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Determinants of voluntary corporate governance disclosure: Evidence from Islamic banks in the Southeast Asian and the Gulf Cooperation Council regions

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ABSTRACT

We investigate the determinants of voluntary corporate governance disclosure practices of 67 Islamic banks in the Southeast Asian and Gulf Cooperation Council regions. We expect that the risks inherent in Islamic banking will lead to a demand for greater corporate governance disclosures. However, we find that the mean level of voluntary governance disclosure is less than 40 per cent. We provide evidence that stronger corporate governance is associated with a higher level of voluntary corporate governance disclosure. Other factors that influence voluntary governance disclosures are the size of Islamic banks, the level of political and civil repression and the legal system. Our results inform the global debate on the need for corporate governance reform by Islamic banks by providing insights on the part played by corporate governance mechanisms in encouraging enhanced disclosure in the annual reports of Islamic banks.

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1. Introduction

The assets of Islamic banks are increasing exponentially. For example, according to a recent study by Ernst & Young (2015), global Islamic banking assets witnessed a compounded annual growth rate of around 17 per cent from 2009 to 2013. Furthermore, these assets in six core markets[1] are expected to reach US$1.8 trillion by 2019. Of concern, however, is that customer satisfaction levels are low (Ernst & Young, 2015). While Islamic banking systems were said to have remained resilient during the Global Financial Crisis (GFC) (Perry, 2011), they have not been immune to corporate governance failures due to incidences of collusion between directors and management, audit failure and excessive risk-taking (Ginena, 2014; Grais and Pellegrini, 2006a).[2]

As with traditional banks, the capital adequacy ratio is used by Islamic banks to measure the sufficiency of the bank's buffer against its credit risk exposure (Ariffin, 2005). However, in addition to credit risk, Islamic banks are exposed to risks

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[1] Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirates (UAE), and Turkey.

[2] There are three well-known cases of financial distress relating to Islamic finance, namely, the collapse of the Bank of Credit and Commerce International (BCCI) in 1991, which affected several institutions that offer Islamic financial services; the collapse of Ihlas Finance House of Turkey in 2001; and the failure of the Patni Cooperative Society of Surat, India in 2003 (Grais and Pellegrini, 2006b).

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associated with the need to comply with *Shari'ah*.[3] In particular, the use of mudarabah investment accounts,[4] as a form of financing based on profit sharing, imposes a unique set of risks not present in conventional banking. These risks, together with the related increase in accountability, have led Islamic banks to establish an extra layer of governance known as *Shari'ah* governance.

A key mechanism of *Shari'ah* governance is the *Shari'ah* Supervisory Board (SSB) (Grais and Pellegrini, 2006a). The SSB assists Islamic banks to manage their funds efficiently while at all times complying with *Shari'ah* (Khir et al., 2008). Failure to comply with the principles of Islamic finance could expose Islamic financial institutions to reputational risk, not only to that institution, but also to the Islamic finance industry as a whole (Besar et al., 2009; Grais and Pellegrini, 2006a). Stakeholders, such as investors and depositors, rely on the SSB to make sure that their investments are mobilised in accordance with *Shari'ah* (Van Gruening and Iqbal, 2008). While SSBs are currently self-regulating, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is drafting a standard to regulate them (Richter, 2010).

Given the unique characteristics of Islamic banks, the quality of corporate governance disclosure is extremely important to maintain stakeholders' confidence in their financial systems. Failure to maintain this confidence can lead to stakeholders reacting negatively, for example, depositors and investors withdrawing their investment (Chapra and Ahmed, 2002). We expect that the need for stronger governance and greater transparency, to address the additional risks in Islamic banking as compared to traditional banks, will lead to extensive voluntary corporate governance disclosures in annual reports. Therefore, we investigate the extent of these disclosures and explore their determinants. The consequences of the lack of disclosure (including corporate governance disclosure) have been observed in the GFC. However, the determinants of corporate governance disclosure in Islamic banks in the context of developing countries have not (to our knowledge) been studied.

Our sample comprises 67 Islamic banks in the Southeast Asian (SEA) and the Gulf Cooperation Council (GCC) regions. The selection of these regions is justified on a number of grounds. They are among the most progressive regions in Islamic finance, being among the first to establish Islamic banks. Moreover, in these two regions, organisations such as the AAOIFI, the Institute of Corporate Governance and other bodies[5] have been established to support the development of Islamic finance (Matoussi and Grassa, 2012). As a result, it is expected that Islamic banks in these regions should have relatively high standards of disclosure. In fact, the AAOIFI standards have been adopted, adapted, or recommended in most of the countries in the SEA and GCC regions, for instance Malaysia, Indonesia, the United Arab Emirates (UAE), Saudi Arabia, Bahrain and Qatar (Grais and Pellegrini, 2006b).

Our study is also motivated by the fact that most prior research on corporate governance disclosures of Islamic banks is based on samples from a single country (Abdeldayem, 2009; Sulaiman et al., 2015), although similar characteristics and values are upheld by Islamic banks worldwide. We extend prior studies by developing a corporate governance disclosure index specific to Islamic banks, which can be applied across jurisdictions. Subsequently, we explore the association between the extent of governance disclosures and the characteristics of Islamic banks as well as societal variables[6] surrounding the banks. Among the factors that make our study different from past studies is our focus on corporate governance, *Shari'ah* governance and mudarabah investment account holders.

Our findings reveal that the level of voluntary corporate governance disclosure of Islamic banks in the SEA and GCC regions averages only 37.007 per cent. We also find that strong corporate governance, measured by a corporate governance index, is positively associated with the level of voluntary disclosure. Further, the results reveal that banks in code law countries have higher levels of voluntary corporate governance disclosures while voluntary disclosures are negatively associated with the level of political and civil repression. Generally, the results suggest that agency theory can be used to partially explain the relationship between Islamic bank characteristics such as governance strength and managerial decisions on voluntary corporate governance disclosures.

The study makes an important contribution to the corporate governance and Islamic banking literatures. It provides evidence on the extent of corporate governance disclosures in Islamic banks and their relationship with key determinants including bank characteristics and societal variables. In addition, our corporate governance disclosure index developed specifically for Islamic banks can be used in future studies. Our findings also have practical implications for several stakeholder groups. The results should be of interest to Islamic bank managers, central banks, and regulators and accounting policy makers internationally and in the nine countries in the study. Other stakeholders (for instance, *zakat*[7] payers, *zakat* beneficiaries, *mudarabah*

[3] *Shari'ah* is Islamic religious law derived from the *Qur'an* and the teaching of the Prophet Muhammad. *Shari'ah* is regarded as the legal and ethical rules to guide a Muslim in life (Thani et al., 2003).

[4] *Mudarabah* is identified as trust financing, trustee profit sharing, equity sharing, sleeping partnership, dormant partnership or profit sharing (Thani et al., 2003; Venardos, 2006). The *mudarib*, as an entrepreneur, runs the business using the money or property provided by the *rabb al-mal* (capital provider). The *mudarib* returns the investment to the *rabb al-mal* together with a share of the profit according to the profit ratio that is fixed at the time of the contract (Tamer, 2005). To avoid inefficiency, the *rabb al-mal* is not allowed to intervene in the business operations. However, they are able to perform follow-up or supervisory tasks (Mirakhor and Zaidi, 2007; Thani et al., 2003; Venardos, 2006) to oversee their investment venture.

[5] The Liquidity Management Centre, the International Islamic Financial Market, the Islamic International Rating Agency, the Islamic Financial Services Board and the Hawkamah (the Institute for Corporate Governance).

[6] Thomas (1991, p. 42) defines societal variables as "factors to which all enterprises within a particular country are subject and which vary between nations".

[7] *Zakat* is a compulsory levy that must be allocated from the well-to-do among the Muslim society to the beneficiaries specified according to *Shari'ah*.

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