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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 expected. The charismatic of independent directors probably will ensure the management to disclose more of business activities and participate in sustainability practices. In addition, with the aspect of environmental, social and profits in IFI's mission and/or vision will also lead to more sustainability practices of the institution.

Thus, based on RBV, this study examines four independent variables, i.e. the SSB size, the Board size, independent directors and organization mission and vision, a dependent variable (sustainability practices) and a moderating variable (country of origins), as shown in Figure 1.

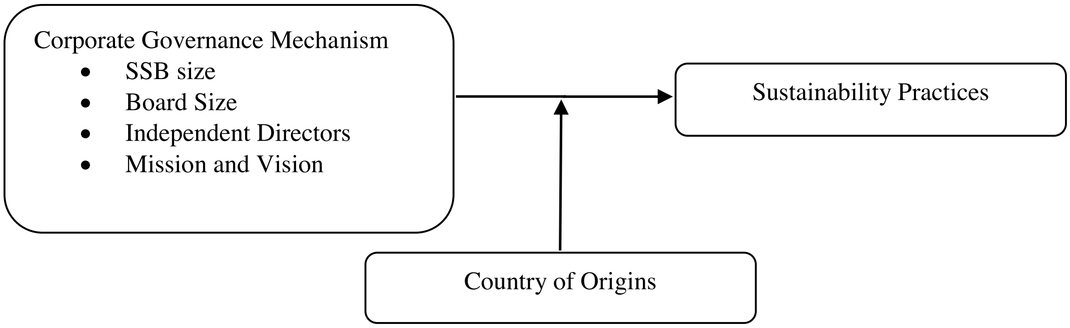

Figure 1. Theoretical Framework

3.1. Size of the Shariah Supervisory Board (SSB) and Sustainability Practices

The IFIs that offer products and services conforming to Islamic principles must be governed by a religious board that act as an independent SSB comprising of at least three Shariah scholars with specialized knowledge of the Islamic laws for transacting, fiqh al mu`amalat, in addition to knowledge of modern business, finance and economics (Dusuki, 2000). The greater the number of SSB members, it may lead to higher levels of CSR disclosure as the capacity of monitoring increases (Sayd et al., 2011). Thus, the first hypothesis is stated as follows:

H_1: The Shariah Supervisory Board size is positively related with sustainability practices

3.2. Board size and Sustainability Practices

Lipton and Lorsch (1992) suggest that the number of BOD should be limited to ten. This ineffectiveness result from growth in size might be due to the communication barrier when there are too many people involved in the decision-making process. While the role-plays of corporate governance on financial governance have received much interest, researchers have demonstrated interest in the effect of board structure to both financial and non-financial disclosure (Cerbioni & Parbonetti, 2007). This is because managers can make opportunistic accrual choices at the expense of shareholders in an organization with a weak board. Therefore, the organization may institute stronger board or complement it with higher level of internal and external audit. However, an effective board might lead to proactive board behavior in fear of scrutiny by their effective board.

H_2: The board size is positively related with sustainability practices

3.3. Independent Directors and Sustainability Practices

Independent directors, also known as external or outside directors, are the non-executive directors that do not participate in daily management of the organization. Boyd (1990) expressed that this group of directors also regarded as boundary spanners that secure resources through linkages to external environment. In addition, these directors borrow their prestige and boost the organization's legitimacy due to their standing in the community. With that, they are expected to take a determined stand in the interest of both organization and its stakeholders. Beasley (1996) found out that the proportion of independence directors is positively associated with the board's ability to a disclosure decision. This is further supported by some researchers report that voluntary disclosure increases with the number of independent non-executive directors (Chen & Jaggi, 2000; Donnelly & Mulcahy, 2008; Huafang & Jianguo, 2007).

H_3: The proportion of independent director is positively related with sustainability practices

3.4. Corporate social responsibility value in the mission and vision and Sustainability Practices

Vision or mission design with CSR value helps organization adopt a better strategy which takes into account that both company's competencies and the demand of external environment in which it must operate. Therefore, organization with vision or mission aligns with CSR value is expected to create a culture and environment that are taking stakeholder's demand into account. Culture influence moral values, which influence at least the issues selected for reporting. Adams and Kuasirikun (2000) found that cultural factors help to explain in environmental concerns. In a study to examine the determinants of environmental disclosure in Malaysia companies, Elijido-Ten (2004) used either or both environmental committees or/and environmental concern in their vision or mission statement as proxies of environmental concern by top management.

H_4: The aspect of corporate social responsibility into company mission and vision is positively related with sustainability practices

3.5. Country of origin as moderating variable

Most government in developed countries is obliged to reduce carbon emission to comply with Kyoto Protocol. Firms in developed countries are prone to pressure from government regulations and stakeholders if they fail to follow the carbon emission regulations. There are many factors that lead organization in different countries to pay more or less attention to environmental issues, for example, accounting regulations, government action, national culture and the economy, the existence of pressure groups and the severity of the environmental problems. Hence, a positive relation is predicted between the country of origin and sustainability practices. The GCC countries such as Bahrain, Kuwait, Qatar, Saudi Arabia and UAE supposedly practice more in Islamic Law. Thus, the higher level Islamic value and culture lead to better sustainability practices.

H_5: The IFIs from GCC countries has a stronger positive relationship between the corporate governance and sustainability practices compared to the IFIs from non-GCC countries

4. Research Methodology

The unit analysis of this study is the Islamic Financial Institutions. The population for this is all Islamic Financial Institutions in the world that issue annual report for year 2011 and 2012. The sampling technique used for this study is convenient sampling. Convenient sampling (also known as availability sampling) is a non-probability haphazard sampling procedure in which cases are selected only on the basis that they are easiest to obtain (Saunders et al. 2012).

The dependent variable for this study is sustainability practices. In order to determine the value of sustainability practices disclosure in annual reports of Islamic financial institutions, the content analysis is applied. For this study, content analysis is adopted in the similar as Amran et al. (2012) in evaluating the disclosure of sustainability practices. Meanwhile, the independent variables for this study are the size of SSB, the size of board, the independent director and the aspect of environmental, social and profit in mission and/or vision of the company. The SSB size is measured by the numbers of Shariah scholars in for each IFIs. The Board of Directors is measured by the number of the directors. The independent director is measured by the numbers of independent directors in the Board of Directors. Finally, the aspect of environmental, social and profit in mission and/or vision of the company is measured by Yes and No. If the mission and/or vision in their annual reports of the company disclosed on environmental, social and profit aspects, then it will have a score of 1 (Yes). Otherwise, zero (No).

The moderating variable is country of origin. In this study, the measurement is to determine whether the IFIs are in The Gulf Cooperation Council or Non- Gulf Cooperation Council. The control variables are total assets (to measure size of the company) and the profitability of the firm. The size is measure whether the firm is big or small firm based on its total assets (log). Finally, the profitability of the firm can be measured by the profitability ratio. The profitability ratio is equal of profit (net income) divided with revenue (sales).

5. Significant Results and Findings

5.1. Descriptive analysis

As shown in Table 1, the average number of SSB sitting on a board is four with a minimum number of two SSB. The highest number of SSB is 10 with an average of 9 board members for the sample of study. On average there is only one independent directors on the board of IFIs. The mean value ranges from -0.192 to 8.91 for each variables. The standard deviation is from 0.173 to 3.752, it means that the largest coefficient of variance has the largest relative spread of data. The Skewness of these variables is from -3.063 to 1.977 and Kurtosis; the pointedness or flatness of the distribution compared with normal distribution, value ranges for this study is from -0.578 to 13.315.

Table 1. Descriptive Analysis

Items	SP	Size SSB	Size Board	Ind	TA	Profitability
Mean	0.266	4.1	8.91	1.57	7.506	-0.192
Median	0.22	4	8	1	7.453	0.234
Mode	0.10a	4	9	0	3.973	-6.391
Std. Deviation	0.173	1.203	3.752	1.736	1.582	1.157
Variance	0.03	1.447	14.079	3.013	2.503	1.339
Skewness	0.05	0.665	1.977	0.687	0.489	-3.063
Kurtosis	-0.578	6.604	4.139	-0.874	1.175	13.315
Range	0.65	8	18	5	7.712	9.296
Minimum	0.02	2	4	0	3.971	-6.391
Maximum	0.67	10	22	5	11.683	2.905

Note: SP = sustainability practices; Size SSB = number of of Shariah Supervisory Board members; Size Board = number of directors in the Board of Directors; Ind = independent directors; TA = log of total assets

The number of IFIs in GCC for this study is 40 and the percentage is 48.8 percent while the non-GCC is 42 (51.2 percent). The total of IFIs that has the aspect of environment, social and profits in mission and/or vision is 35 out of 82 (i.e. 42 percent).

5.2. The role of country of origin as moderator

Based on the results, all independent variables have positive relationship with sustainability practices. The size SSB, the Board size, independent director and the aspect of environmental, social and profit in mission and/or vision of the company has significant value towards sustainability practices. Ideally, the governance in Islamic Financial Institutions has positive relationship with sustainability practices.

Based on Table 2, it shows that Board size, independent director and the aspect of environmental, social and profit in mission and/or vision of the company have positive relationship with sustainability practices. It means that the hypothesis of these three independent variables has been accepted. As expected, the more people in the board, the greater level of sustainability practices in GCC countries. In addition, a lot of independent directors in the IFIs will lead to more sustainability practices. Moreover, the aspect of environmental, social and profit in mission and/or vision of the company also will help the company to focus more on sustainability aspects in the organizations. However, the SSB size did not have a positive significant value when the IFIs are in GCC countries. The result shown suggest that the first hypothesis is not accepted. It means that the SSB size did not give any influence or be affected when the IFIs origin in GCC countries.

Table 2. Regression Result.

	Model 1 Beta (t-value)	Model 2 Beta (t-value)	Model 3 Beta (t-value)
Size SSB	0.086** (6.868)	0.084** (6.292)	0.097** (6.603)
Size Board	0.013*** (3.569)	0.014*** (3.540)	0.013*** (2.487)
Ind	0.018*** (2.164)	0.018*** (2.162)	-0.001*** (-0.105)
Vision	0.051** (1.896)	0.052** (1.907)	-0.009*** (-0.220)
TA	-0.008*** (-0.787)	-0.009*** (-0.872)	-0.010*** (-0.544)
Profitability	-0.020*** (-1.705)	-0.021*** (-1.727)	-0.019*** (-1.587)
GCC		-0.014*** (-0.471)	-0.010*** (-0.084)
GCC x SizeSSB			-0.041*** (-1.355)
GCC x SizeBoard			0.006*** (0.790)
GCC x Ind			0.038*** (2.493)
GCC x Vision			0.104* (1.930)
R Square	0.588	0.589	0.645
F value	17.821	15.149	11.556

Note: *p<0.1; **p<0.05; ***p<0.01; SP = sustainability practices;
Size SSB = number of of Shariah Supervisory Board members;
Size Board = number of directors in the Board of Directors;
Ind = independent directors; TA = log of total assets

6. Discussion

As the results discussed earlier, this study found that the size of SSB has contribute to the sustainability practices among IFIs. This suggests that when the size of SSB members is bigger, there will be more sustainability practices carried out by the IFIs. In other words, there are more sustainability practices when the IFI has many scholars with the different background and experiences. The scholars will tend to ensure that the organizations follow the Islamic laws and do a lot of good things that give benefits to the society and the environment as well. However, the SSB size did not have any influence and affected whether it is in GCC countries or not. This suggests that the scholars only do their responsibilities and make sure the IFIs follow the Shariah where ever the IFIs are located.

The finding shows that the mean value for the size of Board is 9 persons. As suggested by Lipton and Lorsch (1992), the suitable people for board size are eight or nine and not exceed more than ten people. There is a positive relationship between the Board size and sustainable practices. This means that the greater the Board size of the IFIs, the stronger it become and definitely can influence the action and amount of sustainability practices plays by the organization. It suggests that the IFIs are able to do more sustainability activities if there are many people in the board. Currently, the IFIs have many directors on the board to show that the boards are variety enough to face the real world and do the decision making for the future of the IFIs.

The result indicated that there are significant positive relationship between board independence directors and sustainable practices. This result revealed that board independence is a key determinant quantity (Amran et al., 2011). It implied that the existence of independent directors in the board will influence the management decision and encourage the organization to disclose more of their business activities. With the continuous monitoring by independent directors, the organization probably want to look better while running the business. In order to exercise an independent judgment and risk mitigation, independent directors may have the incentive to commit on a greater quality of reporting in order to legitimate organization's operation.

The finding also indicates a strong relationship between the aspects of environmental, social and profits into company's mission and vision and sustainability practices. The organizations which have the aspects of environmental, social and profits in their company's mission and vision will tend to focus more on sustainability practices. The IFIs that have the environmental and social aspects probably will not focus solely on the profit making, but they will also concentrate on all aspects of life. As an Islamic institutions, the society will expect the organization to do more towards humanity aspects. The IFIs must be ready to act as a good example in sustainability practices to other organizations.

The country of origin as moderator is also found to influence the relationship between corporate governance and sustainability practices. The size of Board, the independent directors and the aspects of environmental, social and profits into company mission and vision in IFIs those origins from GCC countries have positive relationship with sustainability practices. It means that the higher level of Islamic value and culture would lead to a better sustainability practices. However, the SSB size is found to be indifference either in GCC or Non-GCC countries. This might be due to the facts that scholars are free, independent, and not bias and only ensure that the IFIs are in compliance with the Shariah law and do not act in any prohibited activities.

7. Conclusions

The corporate governance mechanism will lead the organization to do more sustainability practices when there is a higher number of SSB scholars and more people in the Board of Directors. In addition, organization that has independent directors, who act as shareholder representative of the organizations will tend, disclose more of its sustainable practices. It is also found that more sustainability activities will be conducted when the aspects of the environment and social are include in its mission and/or vision.

This study also has some limitations. This study is set out to investigate the relationship between the corporate governance mechanisms and the sustainability practices of Islamic financial institutions. Due to insufficient information disclosed about Shariah Supervisory Board in the annual reports under this study, it is hard to further examine other characteristics of the SSB such as experience, educational background, gender, and duality role. These information is important to examine the effectiveness of SSB existence in IFIs. Future research should therefore examine these characteristics of SSB on sustainability practice.

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