bouheni and Ammi, 2015).

Currently, IBs operate across jurisdictions under various SG structure (Hasan, 2009), which refers to the structures and processes that ensure IBs compliance with *Shari'ah* rules (Ahmed, 2011). Several studies classified SG models into two main models which are the centralized and decentralized models (CSGM and DSGM) (see, e.g., Grais and Pellegrini, 2006a; Grais and Pellegrini, 2006b; Alman, 2012; Hassan et al., 2013; Hamza, 2013). DSGM reflects the *Shari'ah* supervision at the institutional

[3] *Fatwa* shopping "refers to seeking opinion and rulings by Islamic scholars on matters where there is ambiguity that a certain product or banking activity is in line with *Shari'ah* or not" (p.42) (Malik et al., 2011).