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# Corporate Governance and Sustainability Practices in Islamic Financial Institutions: The Role of Country of Origin

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**Abstract**

This study examines the role of country of origin on the relationship between corporate governance and sustainability practices in Islamic Financial Institutions (IFIs). Different from conventional financial institutions, the IFIs has a group of Shariah Supervisory Board (SSB) to act as the governance decision maker and a gate keeper to the institutions in ensuring that IFIs will comply with the Shariah laws. Thus, the corporate governance dimension in this study includes the size of SSB in addition to the size of board members, the number of independent directors, and the aspects of environmental, social, and profit in the IFIs' mission and/or vision. A total sample of 82 IFIs in Gulf Council Cooperation (GCC) and Non-GCC countries were examined. The study found that the board size, directors' independence, and the aspects of environmental, social and profit in the mission and/or vision have positive relationship for IFIs in GCC countries. However, the size of SSB is found to have insignificant relationship with the sustainability practices of IFIs. The country of origin is found to have a moderating role on the relationships between all of the corporate governance dimensions with sustainability practices except for the size of SSB and sustainability practices relationship. This implies that the size of SSB of IFIs in GCC countries does not have a great influence towards sustainability practices as compared to the size of SSB in non-GCC countries.


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*Keywords:* Sustainability practices; Islamic Financial Institutions; Shariah Supervisory Board; corporate governance; country of origin

## 1. Introduction

In Islamic banking, the sharing of profit and loss is allowed rather than the imposition of interest. The fundamental differences between Islamic banking and conventional banking is not only in the way the business is

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being practiced, but also in the values which guide Islamic banking's whole activities and image (Dusuki, 2010). The values that prevail within the ambit of the Shariah are expressed not only in the activity of its transactions but in the breadth of its role in society. Another obvious way to differentiate between Islamic banking and conventional banking is the existence of a Shariah Supervisory Board (SSB) as part of the internal governance structure of the institutions, whereas the conventional banking has only Board of Directors (BOD). Sound corporate governance in Islamic banking is crucial to ensure that depositors suffer no loss simply because it is easier to 'fleece' them than depositors in conventional banks (Satkunasingam & Shanmugam, 2004).

In recognition of the need for expertise, independent advice, and supervision on Shariah-related matters, the Accounting and Auditing Standards for Islamic Financial Institutions (AAOIFI) established a standard requiring every provider of Islamic financial services to have its own SSB. In addition, Garas (2012) state that since Muslim could not have authority on the conventional financial institutions, they established the Islamic Financial Institutions (IFIs) based on Shariah and these IFIs are controlled by classical BOD as well as SSB to ensure their compliance with Shariah. The existence of SSB supposedly acts as in-house religious advisor so that the IFIs will become more sensitive toward all activities that are related to society and environmental regulations.

Therefore, IFIs could have the advantages over conventional banks when its SSB play well their role. Perhaps, the SSB will lead the IFIs to do more sustainability practices in the future. However, there is limited evidence on how the SSB existence would have an impact on the sustainability practices in the IFIs. In addition, it is supposedly that a country in the Gulf Council Cooperation (GCC) would have higher Islamic value compared to other countries in the non-GCC. Furthermore, the IFIs started in 1970s in Egypt and spread around in especially in the Middle East (Garas, 2012). Thus, this study also investigates whether the country of origin has a role in the relationship between corporate governance and sustainability practices among the IFIs.

## 2. Prior Research

Past studies confirm that organizations which focus more on sustainability practices have higher financial performance measures by return on assets, profits before taxation, and cash flow from operations compared to those without such commitments in some activity sectors (Rashid & Radiah, 2012). Multinational corporations are able to make significant contributions toward sustainable development by initiating investment into social or ecofriendly practices (Chakrabarty and Liang, 2012). An assumption in this prevalent view is that the sustainability practices will somehow continue to perpetuate long after they are put in place. Rapiah et al. (2010) found that the Malaysian Shariah-compliance listed companies have increased their awareness on the importance of sustainability practices by disclosing more about the related information in their annual report. In addition, Amran et al. (2011) shows that Islamic banks discloses more corporate sustainability disclosure than conventional banks in Malaysia. It is said that the role of Islam as a vital factor behind a better disclosure of sustainability practices.

In the case of Islamic corporate governance, the conflict is overcome by the organic participatory nature of Shuratic process both as discursive body as well as learning medium with factors of the world-systems (Choudhury & Hoque, 2006). Corporate governance from Islamic perspective does not differ much with the conventional definition as it refers to a system by which companies are directed and controlled with a purpose to meet the corporation's objective by protecting all the stakeholders' interest and right. Uniquely, within the Islamic paradigm, corporate governance presents distinct characteristics and features in comparison with the conventional system as it refers to a special case of a broader decision-making theory that uses the premise of Islamic socio-scientific epistemology which is premised on the divine oneness of God (Choudhury & Hoque, 2004). In addition, corporate governance within this paradigm, is very imperative as it tends to encourage honesty, integrity, transparency, accountability and responsibility amongst all stakeholders in an organization (Sayd et al., 2011).

## 3. Theoretical Framework and Hypothesis Development

Resource Based View (RBV) theory emphasize the needs of internal capabilities of an organization in formulating strategy is to achieve a sustainable competitive in its market and industries. If an IFI has a good governance mechanism as a resource, it will help the institution to become more sustainable in the future. With a bigger SSB size and board size, it will lead to better decision making and thus, more sustainability practices is