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An Empirical Study on Corporate Governance and Islamic Bank Performance: A Case Study of Bangladesh

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Abstract

Corporate governance refers to the relationship present between the corporation and the stakeholders that determines and controls the strategic direction and performance of the corporation. Good corporate governance should provide adequate incentives for the board and management to pursue objectives that are in the interests of the company and shareholders, thereby encouraging firms to use resources more efficiently. However, the definition of accountability differs between conventional and Islamic Banks. Islam was made accountable not only to stakeholders, but also to Allah, the ultimate owner and authority. These powerful moral ethics help in promoting fair, just and honest business dealing. The aim of this study is to examine the relationship between corporate governance structures and the resultant financial performance of listed Islamic banks of Dhaka Stock Exchange (DSE) in Bangladesh. The panel time series data were collected for the time period of 6 years (2009-2014) from all the listed Islamic banks to run an Ordinary Least Squared (OLS) regression model to examine whether the existing corporate governance mechanisms as well as several other internal and external indicators are significant in influencing the financial performance. Preliminary findings suggest corporate governance mechanisms in Islamic banks are not quite as strong as they should be, hinting at possible market and management inefficiencies.

Key Words: *Corporate governance, Islamic Banking, Developing markets, Bangladesh*

JEL classification: *G21, G34*

Introduction

It is not long since academics, researchers and practitioners started to explore various issues between Islamic and mainstream orientations of global financial system. The wider interests or arguments of different aspects encompass from ideological stances, epistemological approaches to growth and performances of financial institutions that follow Shariah based framework with that of the mainstream or conventional financial institutions. This emerging interests on this field emanates as recent thriving Islamic financial system has pushed many conventional banks to branching out to Islamic services besides their mainstream banking services (Ahmed, Rahman et al. 2014) and, hence, marking its presence to more than 70 countries globally (Iqbal and Molyneux 2005, Chong and Liu 2009, Khan 2010). Islamic banking assets had experienced around 15% growth rate during the period 1994 to 2004 (Benaissa, Parekh et al. 2005). A study argued that the Islamic finance industry is experiencing 20% growth rate which is more than double than that of the mainstream conventional banking industry (Abdelsalam and El-Komi 2014). EY (2015) states that "global Islamic banking assets witnessed a compounded annual growth rate (CAGR) of around 17% from 2009 to 2013".

Though the Islamic finance industry is rapidly growing, the expansion is not proportionate around the globe. The major concentration of the Islamic finance can be traced in few Middle-Eastern and South-East Asian countries. To be specific, Saudi Arabia, United Arab Emirates (UAE), Bahrain and Malaysia could be considered as major hubs for Islamic finance. According to Bahrain Monetary Agency (2006), compare to conventional bank assets growth rate of 6%, Islamic assets grew at 111% annually in Bahrain during 1998 to 2005 (Khan 2010). In a different note, according to World Islamic Banking Competitiveness Report 2014-15 (EY, 2015)—

"Bahrain and six of the rapid-growth-markets (RGMs) – Qatar, Indonesia, Saudi Arabia, Malaysia, the UAE and Turkey (QISMUT) – shall continue to drive the future internationalization of the industry. By 2019, QISMUT is expected to represent a US$ 1.8 trillion Participation banking industry" (EY, 2015).

With reference to above empirical evidence, it is commonly accepted that though global acceptance of the Islamic banking is rising, in order to further enhance its development, proper understanding of its internal dynamics and its dimensions need to be addressed seriously. On this regard, one of the important measures would be to enable an appropriate environment where Islamic Shariah based banking or, broadly, financial system could organically flourish with ease. In order to do so, it is imperative that clear understanding of financial market discipline, assurance of moral integrity of financial institutions and establishment of adequate legal infrastructure and its implementation are crucial (Chapra and Ahmed 2002). In relation to these essential factors, in recent time, a great deal of emphasize has been also given to corporate governance issues of the financial sector. However, despite astounding growth of the Islamic financial system, there is a dearth of research works published in the top ranking journals on Islamic finance (Abdelsalam and El-Komi 2014). Particularly, there is hardly any research works published on corporate governance issues of Islamic banks in Bangladesh. Therefore, in this research, we have conducted an empirical study on corporate governance and its effect on Islamic bank performance of Bangladesh.

Literature Review

Contemporary Research on Corporate Governance

The essence of the philosophy of classical capitalism states that, in a free market mechanism, the "reward" automatically (should) flow to the "deserving" one—person who is hardworking, inventive and innovative (Kim and Nofsinger 2007). However, this model is often criticised for having such myopic vision as it lacks collective approach to "benefit" or utility of the society at large. A "reward" or profit maximization objective of an organization (or an individual or a group of individuals) can push that organization to be selfishly "innovative" that may not be desired by all constituents that are directly and indirectly associated with it. Recently, this critical view of capitalism is marked with a range of "anomalies" (i.e. scandals of Enron, fall of Lehman Brothers, financial crisis of 2008) in the market that reincarnates the importance of corporate

governance. It is widely accepted that the activities of an organization cannot be totally let go in the invisible hand of the market economy rather a mechanism should be developed to ensure ethics in the financial sector.

Generally, corporate governance perceived as an organizational-wide ethical practice that considers different stakeholders (i.e. shareholders, creditors, employees, customers, regulators) in an integrated framework (Al-Malkawi, Pillai et al. 2014). Specifically, corporate governance could be defined as a set of rules and policies to govern various activities of an organization with that of its stakeholders and these policies and rules are legitimated by legal authorities/bodies and protected by the Government (Alam Choudhury and Nurul Alam 2013). From organizational management perspective, corporate governance can be defined as an ethical mechanism to guide overall activities of an organization keeping in mind the objective of the firm, as different interests, often conflicting, of various stakeholders could hinder the process of achieving organizational goal. This issue of conflicting interests of different stakeholder and their influence on achieving organizational goal is popularly known as agency conflict—conflict between managers (agent) and shareholders (principal) (Kasri 2009). Thus, in one sense, one of the crucial tasks of the corporate governance is to minimize agency conflict of an organization. Moreover, if an organization's activities are extended beyond national border, the likeliness of agency conflict increases due to several factors (e.g. geographic distance of the subsidiaries, differences in values and norms of the employees of host nation) and, thus, corporate governance issues become more complex for Multinational corporations, MNCs (Madura 2012). Thus, various international authorities/bodies developed policies to ensure that the MNCs comply with global ethical standards. Particularly, an MNC's operations will fall under various international legal statues; i.e. WTO governance policies such as TRIPS (Trade Related Investment Property Rights), TRIMS (Trade Related Investment Measures), Surveillance and Dispute Settlement Mechanisms, environmental protection, antidumping, corporate transparency, corporate responsibility, equitable distribution of wealth and income, labor laws and many others (Alam Choudhury and Nurul Alam 2013).

From a slightly different perspective, corporate governance is not just having rigid rules and regulations that everyone need to follow as ethics itself is a complex construct and may have relative meaning under different context and, hence, it may be imprudent having a rigid model for that. Realizing this inherent complexity of corporate governance concept it was argued that the corporate governance should be based on principles than structured rules and policies or, in other words, it can be seen as guidelines for a supervisory framework of different environmental structures (Abu-Tapanjeh 2009). This issue has been explored and examined by several bodies/committees/business leaders globally, and after series of discussions and adjustments global corporate governance guidelines were first formalized in 1999 through establishment of Organization for Economic Co-operation and Development (OECD) principles and, subsequently, these principles are now considered to be benchmark for corporations, investors, policy makers and stakeholder and adopted by 30 member countries (Abu-Tapanjeh 2009).

Corporate Governance in Islamic Finance

in relation to above discussion—guiding ethical behaviour through principles and existence of structured rule to ensure ethical standards—it can be argued that the concept of corporate governance is not new in Islam however, Islamic perspective of corporate governance, to some extent, has differences in comparison to conventional concept of corporate governance. A person's daily activities and transaction should be based on the values of truthfulness, firmness, fairness, and respect for the law, kindness, forbearance, tolerance and uprightness, instead of deceit, haughtiness, class consciousness, ostentation, insubordination, envy, jealousy, backbiting and self-aggrandizement (Kasri, 2009). Firstly, in Islam it can be observed that, since initiation of Muslim civilization, both broad guiding principles and structured Islamic jurisprudence (Shari'ah based Islamic laws) persisted to ensure ethical standard in the society. In one hand Muslims always have an "implicit agreement" with God (Allah SWT) for their worldly deeds; on the other hand, while involving with contractual obligations to human, Muslims form "explicit agreements " that reflects Islamic fundamental principles or implicit agreements. As Islamic banks follow PLS (profit and loss sharing) model, depositors also bear risk of the ventures used by those funds by the bank and this is guided by specific mudharaba and musyaraka rules/acts (Chapra, 2002).Thus, implicit agreement to Allah

SWT (God) plays crucial role in corporate governance in Islam (Kasri 2009) and this aspect of having implicit contract with God does not exist in the conventional concept of corporate governance.

Secondly, though the concept of stakeholder is common both in conventional and Islamic concept of corporate governance, difference can be observed the way it is defined in Islam. To be specific, conventional corporate governance does not specifically define the constituents of "stakeholder" whereas, in Islamic, the justifications of stakeholder are more solid (Kasri 2009). Iqbal and Molyneux (2005) argued that any person whose property right is at risk due to any measure taken by the firm could be considered as stakeholder in Islamic finance. They also argued that any person whether having explicit or implicit obligations/contracts to a firm could be perceived as a stakeholder and, thus, should be considered from the Islamic ideology of treating them "fairly" and "justly" with any actions taken by the firm.

Thirdly, according to Islam, everyone is ultimately accountable to God for all their deeds. That is, in any Islamic Shari'ah based contractual obligation, a party is not only legally accountable to other party for fulfilling one's task; rather, by virtue of Islamic philosophy, that person is also accountable to God for his/her obligations. Thus, breaching a contract not only results in legal punishment in this world, that person is deemed to be punished hereafter as well. Hence, fulfilling one's obligations properly becomes a condition for being a true Muslim. Thus, maintaining transparency of one's/firm's actions not only means fulfilling legal requirements properly, but also it deemed satisfying requirements of Islam. This accountability essence of Islam can be further extended to accurate disclosure of true facts to the stakeholders as it is believed in Islam that all resources are trusted to people by God and all the users have right to material information of those resources and, as mentioned earlier, all Muslims have Divine covenants with God in this regard (Kasri 2009).

Thus, it can be argued that Islamic conception of corporate governance is more comprehensive than that of the mainstream one. From a similar vein, according Choudhury and Hoque (2006), from the socio-scientific epistemology, Islamic concept of governance encompasses the complex interplay of the relationships of the entities (constituents) of the world system that is premised on the Devine oneness of God. However, often it is argued that due to such comprehensive and fluid nature of the conception of Islamic governance, it becomes more complex to operationalize it in corporate system. In any case, the Islamic financial system is gradually moving towards implementing clear distinctive corporate governance system compare to the conventional corporate governance system and, thus, it worth exploring the relationship between performances of financial institutions that follow Islamic Shari'ah based corporate governance practices. However, there are dearths of discussion and research works have been conducted in the area of corporate governance issue from Islamic finance perspective (Mannan 1984, Haneef 1995). Hence, in this research sincere efforts have been put to explore that relation for Bangladeshi Islamic banks listed in the Dhaka Stock Exchange from Islamic corporate governance perspective.

Research and Methods

Based on the arguments presented in the literature review and, in order to answer our central question of determining how corporate governance influences the performance of Islamic Banks of Bangladesh, we developed our hypothesis as:

H0: Corporate Governance mechanisms has no significant relationship with Islamic Bank Performance.

H1: Corporate Governance mechanism has significant relationship with Islamic Bank Performance.

Prior literature examining the relationship between financial performance and corporate governance mechanisms has included both the internal and external variables related to a firm. The model used for this research however, included only the internal variables to consider the influence of company insiders on corporate profitability.

To represent Bank performance, Return on Asset (ROA) was taken as the dependent variable. This measures how well the firm is performing by looking at the profit generated with relation to its assets. Bank regulators and analysts long believe that ROA and ROE act as appropriate proxies for profitability (Gilbert and Wheelock 2007, Mostafa 2007, Christian, Moffitt et al. 2008).

This study examines the impact of three sets of variables on profitability, starting with the corporate governance variables represented by Board size, Independent directors, CEO/chair duality etc. Secondly, it considers ownership variables i.e. institutional shareholding and ownership control. Lastly, the relationship is tested by controlling for firm size.

CEO duality is a commonly observed corporate governance mechanism among large corporations. It is usually represented by a CEO hired as a top level manager and at the same time represents shareholders or owners of the company by holding at least one share of the company he/she signs for (Boyd 2006). Size of the board is also another matter of concern in monitoring the status of corporate governance of a company. There are conflicting views regarding what the size of the board should be, as many claim that larger boards make the firm less cohesive and bureaucratic. However some argue that larger boards are useful in dispersing the responsibilities. Empirical research also supported larger boards, as they demonstrated board size and stock price variability are inversely related (Yoshikawa and Phan 2003, Cheng 2008). Other variables included in the model i.e. number of independent directors in the board and board meetings held, director's fees, ownership control and institutional shareholding- all have been well established in the literature as important mechanisms in corporate governance and performance monitoring (Baysinger and Butler 1985, Vafeas 1999, Klapper and Love 2004, Choon, Thim et al. 2012, Ararat, Aksu et al. 2015, Bukair and Abdul Rahman 2015).

Sample

The data used for this model was secondary in nature, collected by calculating from the audited financial statements of all the six listed Islamic Banks of Bangladesh for the time period of six years (2009-2014). This panel time series data was later arranged and ran through the above mentioned regression model.

Estimation Method

Based on the literature and variables identified, the following regression models were developed:

$$ROA_{it} = \alpha_0 + \alpha_1 FS_{it} + \alpha_2 BODS_{it} + \alpha_3 CEODT_{it} + \alpha_4 IND_{it} + \alpha_5 BODM_{it} + \alpha_6 DIRF_{it} + \alpha_7 OC_{it} + \alpha_8 ISH_{it} + \varepsilon_i$$

Where,

FS= Firm size which is natural Log of Total Asset. It is working as the control variable

CEODT= CEO duality, represented by the value of 1 if CEO is also holds at least a share, else 0 is awarded

BODS= No of directors in the board.

IND= Number of Independent Directors in the board/ BODS.

BODM= Number of Board Meetings conducted in a year.

DIRF= Director Fees paid to the directors.

OC= Ownership Control which is represented by debt to asset ratio (Total Debt/Total Asset).

ISH= Institutional Shareholding

Analysis of Descriptive Statistics

Following descriptive statistics were derived for the time series data of the model:

Table 1: Descriptive Statistics

Variables	Mean	Median	Maximum	Minimum	Standard deviation
ROA	0.000328	0.01085	0.0858	-0.1085	0.036603
BODM	15.66667	14.5	30	7	6.270111
BODS	15.58333	15.5	23	7	5.02778
CEODT	0.25	0	1	0	0.439155
DIRF	5378413	4890852	12787017	680147	3181463
IND	0.096944	0.1	0.29	0	0.075017
ISH	0.113706	0.12635	0.2607	0	0.064407
OC	10.22307	11.04865	24.1528	-5.2801	7.241461
FS	10.79667	11.025	11.68	9.64	0.550527

As the table illustrates, ROA and Institutional shareholding had minor deviations from the mean. This implies that most of the Islamic banks of Bangladesh has similar levels of profitability and ownership structure. However, the deviation seem to be quite high for number of board meetings and the size of the board. These might be the contributing factor in the differences in performances among the Islamic banks listed in DSE, something the study looks to explore.

Model Estimates

Following OLS regression estimates for the panel data were found using EViews 8.0:

Table 2: Regression Estimates

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.032444	0.082672	0.392441	0.6978
Size	-0.011603	0.008394	-1.382293	0.0782
No. of Board Meetings	0.000638	0.000664	0.960631	0.3453
Board Size	0.001578	0.001420	1.111029	0.2764
CEO Duality	-0.013600	0.013962	-0.974071	0.3387
Director Fees	5.11E-09	2.78E-09	1.839319	0.0769
No. of Independent Directors	0.064417	0.062206	1.035548	0.3096
Institutional Shareholding	-0.012532	0.071215	-0.175981	0.8616
Ownership Control	0.002903	0.000723	4.016262	0.0004
R-squared	0.790242			
Adjusted R-squared	0.728092			
Prob (F-statistic)	0.000000			

As the R-squared and adjusted R-squared values suggest, the model was strong enough to explain the movements of the financial performance of Islamic Banks of Bangladesh, almost 79% to be exact. The

model's F-statistic value is also below 10% significance level, implying the model is jointly significant in explaining the dependent variable. Thereby, according to the Global F-test for model significance, this variable is adequate enough for Islamic Bank performance.

In terms of the coefficients of the independent variables, firm size was found to have an inverse relationship with ROA. There exists a mixed set of results on this particular relationship in the existing literature, and our findings seems to fall in line with those who argues larger firm size increases redundancy and hurts performance (Capon, Farley et al. 1990, Beck 2003, Amato and Amato 2007). Similar contradictory results can also be observed for CEO duality and institutional shareholding, as they are found to have a negative effect on profitability (Finkelstein and D'aveni 1994, Kyereboah-Coleman and Biekpe 2006).

Hypothesis Testing and Model Interpretations

To determine the individual significance of the independent variables of the model, the P-value test is conducted below for significance level of 10%:

Table 3: Hypothsis Testing

$H_{1.0}$ - $H_{8.0}$ (Null Hypothesis)	$H_{1.a}$-$H_{8.a}$ (Alternative Hypothesis)	P-value	Decision
$H_{1.0}$: There is no significant relationship between ROA and CEO duality.	**$H_{1.a}$**: There is significant relationship between ROA and CEO duality.	0.3387	Accept Null Hypothesis
$H_{2.0}$: There is no significant relationship between ROA and Board Size.	**$H_{2.a}$**: There is significant relationship between ROA and Board Size.	0.2764	Accept Null Hypothesis
$H_{3.0}$: There is no significant relationship between ROA and Firm Size.	**$H_{3.a}$**: There is significant relationship between ROA and Firm Size.	**0.0782**	**Reject Null Hypothesis**
$H_{4.0}$: There is no significant relationship between ROA and No. of Independent Directors in Board.	**$H_{4.a}$**: There is significant relationship between ROA and No. of Independent Directors in Board.	0.3096	Accept Null Hypothesis
$H_{5.0}$: There is no significant relationship between ROA and No. of Board Meetings.	**$H_{5.a}$**: There is significant relationship between ROA and No. of Board Meetings.	0.3453	Accept Null Hypothesis
$H_{6.0}$: There is no significant relationship between ROA and Director Fees.	**$H_{6.a}$**: There is significant relationship between ROA and Director Fees.	**0.0769**	**Reject Null Hypothesis**
$H_{7.0}$: There is no significant relationship between ROA and Ownership Control.	**$H_{7.a}$**: There is significant relationship between ROA and Ownership Control.	**0.0004**	**Reject Null Hypothesis**
$H_{8.0}$: There is no significant relationship between ROA and Institutional Shareholding.	**$H_{8.a}$**: There is no significant relationship between ROA and Institutional Shareholding.	0.8616	Accept Null Hypothesis

The rejection of null hypothesis at 20% significance level implies that independent variable is individually significant in determining the movements of dependent variable. While the model itself is jointly significant, only three of the variables were individually significant. Among them, firm size was the control variable.

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Controlling for firm size, only two corporate governance mechanisms i.e. Director Fees and Ownership control were significant in explaining Islamic Bank's performance. While this low level of individual significance is supported by literature for developing countries, it also implies that more accountability needs to be ensured for the Islamic Banks of Bangladesh.

Conclusion

This research is conducted to exploit the presence of corporate governance on bank's profitability. Unfortunately, even though the model was consistent, not many of the corporate governance variables were found to have a significant relationship with profitability. Some of these mishaps maybe attributed to the critical difference in the underlying corporate governance principles between Islamic and Conventional banking. The state of accountability differs across the conventional OECD principles and structured Islamic jurisprudence in the form of Shari'ah based Islamic laws. The findings suggest some modifications are imminent for conventional corporate governance mechanisms to deal with Islamic Banking principles. Future researches can be directed towards identifying the equivalent Islamic Corporate Governance mechanisms to make this model an even significant one along with the necessary policy implications undertaken by the regulators to enforce authority and ensure financial soundness for Islamic Banks.

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