Review paper

Board Characteristics and Financial Performance of Islamic Banks

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Abstract

Board of directors (BODs) is one of the crucial components of corporate governance mechanism that play immense roles in protecting the interests of the stakeholders. BODs are responsible to ensure bank achieves the desired profitability level and sustainability in the long term. The purpose of this paper is to review past literature on the impact board's characteristics on the bank performance by focusing on the main board's characteristics, which are board size, board independence and board diversity. This paper proposes a conceptual framework to investigate these relationships in the context of Islamic banking. It is expected that BODs characteristics significantly impact the performance of Islamic banking. This paper shed light on the BODs characteristics and performance of Islamic banks and serves as preliminary study to further examine this topic in the future.

1.0 Introduction

Corporate governance has become prominent issue worldwide. It has gained attention both academicians and industry players. According to The Institute of Chartered Accountants in England and Wales (ICAEW), corporate governance is the system that directs and controls the firm. It consists of mechanisms, rules, processes, practices, relations and regulations that must be in place in order to protect the interests of many stakeholders including shareholders, management, customers and government. Corporate governance comprises of internal and external corporate governance mechanisms. Board of directors (BODs) is regarded as most significant internal corporate governance mechanisms (Bhagat & Bolton, 2008). BODs is responsible for the sound governance of firm. It acts as a bridge that links the relationship of the managers and shareholders. Board plays its roles protecting the rights and interest of shareholders while constraining the opportunistic behavior of managers.

Generally, past studies have proven that the characteristics of board may affect bank decision-making and eventually bank's financial performance (see Al-Saidi & Al-Sammari, 2013; Al-Manaseer et al., 2012; Adusei, 2011; Adams & Mehran, 2005; Bukair & Abdul Rahman, 2015; Belkhir, 2009; Durgavanshi, 2014; Morekwa Nyamongo & Temesgen, 2013; Pathan & Faff, 2013; Rachdi & Ben Ameur, 2011; Stepanova, Ivantsova, Stepanov, Vernikov & Bokov (2012); Hoque & Muradoglu, 2013). These literature investigate board characteristics proxies of size, number of meeting, proportion of independence, non executives and female directors, CEO duality role, board diversity, board meeting to represent board structure, board composition and board diversity.

Earlier studies have immensely focused on the conventional bank. Thus, the findings and impacts cannot be generalized to the banking industry as a whole and the focus on the Islamic banking (IB) industry specifically remains limited and scarce. For instance, Ajili and Bouri (2018), Almutairi and Quttainah (2017), Ali and Azmi (2016), Alman (2012), Ben Zaineb and Mensi (2018), Mezzi (2018), Mollah, Hassan Al Farooque and Mobarek (2016), Mollah and Zaman (2015), Nawaz (2017) and Wan Abdullah (2013) are among the studies that focus on IB in relation to performance, risk behavior, corporate and Shariah governance disclosure and efficiency. IB is unique in the sense that its philosophical, bank's objectives, features of contracts are based on Shariah and its corporate governance mechanisms and main players in the corporate governance practice are also difference from its conventional counterpart (Hamdi & Zarai, 2014). For that reason, the existence of Shariah governance as the dual layer governance mechanisms complement the existing corporate governance layer in order to meet Shariah requirements in all aspects of IBs' business operations and transactions.

Thus, the purpose of this paper is to examine the past literature on the board characteristics and their association with the bank performance. This paper focuses on the three main characteristics, which are board size, board meeting, board independence and board gender diversity. Then, the paper suggests a framework for investigating the association of that three board characteristics with the IB's performance by taking into consideration the IB's specific characteristics as control variables.

2.0 Literature Review

Past literature provides empirical evidence on the relationship between the board characteristics and bank performance. In general, the past literature has proven that board characteristics affect bank profitability and market value (see e.g. Adusei, 2011; Belkhir, 2009; Juras & Hinson, 2008; Rachdi & Ben Ameur, 2011). The past literatures have been focusing on the conventional bank and the findings are inconclusive (Bukair & Abdul Rahman, 2015). The evidences on the Islamic banking governance mechanisms are still limited and not extensive (Mollah & Zaman, 2015; Bukair & Abdul Rahman, 2015). This section discusses in depth the empirical findings of each board characteristics bank performance that based on the Islamic banking setting.

According to Grassa and Matoussi (2014), the IB in Southeast Asia (SEA) regions dominated in term of size and women board members. They made comparison on the characteristics of IBs' corporate governance in GCC and SEA countries over the period of 2002 to 2011 and revealed that the average size of board members of IBs in SEA is four compared to three of the Gulf Council Countries (GCC) region. In addition, board members of IBs in SEA countries also prevailed by 3 percent of women directors compared to only 0.36 percent observed in GCC IBs. This major difference is attributed to the tradition and culture norms in GCC region where the participation of women in the professional sector is restricted and far behind those in SEA region (Grassa and Matoussi, 2014).

Mollah and Zaman (2015) examined the performance of 86 IBs and 86 conventional banks in 25 countries during the periods of pre-crisis, during crisis, and post-crisis of 2005 to 2011. Using both accounting and market based performance, their findings using two-step system GMM and GLS-Random Effect models showed that board characteristics, which are size, independence, CEO chair-duality and internally recruited CEO, negatively affect the performance of IBs. However, the interaction between board size and board independence revealed highly positive significant association. This is in harmony with the interaction of CEO chair-duality and internally recruited CEO. However, a more recent study by Nawaz (2017) using similar measure of market value presented contrasting results. Based on the sample of 67 IBs from 26 different countries for the period of 2006–2009, Nawaz found that the characteristics of BOD, which included size, composition (as proxied by non-executive director) and role duality of the board's chairman are not significant with the Tobin's Q. In addition, a study by Almutairi and Quttainah (2017) used as board characteristics of CEO duality, board size, outside directors and board interlocks as control variables to investigate the relationship of SSB characteristics on the performance of IBs in 82 countries in 15 countries over the period of 1993 to 2014.

2.1 Hypotheses development

2.1.1 Board size and bank performance

Past literature use number of board directors as proxy of board size. However, the finding on the relationship between board size and bank performance has been mixed and varied. Larger board size increases diversity of qualifications and experiences of the directors that will eventually enhance the decision-making processes. It hinders the domination of the individual and small group (Ghayad, 2008). However it also creates inefficiency in terms of coordination, communication and monitoring.

There are evidence that proves that large board size negatively effect bank performance. Bukair and Abdul Rahman (2015) examined the 40 IBs in the GCC countries and concluded that their performance as measured by ROE inversely related with the larger board size. According to them, the directors not play their roles well when they are not appointed based on their expertise and experience. Using ROA as measurement, Al-Saidi and Al-Sammari (2013) concluded similar result for a 9 Kuwait banks sample from 2006 to 2010. These corroborate previous results of Morekwa Nyamongo and Temesgen (2013) for Kenyan banks, Rachdi and Ben Ameur (2011) for Tunisian banks, Adusei (2011), Belkhir (2009) Adams and Mehran (2003), Stepanova et al. (2012), (Durgavanshi, 2014), Al-Manaseer, Al-Hindawi and Al-Dahiyat (2012), Pathan and Fanta et al. (2013), Hoque and Muradoglu (2013), Athanasoglou, Delis and Staikouras (2006) for European banks and Yermack (1996). These evidences imply that smaller board size play effective role in the performance monitoring and value creation (Bukair & Abdul Rahman, 2015). These are inconsistent with the stakeholder theory, which indicates the larger board size has more degree of stakeholders' representation (Ghayad, 2008).

On the other hand, there are also empirical studies documented a positive relation between board size and bank performance. Using market value of Tobin's Q as measurement, Adams and Mehran (2005) found that the board size is positively associated with performance. This is supported by a study of Mori and Towo (2017), by using ROA. Few others study such as Belkhir (2009) and Hadi Zulkafli and Abdul Samad (2007) report no impact of board size on the bank performance. Thus, the influence of board size on bank performance should be examined empirically without any direction by following hypothesis:

H1: There is significant association between board size and bank performance.

2.1.2 Board independence

The directors are considered independent directors when they do not have any interest and relationship with the firm except for their appointment. The management appoints the independent directors and shareholders and their status are disclosed in the annual report. While Brickley and James (1987) asserted that managerial behavior are positively affected by the presence of independent directors, Cornett, Marcus, Saunders and Tehranian (2007) argue their independency as their appointment are based on the recommendations from the top management. Thus, they are required to work in hand with the other directors and support the management's decision.

Theoretically, the presence of independent directors could have reduced the agency problems between shareholders and management. Independent directors are supposed to provide monitoring and aligning the firm with its objectives that eventually will be minimizing its corporate risk and enhancing the performance (Elbahar, 2016). The evidences provided by Athanasoglou et al. (2006) and Mura (2007) suggested that the impact of independent directors fraction on bank performance is significantly positive. Morekwa Nyamongo and Temesgen (2013) observed the positive association between the presence of independence directors and performance of Kenyan bank as measured by Return on Asset (ROA) and Return on Equity (ROE).

Yet, this is contradictory with the prior finding of Hoque and Muradoglu (2013). In the similar line, Rachdi and Ben Ameur (2011) examined performance of Tunisian commercial banks through ROA and ROE using generalized least square (GLS) random effect during 1997- 2006 and found the presence of independent directors on the board not enhance bank performance and negatively correlated with bank performance. Pathan and Paff (2013) also produced similar result for a sample of large US bank holding for the period 1997 10 2011. In addition, using accounting measurements of

ROIAE, ROIAA and ROAE, Mollah (2015) found that the increasing number of independent directors adversely impact the performance of 86 IBs covering 25 countries seven year periods from 2005 to 2011. However, the interaction between board size and board independence showed a significant and positive association. Interestingly, a study by Adams and Mehran (2012) corroborates the previous evidence of Bhagat and Black (2002) by indicating that no relationship established between the proportion of outsiders and performance as measured by Tobin's Q. From the above discussion, the following hypothesis will be tested:

H1: There is significant association between board independence and bank performance

2.1.3 Board Gender Diversity

The board's gender diversity is attributed with the presence of female directors. Previous literature provides mixed and inconsistent evidences on the relationship between participation of female director in the boardroom and bank performance. However, the required knowledge on this area is still limited and scarce. The presence of female directors in banking institutions can provide top management with a different perspective on many issues (Jubilee et al, 2018)

and better monitoring (Stepanova et al., 2012)

Jubilee et al. (2018) investigated the role of female in the board through a set of panel data constitutes ten banking institutions listed on the Malaysian stock market for the period from 2007 to 2016. This constituted ten banking institutions in total. Using Tobin's Q as masurement of banking value, they noted that the existence of female directors in the board is associated significantly and positively with bank performance. This supports the previous result of Gulamhussena and Santa (2015) through a sample of 461 large size banks in OECD countries, García-Meca, García-Sánchez and Martínez-Ferrero (2015) through a sample of 159 banks in nine countries during the period 2004 to 2010, Mori and Towo (2017) through an observation of 35 Tanzanian banks from 2009 to 2013 as well as Stepanova et al. (2012). In addition, they further indicated that there is a negative relation between the presence of female independent director and bank's value. Thus, this study specifically hypothesizes that:

H1: There is positive significant association between board independence and bank performance

3.0 Research Framework

To investigate the potential impact of board characteristics on the IB's value, the following conceptual framework is developed to measure the effect of IB's board characteristics and its performance.

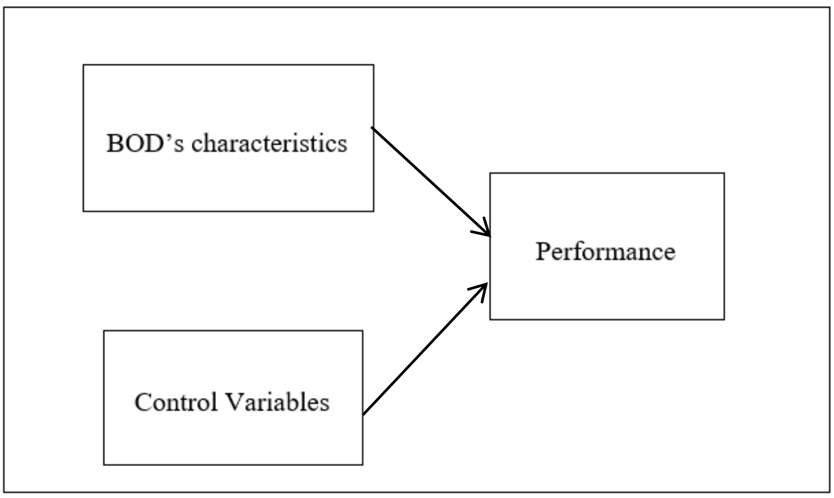

Figure 1: A proposed model for measuring effect of IBs board characteristics and performance

The following regression model describes the IB's value as a function of the BOD's characteristics and firm specific factors as control variables. The model proposed can be specified as follows:

$$\text{Performance}_{it} = f(\text{Board Size}_{it}, \text{Board Independence}_{it}, \text{Board Gender Diversity}_{it}, \text{Control Variables}_{it}) \quad (1)$$

Board Size is the total number of BOD members, *Board Independence* is the ratio of independence director to the total BOD members and *Board Gender Diversity* is the ratio of female directors to total BOD's members on each board. This proposed study employ accounting-based measurements, which are Return on Assets (ROA) and Return on Equity (ROE) as proxies for bank's value. These measurements have been widely used in the previous study including Mori and Towo (2017), Morekwa Nyamongo and Temesgen, (2013) and Mollah and Zaman (2015) – specifically in the IB's context. To control for bank specific effect, bank size proxied by natural logarithm of total assets and bank leverage ratio measured by the ratio of total debt to the total equity are controlled due to their effect on bank's performance.

It is expected that the results of this proposed study will follow the stated hypotheses above.

4.0 Conclusion

This paper intends to provide conceptual framework on the proposed study on the association of BOD characteristics and performance of IBs. While extant previous study has focused predominantly on the conventional banks and developed countries, the results were inconclusive. Thus, there are gaps on the remaining knowledge on the impact of BOD's characteristics on the performance of IBs specifically in the developing countries. Therefore, this study offers motivation for future study on the board characteristics using the proposed framework.

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