DOES THE SHARIAH BOARD STRUCTURE INFLUENCE THE FINANCIAL PERFORMANCE OF ISLAMIC BANKS?

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ABSTRACT

The purpose of this research paper is to study the effect of the Shariah Board's characteristics on the financial performance of the Islamic banks. We employ the regression analyzes to investigate the relationship between the Shariah Board and the banks performance, using a Panel data composed by 32 Islamic banks over the period 2015-2018. The results show that the women shariah members reveal a negative effect on the financial performance of Islamic banks. However, the presence of Mufti and the interlocked shariah scholars do not influence the banks performance. Through this research paper, we aim to investigate the relationship between the financial performance and the Shariah Board and provide new insights to the literature review of Islamic banking.

Keywords: Financial performance, Gender diversity, Islamic banks, Panel data, Shariah Board, Shariah Corporate Governance.

INTRODUCTION

According to the Islamic Financial Services Board (IFSB) governance standards (2009), the shariah corporate governance is a set of organizational and institutional arrangements through which an Islamic institution insures that there is an effective and independent shariah control. Shariah corporate governance is the most essential practice of Islamic finance in maintaining and building the shareholders' confidence with the insurance that all institutions activities are following shariah principles Khalil &Taktak, (2020). Khalil & Taktak (2020) add that shariah corporate governance can be consisted of a simple Shariah Council or extended to a Shariah system (Shariah Board, Shariah control department, Shariah audit department, Shariah risk management department).

The Shariah Board is one of the most important shariah governance mechanisms and is composed of shariah members who issue fatwa and manage the shariah risk Ramly et al. (2018); Khalil & Taktak, (2020). Ramly et al. (2018) add that the Shariah scholars prohibit the bank from certain profitable activities to avoid any violation of Islamic laws and to protect the shareholders' rights. Thus, the respect of shariah principles attracts investors and improves the Islamic banks credibility (IFSB, 2009). Consequently, the Shariah Board plays a critical role in confirming the development and the survival of banks (Khalil & Taktak, 2020).

We purpose in this research study to examine the effect of the Shariah Board's characteristics on the financial performance of Islamic banks from 2015 to 2018. Our research paper is structured as follows:

The literature review is presented in the second section. The sample description and the used variables are in Section 3. The empirical results are discussed in the fourth section. Section 5 summarizes our paper.

LITERATURE REVIEW

Interlocked Shariah Members

Several studies indicate that interlocking improves the shariah members' knowledge and ameliorates their reputation, according to the resource dependency theory Abdullah et al. (2013); Grassa, (2013). Nomran et al. (2018) investigated 82 Islamic banks from 1993 to 2014 and found that the interlocked shariah members diminish shariah risks and increase the financial performance of banks. This result is also confirmed by Abdul Rahman & Bukair (2013); Daly & Frikha (2015) studies. The busyness hypothesis, in contrast, predicts that the interlocking reduces the shariah members' time and makes them busy (Grassa & Matoussi, 2014). Moreover, the interlocked shariah scholars enhance the risk of *'fatwa shopping'* and decrease the Shariah Board credibility, according to Haridan et al. (2018). However, Khalil & Taktak (2020) examined 67 Islamic banks during the period 2005-2014 and found that the interlocked shariah members do not have any significant effect on the banks soundness. The sign of this variable is expected to be negative:

H1. The percentage of interlocked shariah scholars negatively influences the financial performance of Islamic banks.

Mufti

The Mufti is a religious leader who is responsible to interpret the shariah laws and issue fatwas (Zepeda, 2013) adds that the Mufti is usually appointed by the government and has certain qualities (e.g. trustworthy, fair, tolerant and respectable). Plus, Hassan & Chachi (2008) say that the presence of the Mufti improves the role of the Shariah Board and the shariah compliance of financial products. Consequently, a Mufti should be appointed as a shariah member of the Islamic banks. Khalil & Taktak (2020) investigated 67 Islamic banks over the period 2005-2014 and found that the Mufti does not have any significant effect on the Islamic banks soundness. We suggest the following hypothesis:

H2. The presence of Mufti positively affects the financial performance of Islamic banks.

Women Shariah Members

Khalil & Chihi (2020) say that Muslim countries do not nominate the female board in their institutions. This can inhibit Islamic banks shareholders to have more women members Khalil & Chihi, (2020); Khan et al. (2019) argue that female scholars who sit in the Shariah Board are more risk averse than men members and they have a negative effect on the financial performance of banks. Furthermore, Khalil & Chihi (2020) say that the women members make the Islamic banking less competitive. Yar & Ahmed (2020) predict, in contrast, that the board's gender diversity influences positively the financial performance of Islamic banking. Yar & Ahmed (2020) add that Malaysia is the best example of how earning profits has little to do with female scholars in Islam.

Grassa & Matoussi (2014) examined 77 banks from 2000 to 2009 and found that the female shariah members do not have any significant impact on the financial performance of Islamic banks. Our third hypothesis is as follows:

H3. The percentage of women shariah scholars positively influences the financial performance of Islamic banks.

METHODOLOGY

Sample and Data

The sample of our study is composed of 32 Islamic banks over the period 2015-2018. We manually collect data from the annual reports of Islamic banks. The gross domestic product rates are obtained from the World Bank website[1].

We notice that our initial sample comprised 80 Islamic banks. 46 Islamic banks are excluded because annual reports and data are missing. Then, to ensure the reliability of the results, we delete outliers. After the filtering process, our final sample has 124 Islamic banks-years observations. The sample selection is described in Table 1.

Table 1
SAMPLE DESCRIPTION

Islamic banking	Number of Islamic banking
Original sample	80
(-) missing reports	(30)
(-) missing data	(16)
(-) Outliers	(2)
Final sample	32

Variables Measurement

According to Al-Homaid et al. (2020), Belkhaoui et al. (2020), Khalil & Taktak (2020) & Mkadmi (2020), the financial performance of the Islamic banks is measured by two indicators: Return on Assets (ROA) and Return on Equity (ROE).

ROA is a percentage ratio of net income to total assets (Net income/Total assets). Belkhaoui et al. (2020); Mkadmi (2020) say that ROA is regarded to be one of the most popular profitability measures for both conventional and Islamic banks' perspectives. The indicator represents the profit gained on assets and indicates how effectively the financial resources of the bank are used Belkhaoui et al. (2020). The more the ROA increases, the more banks enhance their financial performance, according to Mkadmi (2020).

Return on equity (Net income/ Shareholder's equity) makes it possible to understand the efficiency of Islamic banking from an equity shareholders' perspective (Belkhaoui et al. 2020). Belkhaoui et al. (2020); Al-Homaid et al. (2020) claim that ROE shows the profit gained on the bank equity. Belkhaoui et al. (2020) add that ROE has been frequently utilized in previous research studies for Islamic banking.

We define three characteristics of the Shariah Board. The interlocked Shariah Board members (MINTER) is the percentage of interlocked shariah scholars, the presence of the Mufti (MTI) is a binary variable that is equal to 1 if the Mufti exists and 0 otherwise, and the women Shariah Board members (MF) is the percentage of the women shariah scholars.

We add two control variables to enhance our empirical findings. AGE is the logarithm of the Islamic banks age and GDP is the gross domestic product.

The models below are proposed to examine the influence of the Shariah Board's characteristics on the financial performance of Islamic banks, according to Al-Homaid et al. (2020) & Mkadmi (2020)

$$ROAit = C + \beta1MINTERit + \beta2MTIit + \beta3MFit + \beta4AGEit + \beta5GDPit + \varepsilon it$$

$$ROEit = C + \beta1MINTERit + \beta2MTIit + \beta3MFit + \beta4AGEit + \beta5GDPit + \varepsilon it$$

Where, C: a constant, β1 ... β5: the coefficients to be estimated, εit: the error term, i: the individual which varies from 1 to 32, t: the period which ranges from 2015 to 2018.

In this study, we employ the Panel Corrected Standard Errors (PCSE) method in order to eliminate the problems of heteroscedasticity and autocorrelation and to provide results that are more robust, according to Beck & Katz (1995); Khalil & Taktak (2020).

We use the Panel Corrected Standard Errors (PCSE) method to estimate the model of our research study. According to Beck & Katz (1995), the PCSE method averts the problems of autocorrelation and heteroscedasticity by having more robust results. Khalil & Taktak (2020) add that the PCSE method furnishes a more secure error structure than that provided by the generalized least squares (GLS) method in Table 2.

Table 2
DESCRIPTION OF THE USED VARIABLES

Variable name	Definition	Measure
ROA	Return on Asset	Net income / Total assets
ROE	Return on Equity	Net income / Shareholder's equity
MINTER	Interlocked shariah members	Percentage of interlocked shariah scholars
MTI	Presence of the Mufti	A binary variable that is equal to 1 if the Mufti exists and 0 otherwise
MF	Women shariah members	Percentage of the women shariah scholars
AGE	The bank's age	The logarithm of the banks age
GDP	The gross domestic product	

RESULTS AND DISCUSSION

Descriptive Statistics

Table 3 indicates that 78.854% of shariah scholars are interlocked. (MF) variable ranges from 0% to 100%, with a mean of 11.458%. In addition, Table 3 shows that (AGE) variable has an average of 1.445, with a minimum of 0.568 and a maximum of 3.304. (GDP) variable varies from -4.7 to 13.4.

The average of (ROA) variable is -1.021. The values of the (ROE) variable range from a minimum of -17.5 to a maximum of 219.7.

Table 3
DESCRIPTIVE STATISTICS

Variables	Mean	SD	Median	Min	Max
MINTER%	78.854	55.408	75	0	100
MF%	11.458	4.474	0	0	100
AGE	1.445	0.581	1.278	0.568	3.304
GDP	3.155	2.552	3.1	-4.7	13.4
ROA	-1.021	27.997	1.205	-314	11
ROE	11.962	26.010	8.055	-17.5	219.7

Table 4 shows that 18.750% of the Islamic banking has a Mufti sitting in their Shariah Boards.

Table 4 **FREQUENCY OF BINARY VARIABLE**		
Variables	MTI	
Fréquence %	1	0
	18.750	81.250

Cross-Correlation Matrix

The Cross-Correlation matrix in Table 5 indicates that the variables are not highly correlated and are less than the limit (0.7) proposed by Kennedy (2008).

Table 5
CROSS-CORRELATION MATRIX

Variables	MINTER	MTI	MF	AGE	GDP
MINTER	1.000				
MTI	0.221	1.000			
MF	-0.061	0.175	1.000		
AGE	0.058	0.027	0.116	1.000	
GDP	0.001	0.010	0.184	-0.003	1.000

DISCUSSION

Table 6 shows that the coefficient associated with (MINTER) variable does not have any significant effect on the financial performance of banks. H1, thus, is not supported. This finding does not confirm the mixed results of research studies (Haridan et al., 2018; Nomran et al., 2018; Mansoor et al., 2019), and indicates that the interlocked shariah scholars do not have any significant effect on the financial performance of banks. We notice that the governance standards (IFSB) do not impose any requirement on the interlocked Shariah Board members and remain silent what justifies the finding.

The finding of Table 6 also indicates that MTI is not statistically significant (z-value > 0.1). H2, therefore, is not confirmed. This result contradicts Hassan & Chachi (2008) and shows that the presence of the Mufti does not influence the banks performance.

A possible explanation that can justify this finding is that the governance norms (Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and IFSB) remain silent about the presence of the Mufti in the Islamic banking. Table 6 indicates that the coefficient of MF is negative and significant (p-values<0.1).

H3, thus, is not supported. This means that that the presence of a female shariah board has a negative effect on the financial performance of Islamic banks, which does not confirm the previous researches Grassa & Matoussi, (2014); Yar & Ahmed, (2020).

It seems that the women shariah members are more risk averse than men members and make the bank less competitive, according to Khan et al. (2019); Khalil & Chihi (2020). Eventually, concerning the control variables, (AGE) variable and (GDP) variable do not have any significant impact on the financial performance of Islamic banks.

Table 6
REGRESSION RESULTS

Variables	ROA			ROE		
	Coef.	Z	P>|z|	Coef.	Z	P>|z|
AGE	4.955	1.27	0.204	-1.504	-1.30	0.193
GDP	0.250	0.96	0.338	-0.236	-1.44	0.149
MINTER	-0.037	-0.51	0.612	-0.037	-1.44	0.149
MTI	20.832	1.25	0.213	-6.960	-0.75	0.453

MF	-0.290	-1.80	0.050*	0.641	1.01	0.313
Cons	-22.481	-1.28	0.199	14.508	4.28	0.000***
R2	15.36%			13.33%		
N	128					
Notes : *significant at 10 percent; **significant at 5 percent and *** significant at 1 percent						

CONCLUSION

Due to the presence of the Shariah Board, the corporate governance mechanisms of the Islamic Banks are different from their conventional counterparts. Ramly et al. (2018). Khalil & Taktak (2020) argue that the Shariah Council plays a critical role in insuring the survival of Islamic banking. Moreover, shariah scholars issue fatwa and run the shariah risks which threaten the continuity of the banks, according to Khalil & Taktak (2020).

Thus, this study aims to empirically examine the influence of the Shariah Board's characteristics on the financial performance of Islamic banks. A sample consisted of 32 Islamic banking is used during the period 2015-2018. We employed the Panel Standard Corrected Errors method (PCSE) to eliminate the autocorrelation and heteroscedasticity issues. The results show that the women shariah members reveal a negative effect on the financial performance of Islamic banks. However, the presence of Mufti and the interlocked shariah scholars do not influence the banks performance.

Our research paper is the first to examine, to the best of our knowledge, the effect of the presence of the Mufti on the financial performance of Islamic banking.

This paper aims to fill the research gaps by supplying new empirical proof. Indeed, the findings focus on the role played by the Shariah Council and permit us to strengthen our understanding regarding the relationship between financial performance and Islamic banks.

This study is valuable for researchers, policymakers, bankers, etc., and enhances the literature review about the corporate governance mechanisms and their impact on the financial performance of Islamic banks. Furthermore, we recommend future researches to pay more attention to the impact of the Mufti on the financial performance of Islamic banks. In order to achieve better governance in Islamic banks, we suggest to include other corporate governance mechanisms in the future papers.

ENDNOTES

[1]www.worldbank.org

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