The Impact of Corporate Governance Disclosure on Firm Performance of Islamic Banks: The Risk-Taking as Mediating Variable

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Received: 16 April 2019; Accepted: 2 June 2019; Published: 30 June 2019

Abstract: The paper discusses the potential influence and relationship between corporate governance (CG) disclosures and firm performance in the Islamic banking sector and the mediating role of risk-taking between them. Good CG is a must in ensuring the values required by different stakeholder groups, and it enhances the performance of corporations. CG practices and disclosures support the continuity of a company and help to increase the trust from the society and investors. Similarly, CG disclosures are expected to be relevant to Islamic banks in strengthening the infrastructure of Islamic financial institutions. Therefore, a positive relationship between CG disclosures and firm performance of Islamic banks is expected. The mediating variable of risk-taking, as one of the most relevant factors in determining firm performance in the investment decision, is expected to mediate the relationship between CG disclosures and firm performance of Islamic banks. The dimension of CG disclosure in Islam which is different from the western concept refers to its fundamentals concept whereas, in the Islamic concept, is based on the Shari’ah principle. This study only a conceptual paper that only discusses the CG disclosure and the effect of the firm performance of Islamic bank based on the past literature.

Keywords: Corporate Governance Disclosure; Risk-taking; Firm Performance; Firm Performance

1. Introduction

Discussion about the corporate governance (CG) disclosure issue is still relevant currently, especially after the global economic crisis in 2008 that impacts developed countries. Weak implementation of CG is supposed as one of the causes of the global economic crisis. Realising from the past experience and situations, there is global awareness about the importance of acceleration in the implementation of proper CG disclosure. The CG disclosure is one of the important components in improving the economic efficiency and growth, as well as enhancing the confidence level from investors. The CG involves a set of relationships between the management of the company, the board members, the shareholders, and the other stakeholders related to the company (OECD, 2004). The CG disclosure also provides the structure to set the performance monitoring, the objectives of a company and the procedure to reach these targets related to the company. The occurrence of an effective system of the CG disclosure in an organisation or company, as well as in overall economic issues, helps to give a trust level needed for the well-functioning financial sector, particularly in the capital market.
The recent global financial crisis in the year 2007/2008 has received significant attention from several academics and practitioners (Erkens, Hung & Matos, 2012). They argue that CG disclosure has resolved the conflict among related parties within the firm, and CG disclosure aims not functioned appropriately to preserve from stakeholders interest. Board of director and management of the company plays an important role in CG disclosure. Board of director and management of the company provides strategic and leadership guidance, assessment of management, objective judgment and project selection for companies (Oshry, Hermalin & Weisbach, 2010). Attention to the CG disclosure increased recently by many scholars. CG disclosure as the fundamental internal mechanism has been mentioned in many kinds of literature (Bhagat & Bolton, 2009; Ararat, Black & Yurtoglu, 2016). However, according to the OECD (2004) and BCBS (2006) overseeing the management actions and monitoring the corporate strategy do by the board of director and management of the company. The CG has been further categorised by the board of directors and management of the company.

In recent years, CG disclosure has received considerable attention in Islamic finance. The dimension of CG disclosure in Islam which is different from the western concept refers to its fundamentals concept whereas, in the Islamic concept, is based on the Shari’ah principle. The fundamental principles of tawhid, shura, property rights and commitment to a contractual obligation that govern the economic and social behaviour require IFIs to comply with the Shari’ah rules and principles (Chowdhury & Shaker, 2016; Itam, Hasan & Alhabshi, 2016; Lahsasna, 2010). At this stage, CG structure and disclosure in IFIs need additional measures of governance for the purpose of Shari’ah compliance based on the Shari’ah principle, known as Shari’ah governance (SG). As part of the CG framework in IFIs, Shari’ah governance is the very essence of Islamic finance practice in building and maintaining the confidence of the shareholders and other stakeholders and assuring them that all transactions, practices and activities are in compliance with the Shari’ah principles and can be affected the firm performance of Islamic bank.

2. Literature Review

2.1. Corporate Governance and Firm Performance

The role of CG is manifested in creating value for the corporation and supporting transparency (Lamm, 2010). Good CG is a must in ensuring the values required by different stakeholder groups, and it enhances the performance of corporations in the company (Ganescu & Gangone, 2013). The application of the CG practice and disclosure may support the continuity of a company and help to increase the trust from the society and investors. The CG disclosure has a significant effect on the growth of a company and overall economic development. It is since a proper CG disclosure practice can reduce the risk for the investors, attract investment capital, and improve the performance of companies (Spano, 2005). The CG disclosure is directed to reduce the asymmetric information so that the investors have sufficient information in taking the investment decision. In the end, it will affect the firm performance.

The CG disclosure deals with the way how firms are managed and controlled and how accountability is assured. The efficiency of CG disclosure in an Islamic bank organisation may help the company to reach its objectives, including its risk management and affect the firm performance of the Islamic bank. The CG disclosure mechanism ensures the management acts for the best interest of the company and minimises the agency cost. The CG framework is one of the important keys to increasing the efficiency in business monitoring. The implementation of the CG disclosure is expected to attain a balance of many interests that give benefit to the company. Good firm performance is crucial for firms to be able to keep maintaining the existence of the firms listed as a viable investment for the company. Fahmi and Saputra, (2011) state that profitability depicts the company’s ability to gain profit through all afford, and existing resources such as sales activities, cash, capital, the number of employees, the number of branches, and so on.
Research indicates that CG disclosure affects firm performance through reduced expropriation by insiders and improvement in the expected returns of cash flows that can be distributed to shareholders (Black, Jang & Kim, 2006; Claessens & Fan 2002; Klapper & Love, 2004; Yermack, 1996). Black et al. (2006) report a causal relationship between an overall CG disclosure index and higher share prices in emerging markets. Many previous types of research include the CG framework in financial performance and the firm performance analysis. Various results obtained may be caused by the difference in the research approach and the dimension of the variables based on the objective of the study. Ammann Oesch and Schmid, (2011) investigate the relation between firm-level CG and firm performance based on a large and previously unused dataset from Governance Metrics International (GMI) comprising 6663 firm-year observations from 22 developed countries over the period from 2003 to 2007. The result shows that all three indices that they find a strong and positive relation between firm-level CG and firm valuation. The studies by Gompers, Ishii and Metrick, (2003), Drobetz, Schillhofer and Zimmermann (2004), Black, et al. (2006), Wellalage, (2012), Krafft, Qu, Quatraro, and Ravix (2013), Yu, Krause, Bell, and Bruton, (2016), and Pillai and Al-Malkawi, (2017) also show positive relationship between the CG and the firm performance as well as the financial performance of the company.

2.2. Corporate Governance Disclosure

Islamic bank plays an important role in the industrial expansion, the CG of firms, and capital allocation, especially in the banking sector. When there is proper functioning of Islamic banking, it has implications for the operations of firms and the prosperity of countries. If sound CG mechanisms are designed and implemented, the Islamic bank can allocate capital efficiently and improve its financial performance and firm performance. The effectiveness of CG protects the interests of shareholders as well as other stakeholders (Denis, 2016; Levine, 2003).

On the other way, it is less likely to allocate capital efficiently if the Islamic banks face poor CG mechanisms. In this case, the Islamic bank manager will mainly enjoy acting in his/her own interest rather than in the interests of shareholders or other stakeholders. The situation can lead to banking failures and crises that promote the massive consequences and can pose significant public costs of poor governance of Islamic banking (Levine, 2003). Therefore, efficient CG practices are important to reaching and retaining the public trust and confidence in the banking system, which is critical to the appropriate effective of the Islamic banking sector and the economy as a whole.

According to Levine (2003), banks have two characteristics that are related to the CG of banks. First, even though information asymmetries exist in all sectors, it is larger in the banking industry than nonfinancial firms due to the opaqueness of their assets and activities. Loan quality can be hidden easily for long periods in the banking industry. In addition to this, banks can modify the risk composition of their assets more immediately than most of the non-financial industries, and bank managers can hide problems by extending loans to clients that cannot service previous debt obligations. The greater information asymmetry between insiders and outsiders and relatively severe difficulties in acquiring information about bank activities and monitor continuing bank activities intensifies the agency problem (Caprio, Laeven, & Levine, 2007). Second, governments impose heavy regulation on banks which are usually regulated very seriously since banks are important for the economy of countries.

Various codes of CG have been introduced in many nations to address issues about the CG structure of firms’, especially in banking sectors. It is hoped that better CG measures and improved disclosure will be able to limit the impact of economic downturns, as well as avoid financial crises. Islamic banks are subject to a number of guidelines and standards that have been established to improve their CG structures and disclosure. CG disclosure based CG index proposed by Wan Abdullah (2013) and this disclosure index are selected based on the Accounting and Auditing Organization for Islamic
Financial Institutions (AAOIFI) standards, the Islamic Financial Services Board (IFSB) CG Guidelines, The Organization for Economic Cooperation and Development’s Principles of CG (2004) and the Basel Committee on Banking Supervision (BCBS) (2006) Paper. These disclosure items cover most aspects of CG disclosure, which are relevant to Islamic banks and to strengthening the infrastructure of IFIs. According to Sulub, Salleh, & Hashim (2016), the CG disclosure index based on a study by Wan Abdullah (2013) covers 43 per cent of CG disclosure whereas its focuses on the avoidance of conflicts of interest.

2.3. Mediating Variable of Risk-taking

Mediation refers to a series of causal relationships by which independent variable (IV) applies its effect on the dependent variable (DV) through influencing dominant third variable (Hayes, 2013). Mediation analysis helps to understand a stable relationship by realising how one variable affects the other variable. According to Baron and Kenny (1986), a mediating variable is the third variable that explains the direct relationship between the independent and dependent variable. Additionally, for the variable to be considered a mediator, it must be significantly related to independent and dependent variables. In mediation analysis, the Sobel test (Sobel, 1982) is usually used to calculate the extent to which the mediator carries the relation between the independent variable and the dependent variable.

Risk taking can be defined as an engagement in behaviours associated with some probability of adverse results, or it refers to the grouping to engage in activities that have the possibility to be destructive or threatening (Repullo, 2004; Jiménez, Lopez, & Saurina, 2013; Haselmann & Wachtel, 2016; Bolton, Mehran, & Shapiro, 2015). Risk taking is one of the most relevant factors determining firm performance in investment decision (Minton, Taillard & Williamson, 2014). The literature on the relationship between risk taking and financial performance is still in infancy. Investigating the firm risk-taking and its impact on financial performance are critical issues for managers. During recent years, bank risk-taking and its determinants have been widely discussed, whereby numerous study attempts to explain risk taking the behaviour of financial regulators, policy makers and researchers (Mollah, Hassan, Al Farooque, & Mobarek, 2017). Behaviours of financial intermediaries are central in economics and finance since controlling the risk-taking in banking relates to the protection of financial systems and depositors as a whole (Lassoued, Sassi & Attia, 2016). In addition, as a recent financial crisis, which has been associated with the excessive bank risk taking raise the attention to this topic. Risk taking in the Islamic banking industry has attempted to investigate in the theoretical and empirical literature, according to the agency problem (theory), the conflict between managers and shareholders affect risk-taking behaviour (Jensen & Meckling, 1976). According to this theory, risk-averse managers, where shareholders using a diversified stock portfolio, have the incentive to raise Islamic bank risk-taking after amassing depositor and funds.

The relationship between CG disclosure, firm performance and risk-taking has been explored in previous research. For example, Akhigbe and Martin (2008) have revealed that the measures of firm performance or performance for the short-term and long-term risk-taking are inversely associated with their governance structures’ strength. Likewise, when Laeven and Levine (2009) examined the underlying reasons for risk-taking, they found that the effects of regulations on risk-taking depending on the bank’s CG structure and disclosure. Risk management has received much awareness in recent literature. It appears recognisable that financial firms or companies took excessive risks to inflate stock prices. CG is said to have failed when banks’ risk management measures failed (Rose, 2010). Accordingly, many scholars and researchers study whether the failure of risk management was ultimately a CG failure. The Organization for Economic Co-operation and Development (OECD) has pinpointed failures in risk management as the most important cause of the financial crisis and noted that this failure was assigned to the weaknesses in CG disclosure and implementation more than to defaulting risk assessment or risk
models. Kirkpatrick (2009) concluded that CG arrangements did not serve their purpose to preserve against excessive risk-taking when they were put to the test in a number of financial services companies.

Kirkpatrick (2009) pointed to major risk management failures due to improper CG disclosure and implemented the procedures in main financial institutions. For example, in their study, many boards failed to ensure that approved risk management procedures were implemented, whereas others were not made aware of exposure risks at all (Kirkpatrick, 2009). Rose (2010) considered the one that linked the crisis to excessive risk-taking most persuasive. To determine if the crisis resulted from a failure in CG, he conducted empirical tests on the links between risk management and specific CG factors. Risk management works hand in hand with CG as a means to constrain agency costs and to promote effective management. The study aims to empirically evaluate how CG disclosure affected risk-taking and how risk-taking affected firm performance by exploring whether Islamic bank with strong governance disclosure took lower risks than organisations with weak governance and accordingly earned higher returns.

2.4. Firm Performance of Islamic Bank

The majority of the prior literature on the relation between CG and firm performance, documents that a stronger CG disclosure is associated with a higher firm valuation (e.g., Bebchuk, Cohen & Ferrell, 2008; McCahery, Sautner, & Starks, 2016; Brown & Caylor, 2006; Jo & Harjoto, 2011). While much of this literature deals with specific aspects of CG, such as ownership structure or board structure and part of the literature aggregates individual CG attributes to CG indices. There are several numbers of studies (e.g., Bebchuk & Cohen, 2005; Bebchuk et al., 2008; Gompers et al., 2003) demonstrate the value-relevance of such governance indices aggregating a number of firm-level governance attributes (Caprio, Laeven, & Levine, 2007).

The term value refers to the utility or the benefit derived from a good or an object. In economics or finance, the term value refers to the price for which a good or object can be exchanged (exchange value or market value). There are different concepts of the value of a firm such as intrinsic value, social value and hedonic value. The social value or performance can be different from the accounting-based performance and market-based performance of an object due to market imperfections, external economies and diseconomies and market non-existence. According to Easton and Monahan (2016), the performance of a firm is determined by the future expected cash flow discounted at a rate that reflects the riskiness. The important factor to valuation is, therefore, an assessment of the likely future cash flows, and the application of the appropriate rate of discount to establish present performance (Altuntas, Liebenberg, Watson & Yildiz, 2017). Good CG is an essential factor in improving the value or performance of a firm in capital markets of both the developing and developed countries (Al-Janadi, Al-Janadi, Abdul Rahman, Abdul Rahman, Alazzani & Alazzani, 2016).

Firm performance or firm value can be measured using many ways. Empirical studies on CG use financial measures for firm performance which are either accounting-based or market-based measures (Kiel & Nicholson, 2006). The Common used of the accounting-based are measured by the ROA (Kiel & Nicholson, 2006) and ROE (Baysinger & Butler, 1985). The market-based measures that are mostly used in the literature are Tobin’s Q (Claessens & Fan, 2002). Accounting-based measures are usually criticised when compared to current market-based measures. Management can use its authority to manipulate accounting methods which may result in a change of accounting policies, accruals and estimates that will be difficult to interpret and understand across industries. In addition, accounting-based information used to measure performance is historical and focuses on past transactions and events (Kiel & Nicholson, 2006). Moreover, accounting-based reports do not include relevant risk factors and do not consider the time value of money principle (Klapper & Love 2004). In contrast, market-based measures are established.
on the real value of companies’ common stock and management cannot manipulate or have an impact on this method of performance or firm performance measure. Market-based measures reflect risk-adjusted performance (Ramaswami, Srivastava, & Bhargava, 2009) and are considered to be forward-looking and reflect organisational strategies (Kiel & Nicholson, 2003). In this study, firm performance or firm performance, we will mainly focus on both of the accounting based performance and market-based performance measurement.

3. Conceptual Framework

The following diagrammatic framework is developed.

![Figure 1: Proposed Conceptual Framework](image)

4. Research Methods

To examine the CG disclosure and firm performance or firm performance, content analysis method will be used. Bryman and Bell (2003) define content analysis as a method that involved a process of analysing documents and texts to quantify the content in terms of predetermined categories in a systematic and replicable manner. This method is deemed to be appropriate since most of the previous studies on disclosures by IFIs have adopted this method (Harahap, 2003; Maal, Casson & Napier, 2006; Haniffa & Hudaib, 2007). The population of this study consists of Islamic bank located in the SEA regions, i.e. Malaysia, Indonesia, Brunei, Thailand, and the GCC region, i.e. Bahrain, Saudi Arabian, Kuwait, Oman, Qatar, and the United Arab Emirates. The selection of Islamic bank in the SEA and the GCC regions because the regions are among the progressive in Islamic finance. These regions are also among the first to establish Islamic financial institutions (IFIs). The empirical procedures involve a cross-sectional analysis study being applied to the disclosure data from the annual reports of Islamic bank in the SEA and the GCC region for the year 2012 to 2016.

5. Conclusions

This research examines the effect of the CG disclosure to the firm performance of the Islamic bank, either direct or indirect through financial performance. The CG disclosure is measured by information disclosure index based on a study by Wan Abdullah (2013). The firm performance is quantified from ROA, ROE and Tobin’s Q based on measurement of accounting and marked based performance. Risk-taking as a mediating variable is used to strengthen the result between CG and firm performance. Based on the reviewed past literature, we can conclude that a better CG disclosure will lead to a better firm...
performance or firm performance of the Islamic bank. Besides that, the CG disclosure has a direct effect on the firm performance in the Islamic bank. The implementation of good CG will increase the efficiency and urge the economic growth. The presence of effective CG will help in increasing the trust level needed for the well-functioning financial sector, particularly in the capital market especially in the Islamic banking sectors.

The proposed study makes an original contribution to the literature since it is a limited comprehensive investigation into the combination of CG in affecting the firm performance or firm performance of the Islamic bank. Past literature only focuses specific CG like board size, board independence, CEO duality and otherwise. These studies have been using CG index based on the index developed by the Wan Abdullah (2013), whereas this CG index is more comprehensive for the disclosure on the Islamic bank. Past researchers have shown that CG is an important factor affecting the performance or value of a firm in a specific industry. This studies, which explicitly considers the differences in the social, economic and institutional variations because it is focused on Islamic banking in the SEA and GCC region.

This study has significant practical importance because its econometric results support the application of appropriate regulatory, financial and CG policies. Finance is important for economic development, and sound financial management through good CG can make a substantial contribution to economic development in these markets. The performance of a firm will be improved by using these relevant recommendations for the developing market, which previously was lacking in the existing literature.

7. References


