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CONTENTS

Corporate Governance Characteristics and Financial Performance: Evidence from Islamic Banks in Malaysia

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ABSTRACT

Corporate governance has been proven to be an effective mechanism in managing business operations that have major impact on the financial performance, increase investor confidence level and goodwill. Past studies have focused more towards the relationship between corporate governance and financial performance among various industries including financial services. However, limited studies explored in overseeing the performance of Islamic financial services in relation to the implementation of Shariah governance principles since 2010 which are fully governed by the Central Bank of Malaysia. Hence, this research aimed to investigate the relationship between corporate and Shariah governance characteristics (board size, board independence, CEO duality, size of the Shariah Committee and disclosure of the Sharia Committee Report) and bank performance (return on equity) among Islamic banks in Malaysia. A total of 16 Islamic banks listed in Bursa Malaysia were selected and data from the annual reports were collected and analysed from 2011 to 2018. This research shall provide greater insights to various stakeholders and shareholders as the potential investors. It gives better and clear understanding of the functions of both corporate and Shariah governance in enhancing the performance and operation activities of Islamic banks in Malaysia.

KEYWORDS: Corporate Governance, Islamic Banks, Financial Performance

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INTRODUCTION

Banks are the important players in economic growth as they are the key elements of the economy of a country (Epstein, 2015). Poor corporate governance within the banking sector will lead to improper banking activities and risk management, lack of oversight of senior management and complex organizational structures (Dorina, 2016). Therefore, it is important that the Malaysian financial institutions ensure that they are able to maintain good governance in their operational activities. Malaysia has overhauled the banking sector completely after being affected by the Asian financial crisis in 1997 in order to enhance corporate governance and resilience so that it is able to withstand systemic shocks (Lee & Isa, 2015). According to Wasiuzzaman and Gunasegavan (2013), corporate governance is one of the important factors which has an impact the bank performance in Malaysia.

The Malaysian banking industry is divided into Islamic banking and conventional banking. The most important feature that distinguishes Islamic banks from the conventional ones which is well known by society is the riba free feature which in the conventional bank system appears in the form of interest (Ulfi, Mubarrok and Wahyudi, 2020). Conventional banks apply a comprehensive governance framework for reviewing its banking activities to provide for accountability, transparency and to maintain best practices that comply with the principles of corporate governance and legal and regulatory requirements (Wijethunga & Ekanayake, 2015). In a conventional bank, the board of directors, shareholders and the management are the parties concerned with how the processes within a company are monitored (Abdullah Saif, Alnasser & Muhammed, 2012). However, there is a difference in the corporate governance structure between Islamic and conventional banks whereby Islamic banks establish the Sharia Supervisory Board (SSB) as a main part of their corporate governance framework (Suleiman, 2009 as cited in Wasiuzzaman & Gunasegavan, 2013).

Corporate governance within a company can have a significant impact on its credit quality especially for those that have poor corporate governance (Olson, 2005). According to Ashbaugh-Skaife, Collins and LaFond (2006), weak governance can cause the firms to bear higher debt financing costs as a firm with weaker governance will give excess CEO remuneration compared to those with governance. A bank with a poor corporate governance structure will result in excessive risk taking, inappropriate incentive compensation, and a board structure that values short-term gains over long-term performance (International Finance Corporation, 2012). This is similar to the Bank Islam case, which incurred losses amounting to RM 2.2 billion due to unexpected provisions for non-performing loans in 2005 by loaning to companies in Sarajevo and South Africa where some of the companies no longer exist because of the lack of internal controls and risk management (Thajudeen, 2013). All these cases show that poor corporate governance will have a negative impact towards corporate performance not only among conventional banks but also Islamic banks in terms of financial loss and lack of public confidence.

Although there has been extensive research done previously most of the research compared conventional banks with Islamic banks on various factors but not specifically on Sharia governance of Islamic banks and their performance. Furthermore, those researches rarely touched on the Islamic banking sector in Malaysia. It is important to explore compliance to Shariah principles among Islamic financial institutions to ensure that the level of confidence among stakeholders is properly maintained through effective implementation of corporate governance (Ulfi et.al, 2020). Furthermore, strong governance can be obtained through support and encouragement from Islamic banking regulators for scholars to identify, understand and verify the authenticity of Shariah-compliant financial products, especially innovative instruments (Ulfi et.al, 2020), (Nomran and Haron, 2020).

A study conducted by Tazilah, Rapani, Halim and Majid (2017) focused specifically on the importance of doing an exploratory study on the understanding of Shariah governance characteristics that focus on the function of the Shariah supervisory committee, Shariah committee report, Shariah supervisory board meeting, Shariah audit, Shariah review, Shariah risk management and Shariah research as well as the performance of Islamic Financial Institutions in Malaysia. However, this study aims to further investigate the relationship between corporate governance characteristics (board size, CEO duality, board independence, Shariah committee and report disclosures) and financial performance (Return on Equity) among Islamic banks in Malaysia. This study will provide a better understanding of the function of the governance structure of Islamic banks in Malaysia as well as the significance of the relationship of governance towards bank performance.

LITERATURE REVIEW

Research Theory

The Agency Theory (AT) has been widely used by many researchers since it was introduced 1970s. Ross (1973) described the AT as the relationship which arises between two (or more) parties, when one is appointed as the principal, who is responsible for decision making while the other acts as the agent. This theory is rooted in economics and is applied when economists explored the risk sharing problem among individuals or groups, which arises when cooperating parties have different attitudes or goals toward risks (Eisenhardt, 1989; Ross, 1973). Despite of being used in economics the AT is also widely used in various research fields, such as managerial accounting (Boučková, 2015), family firm behaviour and governance (Madison, Holt, Kellermanns, & Ranft, 2016), sport management (Kennelly & Toohey, 2016), and supply chain management (Prosman, Scholten, & Power, 2016). As the mechanism that solving the agency problem, where agent (manager) and principal (shareholders) needs is always conflicting, by practising corporate governance it helps to control the corporate behaviour (Arifin and Tazilah, 2016). Hence, the relevance of using this theory is to examine the effect of management decision making towards the organisation's performance among the banking institutions in Malaysia.

Return on Equity (ROE)

The dependant variable of this study is return on equity (ROE) which measures the financial performance of Islamic banks. ROE can be measured easily and has been widely being used in past studies to find the relationship between governance and firm financial performance. Financial performance refers to the result from the value of shareholders at the end of a given accounting period and it also can be measured in terms of ratios derived from financial statements or by using data of stock market prices (Kakanda, Salim & Chandren, 2016). Return on equity (ROE) is defined as a measure of how much profits a company can generate by spending the money shareholders have invested or by efficiently utilizing the resources or equities (KPI Library, 2017). Even though good corporate governance may not perceptibly increase business performance but excluding governance shareholders will face the risk of violation of economic value. Hence, corporate governance helps to monitor a company effectively and efficiently (Arifin and Tazilah, 2016).

Board Size

Aktan, Turen, Tvaronavičienė, Celik, Alsadeh (2018) have indicated that the board size of a bank is associated with the ability of directors in monitoring and advising the executive management, ensuring the efficiency in monitoring and advising roles, as well as creating values through large and less independent boards. According to Cerbioni and Parbonetti (2007) board size refers to the number of board of directors, which is also known as a powerful corporate governance mechanism affecting firm performance (as cited in Mollah & Zaman, 2015). Different countries, companies and banks with different cultures, rules and ownership structures will have different board sizes (Ghaffar, 2014). From an Islamic perspective, the board of directors is elected by the shareholders and believe that the BOD will be responsible to manage Islamic bank activities effectively and will safeguard their interests and provide the best value for them (Al-Nasser Mohammed & Muhammed, 2017).

H_1: There is negative relationship between the size of the board and financial performance of Islamic banks.

CEO Duality

A situation called CEO duality happens when an individual is assigned to perform duties as a chairman of the board and as well as CEO at the same time (Haan & Vlahu, 2013). Theoretically, the CEO is the one who is responsible to communicate with the board and stakeholders, and manage daily business activities, while the chairman is the one who is responsible to monitor the board's decision making in order to make sure it makes decisions in the best interest of the company (Al-Amarneh, 2014). The separation of the roles of CEO and chairman is important to ensure that there are clear guidelines of responsibilities within the company (Al-Manaseer, Al-Hindawi, Al-Dahiyat, & Sartawi, 2012). However, in practice lots of companies which have appointed the CEO as a chairman to manage and monitor the business effectively. (Li et al., 2014). Meanwhile, Aktan et.al

(2018) stated that sometimes the CEOs may weaken the power of the board at the costs of the shareholders while maximising their interest in a firm and enjoying the discretion to "rubber stamp" the decisions of the board.

H_2: There is a positive relationship between CEO duality and financial performance of Islamic banks.

Board Independence

Khan, Zahid and Akhtar (2018) stated that the board of directors referred to as the body that upholds the interest of all the stakeholders involved and it is crucial that board members comprise of both executive and non-executive members in order to further strengthen stakeholders' interests. Hence, business complexity in banking requires a relatively larger board size which requires independence by country regulators (Khan et.al, 2018). A study conducted by Chan and Lee (2010) found that independent directors play an effective monitoring role in assessing and overseeing the performance of banks in Malaysia. The outcome is in line with Rashid and Khan (2014) carried out in Pakistani banks which showed that there exists a positive correlation between board independence and bank profitability along with the efficiency of independent directors have been effective in monitoring managers and providing recommendation which can positively enhance company performance. This means that independent directors play an important role in enhancing a bank's value and improve performance.

H_3: There is positive relationship between the independence of the board with the financial performance of Islamic banks.

Shariah Committee

According to Lesmana and Haron (2019), in order to ensure the successful implementation of Islamic principles, it is important that the function of SSB in the operations of Shariah banks should guarantee that SSB members are qualified enough and are chosen by the board of directors. A Sharia board plays a very significant role in ensuring good Sharia governance (Abdullah Saif Alnasser & Muhammed, 2012). According to Abdullah Saif Alnasser et al. (2012), the role of Shariah Supervisory Board (SSB) is to ensure that the operations comply with sharia principles through advising the BOD on Sharia matters at all time. They also have to approve and review the relevant documentations of bank products and services, internal policies, manuals and marketing advertisements. Furthermore, a specific board that consists of Islamic experts in Shariah law and jurisprudence known as a Shari'ah supervisory board (SSB) should be established whereby the members should be equipped with adequate knowledge of current finance activities to ensure that the banks comply with Shari'ah economic laws continuously (Khan, Zahid and Akhtar, 2018). In addition, Khan et. Al (2018) stated that the function of SSB which is mainly related to fatawa views, performing Shari'ah audit, zakat calculation and measurements, Shari'ah non-compliance income through proper disposal and distribution, and provide guidance for the banks towards their social roles. This is to ensure that the banks are able to maintain the trustworthiness of the Islamic financial industry in enhancing the confidence level of both shareholders and stakeholders pertaining to Islamic Banks (IBs) products and services. A sufficient number of members on the board should be able to assist in monitoring and ensuring the effectiveness of the committee activities through a Shariah review which can be performed systematically and in a timely manner (Tazilah and Rahman, 2014). The study conducted by Mollah and Zaman (2015) indicated the impact of a Sharia Committee, board structure and CEO power on financial performance of Islamic banks. Its results showed that SSB has a significant positive effect on the performance of IBs as the SSB is able to improve IBs' performance by improving the adverse impact on over-risk taking. In addition, according to Tazilah, Rapani, Halim and Majid (2017), in order to add further contribution of studies in Shariah governance, it is important to analyse the relationship between the size of shariah committee and bank performance specifically in Malaysia which is currently minimally explored.

H_4: There is positive relationship between Sharia Committee and the financial performance of Islamic banks.

Shariah Committee Report

According to BNM (2016), the Sharia Committee Report (SCR) is an essential document provided by the Sharia Committee about the state of sharia compliance in the Islamic financial institutions (IFIs). The SCR acts as an independent review of the Sharia Committee given to stakeholders about the activities, business and operations of Islamic financial institutions that have complied with Sharia principles. As a Sharia-approved company, disclosures on how duties and obligations are fulfilled according to Sharia are necessary as it presents a religious dimension for the interest of Muslim stakeholders (Othman & Thani, 2010). Besar, Sukor, Muthalib, and Gunawa (2009) conducted a study to determine the effectiveness of Sharia Review in IFIs. Sharia reviews make certain sharia compliance on the activities conducted by IFIs. With a sufficient disclosure in SCR, public confidence towards Islamic banks can be built and enhanced as the public will have a clear view on Sharia compliance of Islamic bank. Such disclosure of information is crucial as the users will analyse the performance of IFIs for decision making and to gain confidence towards IFIs governance specifically on Shariah matters and compliance (Tazilah, Rapani, Halim and Majid, 2017). Therefore, there is a probable significant relationship between the SC report and performance of IFIs that need to be explored further. Hence, this will lead to improvement of the financial performance of Islamic banks when the degree of public confidence increases. Therefore, this shows that SCR has a positive relationship with the financial performance of Islamic banks.

H_5: There is positive relationship between the Sharia Committee Report and the financial performance of Islamic banks.

RESEARCH METHODOLOGY

The target population for the research project is the Islamic banks in Malaysia. According to Abdullah Saif Al Nasser & Muhammed (2013) Islamic banking is defined as a banking system which is established and founded on the principles of Islamic law or Sharia following Islamic economic guidelines. The reason for choosing the Islamic banking industry is because Islamic banks have shown a dramatic growth in almost three decades in Malaysia (Lo & Leow, 2014). Moreover, Sharia governance is the overall system that manages the conformity of Islamic banks which is different from the corporate governance of conventional banks (Ginena, 2014). The data was collected from the Islamic banks listed in Bank Negara Malaysia which was obtained from the Bank Negara Malaysia website. There was a total of 16 Islamic banks, including 6 which are foreign owned. This research tested all the Islamic banks listed in Bank Negara Malaysia.

Data Collection Method

This study covered 16 Islamic banks in Malaysia during the period of 2011-2016 in order to conduct a performance analysis. The period chosen was due to the Sharia Governance Framework for Islamic financial institutions that took effect from 1 January 2011 (BNM, 2017). All information for the variables used for this study was available in each Islamic bank's annual report and the data of Islamic banks was obtained from their official website or from Bursa Malaysia.

Measurements

Table 1: Measurement of Variables

Variables	Definition
Dependent variable Return on Equity (ROE)	Profits generated by utilizing the money invested by shareholders.
Independent variable Board Size	Total number of directors in the board.
CEO Duality	Individual holding the position of CEO and Chairman of the board at the same time.
Board independence	The proportion of independent directors in the board of directors.
Sharia Committee	Total number of scholars as Sharia board members.
Sharia Committee Report	Document that shows the state of Sharia compliance in Islamic financial institutions.

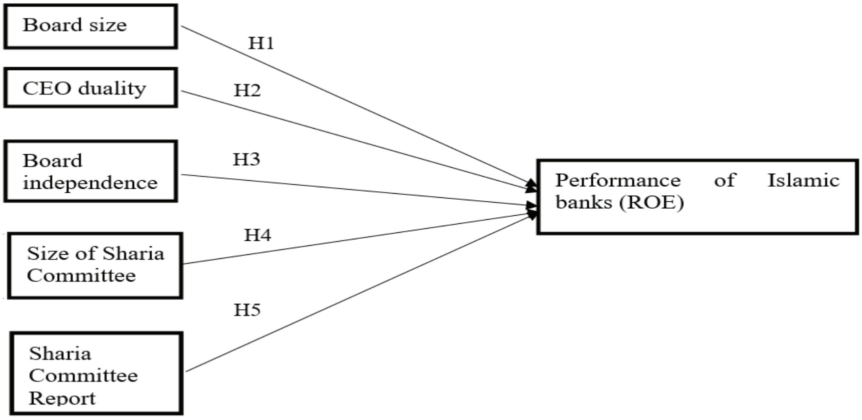

Figure 1: Conceptual Framework

DATA ANALYSIS

Pearson Correlation Test

Table 2: Pearson Correlation Test

VARIABLES	BS	INED	SC	SCR	ROE
	**1.00000	**-0.60628	**0.03596	**0.31418	**-0.06319
BS		***0.0166	***0.8988	***0.2541	***0.8230
INED	**-0.60628	**1.00000	**0.03664	**-0.18741	**0.28010
	***0.0166		***0.8969	***0.5036	***0.3119
SC	**0.03596	**0.03664	**1.00000	**0.16677	**0.59891
	***0.8988	***0.8969		***0.5525	***0.0183
SCR	**0.31418	**-0.18741	**0.16677	**1.00000	**0.67164
	***0.2541	***0.5036	***0.5525		***0.0061
ROE	**-0.06319	**0.28010	**0.59891	**0.67164	**1.00000
	***0.8230	***0.3119	***0.0183	***0.0061	

Based on Table 2 above, there is a positive strength of relationships between each variable by referring to the coefficient level (r). By referring to the p-value, BS (p-value=0.8230) and INED (p-value=0.3119) do not have a significant relationship with ROE as their p-value is greater than 0.05. Correlation for SC (p-value=0.0183) and SCR (p-value= 0.0061) with ROE is a significant as the p-value is lesser than 0.05. The strength of the relationship between SC and ROE is 0.59891 which shows a positive moderate relationship. Meanwhile, the strength of the relationship between SCR and ROE is 0.67164 which also shows a positive moderate relationship. Among these four independent variables, SCR has the strongest relationship with ROE. Furthermore, the strength of relationships between the independent variables also helps to determine whether a multicollinearity problem exists in this study. A multicollinearity problem exists when the coefficient level between the independent variables exceed the threshold of 0.9 which means a very strong relationship between the independent variables. From the results in Table 4.2, we were able to determine that the strength of relationships between the independent variables which ranged from 0.03596 to 0.67164. Therefore, it can be concluded that there is no multicollinearity problem in this study since the correlation between the independent variables is lower than 0.9.

MULTIPLE LINEAR REGRESSION (MLR) TEST FOR RETURN ON EQUITY (ROE)

Table 3: MLR for ROE

Parameter Estimates								
Variable	DF	Parameter Estimate	Standard Error	t Value	Pr > |t|	Standardized Estimate	Tolerance	Variance Inflation
Intercept	1	-0.33606	0.09821	-3.42	0.0076	0	.	0
BS	1	-0.00360	0.00644	-0.56	0.5900	-0.09412	0.58995	1.69505
CD	1	0.07985	0.14286	0.56	0.5898	0.07853	0.84822	1.17893
BINED	1	0.15168	0.07505	2.02	*0.0740	0.33024	0.62723	1.59432
SC	1	0.03611	0.00990	3.65	*0.0053	0.49284	0.91774	1.08963
SCR	1	0.35805	0.07293	4.91	*0.0008	0.70642	0.80886	1.23631

Table 4.5 shows that the board size is not significant in influencing return on equity as the p-value of the board size is 0.59 which is higher than 0.05. Therefore, we do not reject H_0 stating that the board size is not associated with return on equity as there is no sufficient evidence to prove that the board size can negatively influence the return on equity of Islamic banks.

H_1: There is negative relationship between board size and Islamic banks' financial performance.

However, CEO duality indicated that there is no significant relationship with return on equity based on the result as the p-value of CEO duality is 0.5898 which higher than 0.05. Hence, H_0 is not rejected. Therefore, we were unable to conclude that CEO duality has any influence on the return on equity of Islamic banks since there is no sufficient evidence.

H_2: There is a significant relationship between CEO duality and Islamic banks' financial performance.

The result of the multiple linear regression test showed that board independence is significant in influencing return on equity as the p-value of board independence is 0.0740 which is higher than 0.05 but lower than 0.1. According to Amrhein, Korner-Nievergelt and Roth (2017), a p-value between 0.05 and 0.1 can be explained to reject H_0. Therefore, H_0 is rejected as there is sufficient evidence to support that board independence can positively influence the return on equity of Islamic banks.

H_3: There is positive relationship between board independence and Islamic banks' financial performance.

Furthermore, Sharia Committee size has a significant relationship with ROE as the p-value of the Sharia Committee size is 0.0053 which is lower than 0.05. Therefore, H_0 that states that Sharia Committee is not associated with return on equity is rejected as there is sufficient evidence to support H_1 which states that the Sharia Committee can positively influence return on equity of Islamic banks.

H_4: There is positive relationship between Sharia Committee and Islamic banks' financial performance

For the last independent variables, the Sharia Committee Report has a significant influence towards ROE since the p-value of Sharia Committee Report is 0.0008 which lower than 0.05. Hence, H_0 which states that there is no relationship between Sharia Committee Report and return on equity is rejected as there is sufficient evidence to prove that the Sharia Committee Report is able to positively influence return on equity of Islamic banks.

H_5: There is positive relationship between Sharia Committee Report and Islamic banks' financial performance.

DISCUSSION OF FINDINGS

Board Size

The role of the board of directors provides a significant impact on corporate governance and therefore by understanding the relationship of the board size towards the financial performance of Islamic banks is one of the most important issues in corporate governance. However, based on the data collected, it is evident that board size has no relationship with ROE. In other words, no matter how large the board size is, it will not affect firm performance. Thus, H1 is not supported. Nevertherless, this research is consistent with the findings of research such as Belkhir (2006), Zulkafli and Samad (2007), Praptingsih (2009), and Tomar and Bino (2012) that proved that board size is not associated with financial performance (Doğan

& Yildiz, 2013). This is because other board characteristics such as role and responsibility, educational level and functions of the board committee may be factors that affect financial performance, instead of the board size.

CEO Duality

Based on our research, we realized that there are two possible results when discussing about the relationship between CEO duality and ROE. By using multiple linear regression, the result showed that CEO duality has no significant relationship towards financial performance of Islamic banks, in contrast, the independent t-test, denotes that CEO duality significantly affects the financial performance of Islamic banks. Due to many empirical researches such as Grassa and Matoussi (2014), Li et al. (2014), and Mollah and Zaman (2015) that support that CEO duality has a significant impact towards firm performance. If the CEO and chairman is the same person, then he or she will be able to comprehend business and management operations and will be familiar with the decision-making process, and hence CEO duality helps to make quick decisions and boost bank performance. Thus, H_0 is rejected and H_2 is accepted.

Board Independence

Based on the results, the independence of the board has shown a positive relationship with the financial performance Islamic banks. It shows that the greater the number of outside and independent directors on the board, the performance of Islamic banks becomes better. By using multiple linear regressions, the result showed that CEO duality has a positive relationship towards the financial performance of Islamic banks, in contrast, using the Pearson correlation test, denoted that board independence does not show any impact on the banks' financial performance. This result is parallel with most of the studies that proved that board independence positively affects firm performance by concluding that independent directors play an effective monitoring role in management and always provide recommendations which can positively enhance the performance of banks in Malaysia (Chan & Lee, 2010, and Rashid & Khan, 2014). Moreover, according to Bebeji, Mohammed, and Tanko (2015) the high percentage of independent directors on board is able to perform better and show good consequences than those with rare independent directors on the board as independent director do not have any conflict of interest with the shareholders which ensures that there will be no agency problems in making decisions. Therefore, H_0 rejected.

Sharia Committee

According to past research, the total number of scholars who are members of the Sharia board range from 4 to 9 members. Based on multiple linear regression analysis, it is proven that the Sharia Committee is positively related to the financial performance of Islamic banks. Thus, H_0 is rejected. Correspondingly, the findings were similar with other studies which support that the Sharia Committee had positively influenced the financial performance of Islamic banks (Li et al., 2014; Mollah & Zaman, 2015). This is because the Sharia Committee manages the sharia non-compliance risks such as risks of failure to comply with the principles of Islamic law which will help to assure the viability and reliability of financial institutions. Furthermore, according to Al-Saidi and Al-Shammari (2013) the Sharia Committee is also able to improve IBs' performance as the Sharia Committee has great knowledge, expertise, skills and experience which related to Sharia and banking issues (cited in Bukair & Abdul Rahman, 2015).

Sharia Committee Report

Among all the independent variables, the Sharia Committee Report has a greater impact on the regression model of this study because it has the strongest relationship with ROE as shown in the result of the Pearson correlation test. In the multiple linear regression tests, the result signified that the relationship between the Sharia Committee Report and the financial performance of Islamic banks is significantly positive. Hence, H_0 is rejected. This is supported in the studies of Besar et al. (2009) and Darmadi (2013) which indicated that the Sharia Committee Report has a positive relationship with the financial performance of Islamic banks. This positive result was due to the clear disclosures provided by Sharia Committee which help to enhance monitoring and internal controls and hence lead to improved financial performance of Islamic banks.

CONCLUSION

From a theoretical perspective, this research has shown how a corporate governance mechanism is able to affect the financial performance of Islamic banking institutions. There is abundant research on corporate governance that have been conducted in banking institutions but not many focussed on Islamic banking institutions especially those in Malaysia. Therefore, this study has a theoretical contribution that examined the relationship of corporate governance mechanisms and financial performance of the Islamic banking sector in Malaysia. Besides, our study can also help to save the time of other scholars who intended to conduct research on a similar area in Malaysia.

Furthermore, this research able to provide information based on the understanding towards Sharia corporate governance in Islamic financial institutions. Management teams and external users also can refer to the variables in the research to evaluate bank performance to make better management or investment decisions based on the results. Besides that, our research also provides information on the variables that could affect the financial performance among Islamic banks in Malaysia.

Future researchers who wish to study the same area are encouraged to use a better approach to examine the independency of independent non-executive directors. For example, an examination of their advisory, strategic and monitoring duties can be conducted in order to ensure the independency of independent non-executive directors in Islamic banks. Future research is recommended to include more corporate governance measures in testing their effects toward the financial performance of Islamic banks in Malaysia, such as ownership concentration, compensation mix variables, board tenure and directors training. By adding more corporate governance variables, future researchers can contribute more to the researches in same area. Moreover, the dependent variable may include other financial performance measures, including ROA, EPS or Tobin's Q, in order to measure the banks' financial performance more comprehensively.

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