WOULD MEETINGS BETWEEN THE BOARD OF DIRECTORS AND THE SHARIAH SUPERVISORY BOARD AFFECT THE FINANCIAL PERFORMANCE OF ISLAMIC BANKS?

Afef Khalil, University of Carthage-Tunisia
Sabrine Chihi, Cresppa-GTM, UMR 7217, CNRS-University of Paris 8, France and University of Tunis ElManar, Tunisia

ABSTRACT

This research paper aims to examine the relationship between the Board of Directors and the Shariah Board and to investigate its impact on the financial performance of Islamic banks. We employ regression analyzes to study the impact of the feature connecting the Board of Directors to the Shariah Board on the banks performance, using a Panel data which consisted of 32 Islamic banks during the period 2015-2018. The results show that meetings between the Board of Directors and the Shariah Board have a negative impact on the financial performance of Islamic banks. Through this research study, we aim to furnish new insights into the literature review of Islamic banks. Unlike previous researches, we use one new feature linking the Board of Directors to the Shariah Board. In addition, we employ a new measure to study the relationship between the Board of Directors and the Shariah Board, and its effect on the financial performance of banks.

Keywords: Board of Directors, Financial performance, Islamic banks, Meetings, Panel data, Shariah Board.

INTRODUCTION

Corporate governance is defined as a set of relationships and duties between managers, directors, investors and other stakeholders (Islamic Financial Services Board (IFSB), 2006). Amine (2018) adds that the concept of corporate governance refers to how the company is managed and protects the interests of its stakeholders. The corporate governance of the Islamic banking differs from their conventional ones in that Islamic banking conform to the shariah principles and are allowed to have a shariah governance mechanism in place that supervises their shariah compliance (Khalil & Chihi, 2020; Khalil & Taktak, 2020).

Thus, the Islamic banks are run by two independent bodies namely the Shariah Board and the Board of Directors, which affect their corporate governance Grassa & Matoussi, (2014); Khalil & Chihi, (2020). The Shariah Board is one of the internal governance structures covering the monitoring of the Islamic banks transactions to ensure compliance with Shariah laws, according to Amine (2018); Khalil & Taktak (2020). Plus, Dalwai et al. (2014) and Almutairi & Quttainah (2020) say that the Shariah Council is responsible for all shariah issues, while global corporate governance is discussed by the Board of Directors. Consequently, the Shariah Council and the Board of Directors improve the banks credibility and attract investors (Alam et al., 2020). Muneeza & Hassan (2011) suggest that the Shariah Board scholars should assume their roles as directors. Currently, the corporate governance calls the Board of Directors and the Shariah Board to work collaboratively, specifically on shariah issues (Quttainah et al. 2013; Ramly et al. 2018).

Despite the rapid growth of Islamic banks in the world, we notice that there is no empirical research that explores the features connecting the Board of Directors to the Shariah Board and their influence on the bank performance. This research paper will, thus, be an opportunity to examine the impact of the relationship between the Board of Directors and the Shariah Council on the financial performance of Islamic banks from 2015 to 2018. This study is organized as follows: Section 2 represents the literature review. The sample and the variables measurement are described in the third section. Section 4 discusses the empirical results. Section 5 concludes our research study.

LITERATURE REVIEW

Meetings between the Board of Directors and the Shariah Board

Othman et al. (2012) argue that the Board of Directors and the Shariah Board should work together to minimize the shariah risks and enhance the financial performance of the Islamic financial institution (IFI). Thus, the bank activities will be supervised by the Shariah Board and the directors, according to Qutainah et al. (2013). Almutairi & Quttainah (2020) & Mesliera et al. (2020) argue that the directors work with the shariah scholars to enhance positive managerial behavior and reduce agency costs. Hasan (2011) adds that the number of meetings between the Board of Directors and the Shariah Board enables the two bodies to keep contact and improve communication between members. Moreover, Misman & Bhatti (2020) reveal that the Shariah Council advises the Board of Directors on the credit risk associated with the products before marketing them. Merton (1977) adds that shariah scholars must prohibit the directors from engaging in activities with higher risks, during the financial crisis. Mollah et al. (2016) say that some banking transactions may be prevented by the Shariah Board to avoid any violation of shariah laws and protect the investors' rights. Consequently, the collaboration between the Board of Directors and the Shariah Board decreases shariah risks and increases the financial performance of banks. Almutairi & Quttainah (2017) investigated 100 Islamic banks over the period 1993-2014 and found that the outside directors meeting the Shariah Board have a positive effect on the financial performance of Islamic banks. Otherwise, IFSB (2006) says that the Board of Directors and the Shariah Council should meet at least once a year to discuss the IFI development. We propose the following hypothesis:

H1. Meetings between the Board of Directors and the Shariah Board have a positive effect on the financial performance of Islamic banks.

METHODOLOGY

Sample and Data

Our sample is composed by 32 Islamic banks during the period 2015-2018. We use the Islamic banks website to download the annual reports. The gross domestic product and the inflation rates are obtained from the World Bank website[1].

Our original sample included 80 Islamic banking. We excluded 46 Islamic banking because annual reports and data are missing. Plus, we apply some filtering rules regarding outliers in order to avoid the effect of extreme observations. Our final sample has 124 Islamic banking-years observations. Table 1 describes the sample selection.

Table 1
SAMPLE DESCRIPTION

Islamic banking	Number of Islamic banking
Original sample	80
(-) missing reports	(34)
(-) missing data	(12)
(-) Outliers	(2)
Final sample	32

Variables Measurement

According to Al-Homaid et al. (2020), Belkhaoui et al. (2020), Khalil & Taktak (2020) & Mkadmi (2020), we measure the financial performance of the Islamic banks by two indicators:

- Return on Assets (ROA). ROA is defined as after-tax profits (net income) divided by total assets. Mkadmi (2020) adds that ROA is the most applied ratio to compare the banks efficiency as it shows the income generated by the assets financed by the banks. The more the ROA enhances, the more the financial performance of banks improves. It is calculated as follows:

$$ROA = \text{Net income} / \text{Total assets} \quad (1)$$

-Return on Equity (ROE). ROE is a percentage ratio of net profits to Shareholder's equity. Al-Homaid et al. (2020) assert that ROE shows how its equity capital is employed successfully by bank managers. The more the ROE increases, the more the financial performance of banks enhances. It is measured as follows:

$$ROE = \text{Net income} / \text{Shareholder's equity} \quad (2)$$

A review of various studies on the Shariah Council and the Board of Directors allowed us to choose one feature in order to examine the interplay between the shariah members and the directors and its impact on the financial performance of banks. (REU) is a binary variable that is equal to 1 if the Board of Directors and the Shariah Council meet together and 0 otherwise1. We notice that the data for the (REU) variable are obtained through the organizational structures and the annual reports of Islamic banks. We employ 3 control variables to improve our empirical results. YEAR is the logarithm of the banks age, GDP is the gross domestic product rate, RINF is the inflation rate.

The models below are suggested to investigate the impact of the variable linking the Board of Directors to the Shariah Board on the financial performance of banks, according to Al-Homaid et al. (2020) & Mkadmi (2020).

$$ROAit = C + \beta1REUit + \beta2YEARit + \beta3GDPit + \beta4RINFit + \varepsilon it \quad (3)$$

$$ROEit = C + \beta 1REUit + \beta 2YEARit + \beta 3GDPit + \beta 4RINFit + \varepsilon it \quad (4)$$

Hence, C: a constant, β1 ... β4: the coefficients to be estimated, εit: the error term, i: the individual which varies from 1 to 32, t: the period which varies from 2015 to 2018.

We apply the Panel Corrected Standard Error (PCSE) method to have results that are more robust and avoid autocorrelation and heteroskedasticity issues, according to Beck & Katz (1995); Khalil & Taktak (2020); Beck & Katz (1995) clearly show that the PCSE specification gives a more reliable structure of error than that produced by the method of generalized least squares (GLS) viewed as too confident 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
REU	The meetings between the Shariah Council and the Board of Directors	A binary variable that is equal to 1 if the Board of Directors and the Shariah Council meet together and 0 otherwise
YEAR	The bank's age	The logarithm of the banks age
GDP	The gross domestic product	
RINF	The inflation rate	

RESULTS AND DISCUSSION

Descriptive Statistics

Table 3 shows that 40.625% of the Board of Directors and the Shariah Board have meetings. This does not confirm the Pakistan's corporate governance standards requiring that the Board of Directors has to meet with the Shariah Board at least twice a year (Ullah et al., 2014).

Table 3
Frequency of binary variable

Variables	REU	
	1	0
Frequency %	40.625	59.375

Plus, the descriptive analysis indicates that the (YEAR) variable is between 1 and 4.383. The average of the (GDP) variable is 3.621. The (RINF) variable has a mean of 6.196. Table 4 shows that the (ROA) variable varies from a minimum of -314 to a maximum of 11. The (ROE) variable has an average of 11.962.

Table 4
Descriptive statistics

Variables	Mean	SD	Median	Min	Max
YEAR	1.469	0.648	1.301	1	4.383
GDP	3.621	2.186	3.8	-4.7	13.4
RINF	6.196	10.758	2.65	-0.8	-63.3
ROA	-1.021	27.997	1.205	-314	11
ROE	11.962	26.010	8.055	-17.5	219.7

Cross-Correlation Matrix

According to the Cross-Correlation matrix, all correlation coefficients are less than 0.7, which follows the limit in Table 5 suggested by Kennedy (2008).

Table 5
CROSS-CORRELATION MATRIX

Variables	REU	YEAR	GDP	RINF
REU	1.000			
YEAR	-0.308	1.000		
GDP	0.045	-0.050	1.000	
RINF	0.176	-0.083	-0.131	1.000

DISCUSSION

Table 6 shows that the coefficient associated with (REU) variable has a negative impact on the financial performance measured by (ROE) variable. H1, thus, is not confirmed. This means that meetings between shariah scholars and directors have a negative effect on the financial performance of banks. This result does not support the previous studies (Mollah et al., 2016; Hakimi et al., 2018; Ramly et al., 2018), and indicates that the relationship between directors and shariah members increases the agency costs and conflicts between the Shariah Board and the Board of Directors. This result supports Haridan et al. (2018) study who argues that the relationship between the shariah members and the directors is subject to different aims and contributes to the conflict of interest. Indeed, Khalil & Taktak (2020) say that the Shariah Council inhibits the directors from participating in transactions with higher financial risks over the financial crisis, or valuable and not following the shariah laws. Khalil & Taktak (2020) add that the shariah members require the Board of Directors to distribute illicit gains to the charity. These raise agency costs and interest conflicts between the shariah scholars and the directors and reduce the financial performance of Islamic banks (Alam et al., 2020). Plus, Table 6 indicates that (YEAR) variable exhibits negative coefficients and is statistically significant. This suggests that the old bank cannot be up to date with new technology (Khalil & Taktak, 2020). Moreover, the findings show that other variables (GDP, RINF) do not have any significant effect on the financial performance of banks.

Table 6
REGRESSION RESULTS

Variables	ROA			ROE		
	Coef.	Z	P>|z|	Coef.	Z	P>|z|
YEAR	1.826	2.05	0.040**	-1.166	-1.13	0.259
GDP	0.875	1.48	0.139	0.146	0.52	0.604
RINF	0.624	1.21	0.226	0.088	1.45	0.148
REU	-39.670	-1.23	0.221	-7.530	-4.85	0.000***
Cons	-6.140	-1.36	0.175	14.925	5.85	0.000***
R2	13.34%			18.48%		
N	128					

Notes : *significant at 10 percent; **significant at 5 percent and ***significant at 1 percent

CONCLUSION

The Board of Directors and the Shariah Council are the two most important bodies that influence the corporate governance of Islamic banking, according to Grassa & Matoussi (2014). The shariah corporate governance is currently calling the Board of Directors and the Shariah Board to work collaboratively, specifically on shariah matters Quttainah et al. (2013); Ramly et al. (2018). Khalil & Taktak (2020) insert that the Board of Directors and the Shariah Board support each other and share control and advisory responsibilities.

Therefore, the purpose of this research paper is to study the impact of meetings between the Board of Directors and the Shariah Board on the financial performance of Islamic banks. A sample composed by 32 Islamic banks is used over the period 2015-2018. The results show that meetings between the Shariah Board and the Board of Directors have a negative impact on the financial performance of banks. This implies that the relationship between directors and shariah members increases the agency costs and conflicts between the Shariah Board and the Board of Directors.

The Islamic banking authorities should, thus, reevaluate the laws and make some more efforts to implement governance reform measures that can ensure the corporate governance mechanisms performance. Besides, the supervisory authorities should reinforce their strategies, avoid any misbehavior, and guarantee the effective governance of Islamic banking. We note that this research paper is the first to examine the relationship between the Board of Directors and the Shariah Council and to empirically investigate its impact on the financial performance of banks. In addition, we use a new measure connecting the Board of Directors to the Shariah Council. This study is valuable for policymakers, academics, bankers, etc., and improves the literature review about the relationship between the Board of Directors and the Shariah Board and their effect on the financial performance of Islamic banks. Moreover, we recommend future researches to investigate other corporate governance mechanisms in order to enhance the corporate governance framework of Islamic banks.

ENDNOTES

[1]www.worldbank.org

REFERENCES

Alam, M.K., Miah, M.S., Siddiquii, M.N. and Hossain, M.I. (2020), "The influences of board of directors and management in Shariah governance guidelines of the Islamic banks in Bangladesh", DOI: 10.1108/JIABR-08-2019-0155.

Al-Homaid, E.A., Tabash, M. and Ahmad, A. (2020), "The profitability of Islamic banks and voluntary disclosure: empirical insights from Yemen", Economics & Finance, DOI: 10.1080/23322039.2020.1778406.

Almutairi, A.R. & Quttainah, M.A. (2017), "Corporate governance: evidence from Islamic banks", Social Responsibility Journal, Vol.13 No.3, pp.601-624.

Almutairi, A.R. & Quttainah, M.A. (2020), "Foreign directors and corporate governance in Islamic banks", Journal of Islamic Accounting and Business Research, Vol.11 No.4, pp.765-791.

Amine, B. (2018), "Contribution of Governance to Ensure the Stability of Islamic Banks: A Panel Data Analysis", International Journal of Accounting and Financial Reporting, Vol.8 No.3, pp.140-155.

Beck, N. & Katz, J.N. (1995), "What to do (and not to do) with time-series cross-section data", American Political Science Review, Vol.89 No.3, pp.634-647.

Belkhaoui, S., Alsagr, N. and Hemmen, S.F.V. (2020), "Financing modes, risk, efficiency and profitability in Islamic banks: Modeling for the GCC countries", Economics & Finance, Vol.8 No.1, pp.1-25.

Dalwai, T., Chugh, G., Prasad, S. & Mohammadi, S.S. (2014), "Can Effective Corporate Governance Of Islamic Banks Enhance Financial Inclusion In The Sultanate Of Oman?", International Journal of Humanities and Social Sciences (IJHSS), pp.61-74.

Grassa, R. & Matoussi, H. (2014), "Corporate Governance Of Islamic Banks: A Comparative Study Between GCC And Southeast Asia Countries", International Journal of Islamic and Middle Eastern Finance and Management, Vol.7 No. 3, pp.346-362.

Hakimi, A., Rachdi, H., Ben Selma Mokni, R. & Hssini, H. (2018), "Do board characteristics affect bank performance? Evidence from the Bahrain Islamic banks", Journal of Islamic Accounting and Business Research, Vol. 9 No.2, pp.251-272.

Haridan N.M., Hassan, A.F.S. & Karbhari, Y. (2018), "Governance, religious assurance and Islamic banks: Do Shariah boards effectively serve?", Journal of Management Governance, Vol.22, pp.1015-1043.

Hasan, Z. (2011), "A survey on Shariah governance practices in Malaysia, GCC countries and the UK: Critical appraisal", International Journal of Islamic and Middle Eastern Finance and Management, Vol.4 No. 1, pp.30-51.

IFSB (2006), "Guiding Principles On Corporate Governance For Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions And Islamic Mutual Funds)", Islamic Financial Services Board.

Kennedy, P. (2008), "A Guide to Econometrics", Blackwell, Malden, MA.

Khalil, A. and Chihi, S. (2020), "Do board characteristics affect the financial soundness of Islamic banks", African Scientific Journal, Vol.3 No.2, pp.85-102.

Khalil, A. and Taktak, N.B. (2020), "The impact of the Shariah Board's characteristics on the financial soundness of Islamic banks", Journal of Islamic Accounting and Business Research, DOI: https://doi.org/10.1108/JIABR-08-2018-0127.

Merton, R.C. (1977), "An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees", Journal of Banking and Finance, Vol.1, pp.3-11.

Mesliera, C., Risfandya, T. and Tarazi, A. (2020), "Islamic banks' equity financing, Shariah supervisory board, and banking environments", Pacific-Basin Finance Journal, Vol.62, pp.1-17.

Misman, F.N. and Bhatti M.I. (2020), "The Determinants of Credit Risk: An Evidence from ASEAN and GCC Islamic Banks", Journal of Risk and Financial Management, Vol.13 No.89, pp.1-22.

Mkadmi, J.E. (2020), "The Determinants of Financial Performance: A Comparative Analysis Between Conventional and Islamic Malaysian Banks", Journal of smart economic growth, Vol.5 No.1, pp.15-35.

Mollah, S., Hassan, M.K., Farooque, O.A. and Mobarek, A. (2016), "The governance, risk-taking, and performance of Islamic banks", Journal of Financial Services Research, Vol.49 No. 1, pp.1-25.

Muneeza, A. and Hassan, R. (2011), "Legal Obstacles in Shari'ah Corporate Governance of Islamic Financial Institutions in Malaysia", JKAU: Islamic Economic, Vol.24 No. 2, pp.177-180.

Othman, A.A., Hassan, R., Omar, M.N., Napiah, M.D.M., Ariffin, M., Yusoff, A., Khatimin, N. and Zaharim, A. (2012), "Shariah Governance for Islamic Financial Institutions in Malaysia on the Independency of Shariah Committee and Efficiency of Its Shariah Decisions", Recent Advances in Management, Marketing and Finances, pp.93-100.

Quttainah, M.A., Song, L. and Wu, Q. (2013), "Do Islamic Banks Employ Less Earnings Management?", Journal of International Financial Management and Accounting, Vol.24 No.3, pp.203-233.

Ramly, Z., Datuk, N. and Nordin, M.H. (2018), "Shariah Supervision Board, Board Independence, Risk Committee and Risk-taking of Islamic Banks in Malaysia", International Journal of Economics and Financial Issues, Vol.8 No.4, pp.290-300.

Ullah, S., Khokhar, Z.A., Tanveer, N., Khan, M.W., Shabbir, G. and Ahmed, A. (2014), "Shariah Governance Framework For Islamic Banking Institutions", Islamic Banking Department, State Bank Of Pakistan.