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Shari'ah supervision, corporate governance and performance: Conventional vs. Islamic banks

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A B S T R A C T

The performance and accountability of boards of directors and effectiveness of governance mechanisms continue to be a matter of concern. Focusing on differences between conventional banks and Islamic banks, we examine the effect of (i) Shari'ah supervision boards, (ii) board structure and (iii) CEO-power on performance during the period 2005–2011. We find Shari'ah supervision boards positively impact on Islamic banks' performance when they perform a supervisory role, but the impact is negligible when they have only an advisory role. The effect of board structure (board size and board independence) and CEO power (CEO-chair duality and internally recruited CEO) on the performance of Islamic banks is overall negative. Our findings provide support for the positive contribution of Shari'ah supervision boards but also emphasize the need for enforcement and regulatory mechanism for them to be more effective.

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1. Introduction

The global financial crisis has heightened interest in the relationship between the governance and performance of banks (Aebi et al., 2012; Pathan and Faff, 2013). The performance and accountability of the boards of directors and their attitude towards risk-taking and ethical principles in banking has come under increased scrutiny. The unprecedented amounts of losses recognized by some of the world leading financial institutions have brought into the spotlight issues concerning regulatory oversight, risk management, and disclosure. Many observers attribute the current financial crisis to failures in corporate governance, such as lax board oversight and flawed executive compensation practices that encourage aggressive risk taking (Erkens et al., 2012; Kirkpatrick, 2009; Sharfman, 2009). Some researchers have lately focused on comparing the performance of conventional banks (CBs) with Islamic banks (IBs). Wilson (2010) notes the potential contributions of IBs and governance reforms in restoring credibility and stability in the international financial market. In contrast to the failures in the conventional banking sector, IBs did not announce substantial write-offs but have been rather resilient during the financial crisis (see Chapra, 2009, 2010; Green, 2010).[1] While CBs faced significant difficulties, IBs seem to have fared better during the global financial crisis.

There are significant differences between CBs and IBs. The latter provide Shari'ah compliant finance and have Shari'ah Supervision Boards (SSB) as a key feature of their governance. As Beck et al. (2013) note, IBs are prohibited from charging interest (*riba*) payments, are not allowed to engage in speculation, and are based on a profit and loss and thus risk-sharing model. SSBs are a significant feature of IBs and are considered as the 'Supra Authority' (Choudhury and Hoque, 2006). They represent an additional layer of governance. Together with the regular boards of directors and routine executive and other operational committees, the institution of SSBs in IBs changes their governance into what we call

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[1] IBs generally comply with Basel II and follow Islamic Financial Services Board (IFSB) guidelines. IBs build up a profit equalization reserve, which is used to finance pay-outs during difficult years. They were neither exposed to toxic securities (Desai, 2008; Brewster, 2008) nor offered products like collateralized debt obligations (CDOs) and mortgage backed securities (MBS) due to Shari'ah prohibitions (Ahmed, 2009). Derivative products like credit derivative swap (CDS) are prohibited under Islamic law, Shari'ah, due to the existence of risky or hazardous sale.

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"multi-layer" governance. This contrasts with the "single-layer" governance structure, which typically comprises the board of directors and executive/board subcommittees, in CBs. SSBs are an additional layer of monitoring and oversight as well as a constraint on operations. SSBs might restrain boards of directors and management from engaging in aggressive lending and major risk taking activities. At the root of Islamic banking is a theoretical commitment to ethical behavior, key manifestation of which is the adoption of profit-and-loss sharing schemes and prohibition of interest. The spiritual underpinning of Islamic banking together with the prohibition of interest suggests that IBs and their executives ought to be averse to unethical practice.

This paper examines whether "multi-layer" corporate governance model in Islamic banking and the expected adherence of IBs to ethical behavior, which is theoretically the cornerstone of IBs, is associated with performance. Specifically, we examine the effect of Shari'ah supervision and corporate governance on the performance of IBs vis-à-vis CBs. Given concerns about the relationship between governance and performance (Aebi et al., 2012; Pathan and Faff, 2013), we focus on the role of (i) Shari'ah supervision, (ii) board structure and (iii) CEO-power in affecting bank performance. By using a matched pair sample of 86 IBs with 86 CBs from 25 countries for the period 2005–2011, including 2005–2007 as pre-crisis, 2008–2009 as during-crisis, and 2010–2011 as post-crisis, we find that SSBs have a significant positive effect on the performance of IBs, but the results are mixed when we split our sample into pre-crisis, crisis and post-crisis periods. Notably, we find board structure (board size and board independence) has a negative and significant influence and CEO power (CEO-Chair duality and internally recruited CEO) has a negative, though insignificant, association with performance of IBs. For the CBs sample, we find board structure generally has a positive relationship, while CEO power has a negative, though insignificant, relationship with performance. Interestingly, interaction terms between board structure and CEO power variables seem to influence performance of IBs positively. We also provide additional insights from a survey of SSB members. The findings shed light on current practices and emphasize the need for well-functioning, independent and diligent Shari'ah boards, working in concert with the regular boards of directors, to better realise the ethical goals of Islamic banking in practice. Overall, our paper demonstrates that SSBs positively impact on IB performance when they have a supervisory role, but that impact is negligible when it has only an advisory role. There is a need for some form of enforcement or regulatory mechanism for SSBs to be more effective.

Our focus on IBs vis-à-vis CBs is important because there is renewed debate about the role and performance of IBs and some recent studies on stability, efficiency, and profitability cast doubt on the current state of IBs (see Abedifar et al., 2013; Ariss, 2010; Beck et al., 2013; Bourkhis and Nabi, 2013; Hasan and Dridi, 2010; and Olson and Zoubi, 2008). Our paper differs from prior research and contributes to the literature in a number of ways. First, to the best of our knowledge, this is the first paper to examine the relationship between Shari'ah supervision, corporate governance and performance. The literature relating to Islamic banking often tends to be normative and theoretical and there is limited empirical evidence on their performance, especially evaluation of the performance of IBs vis-à-vis CBs. We thus consider our comparison of IBs with CBs to be an important and timely contribution to this field and recognition of the paucity of research on the governance of IBs. In contrast to research which has focused mainly on the performance of CBs (e.g. Adams and Mehran, 2012; Andres and Vallelado, 2008; Francis et al., 2012; Pathan and Faff, 2013; Sierra et al., 2006; and Wintoki et al., 2012) or provides theoretical contributions about the uniqueness of IBs due to Shari'ah governance (Choudhury and Hoque, 2006; Grais and Pellegrini, 2006; Hassan, 2011; Lewis, 2005; Safieddine, 2009), we provide empirical evidence on the effect of governance on the performance of IBs vis-à-vis CBs. In spite of the popular thinking that SSBs in IBs play a vital governance role, we are not aware of any study examining the effect of Shari'ah supervision and corporate governance on the performance of IBs vis-à-vis that of CBs.

Second, in examining the effect of Shari'ah supervision and corporate governance on bank performance, we extend our base model by investigating the impact of Shari'ah supervision, including supervisory or advisory role of SSBs, on performance. We also investigate whether Shari'ah board is integrated or segmented with regular board. We also extend our base model by examining the effect of Shari'ah supervision and corporate governance on bank performance in the context of small or large banks and large or small country. We thus augment the literature on the performance and governance of banks by offering an extended analysis on Shari'ah supervision and more specifically extend the comparative literature (IBs vis-à-vis CBs) such as Abedifar et al. (2013), and Beck et al. (2013) and Cihak and Hesse (2010).

Third, the recent global financial crisis emphasizes the need for further research.[2] Using panel data we also examine if during the financial crisis the effect of governance on banks performance was different. This enables us to capture governance effects that might only manifest in exceptional times. We split our sample into pre-crisis, during-crisis and post-crisis periods. By splitting the sample, we add to previous research, e.g. Aebi et al. (2012), Andres and Vallelado (2008), Ariss (2010), Beck et al. (2013), Johnes et al. (2013), and Pathan and Faff (2013), in terms of different effect of corporate governance on bank performance due to different time periods.

Fourth, we complement the analysis of our panel data for IBs by adding the findings from a questionnaire survey of SSB members, thus providing additional insights into the nature and role of SSBs in IBs. Fifth, in measuring bank performance, we include a range of accounting measures as well as market-based measure Tobin's Q to proxy for shareholder value. Our research thus complements Adams and Mehran (2012), Andres and Vallelado (2008), Aebi et al. (2012), Francis et al. (2012), Pathan and Faff (2013), Sierra et al. (2006), and Wintoki et al. (2012) who focused entirely on CBs, whereas our study captures both IBs and CBs.

The rest of the paper is organized as follows. Section 2 outlines the literature review and hypotheses development. Section 3 specifies the model applied and the description of the data used in the paper. The empirical results are reported in Section 4 and the concluding remarks are in Section 5.

2. Prior literature and hypotheses development

Given the focus of our paper is on the effects of three important dimensions of governance (i.e. Shari'ah supervision, structure of boards of directors and CEO-power) on bank performance, in this section we provide a brief review of the pertinent literature. The scope of the review is limited to issues related to the development of hypotheses concerning the relationship between firm performance and (i) Shari'ah supervision, (ii) board structure and (iii)

[2] Kashyap et al. (2008) argue that while the failure to offload subprime risk has resulted in the credit crisis, the root cause of the crisis lies in the breakdown of shareholder monitoring and ill-conceived managerial incentives. Cornett et al. (2009) observe that bank performance has decreased dramatically during the financial crisis. They also note that corporate governance weakened significantly just before and during the financial crisis. Erkens et al. (2012) add that the focus of independent boards and institutional investors on short-term profitability has encouraged risk taking by firms before the crisis, which exacerbated the losses suffered during the crisis. Weisbach (1988), Volpin (2002), and Parrino et al. (2003) advocate that CEO turnover is more sensitive to shareholder losses for firms with greater board independence and larger institutional ownership because these external monitors' fiduciary duty is to focus on the creation of shareholder value.

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