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TESIS DOCTORAL

**CORPORATE GOVERNANCE MECHANISMS AND
PERFORMANCE IN THE ISLAMIC BANKING INDUSTRY**

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DEDICATION

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INTRODUCTION

The aim of this research project is to provide insights into the characteristics of Islamic Banks' Corporate Governance (CG) mechanisms and their relationship, if any, with firm performance.

There are several motivations for this research:

In first place, Islamic financial institutions have experienced exponential growth in recent decades. In particular, Islamic banks have expanded into several European countries, such as the UK and Luxembourg but most notably, they have registered a sharp increase in two specific areas, namely the Gulf Cooperation Council (GCC) and South Asian (SA) countries, where now they constitute an important block of the banking sector (International Organization for Securities Commissions, 2004; Islamic Financial Services Industry Stability Report, 2014). The development and growth of Islamic banks have raised a number of research challenges, which, among other issues, include identifying the main determinants of this expansion.

Second, there has been a shift from exclusively financial interests towards more inclusive, diverse, environmental and social values. Good examples of this change are the new trends on non-financial reporting and the so called "Integrated reporting" comprising not only the Annual Accounts but also information about diversity, environmental and governance practices. In this vein, Islamic banks represent an interesting area to investigate due to their religious and social connections. The *Maqasid Shariah* stipulates that financial institutions are

expected to contribute to the fair distribution of wealth and promote social well-being (Laldin and Furqani, 2013), mainly through three elements: educating individuals, establishing social justice and attracting public interest (Amin et al., 2014).

Third, there is a need to explore the causes of the global economic crisis that struck around 2008. The impact of the economic crisis was felt in many countries, often reaching systemic proportions and the sub-prime crisis triggered a lack of trust in the mortgages-based financial instruments in the USA (Rosman et al. 2014). Thus, there is a vital need to investigate healthier financial systems and alternative financial instruments. The Islamic financial institutions, despite experiencing a severe drop in profitability from 2008-2010 (Grassa and Matoussi, 2014), did not suffer the same degree of financial turmoil as their conventional counterparts. Islamic banks, with their Shariah-derived principles, provide an interesting arena of research for several reasons:

The range of typical financial products differs from that of their conventional counterparts. The avoidance of volatile investments and speculation imposed by Shariah law, fostered the resilience exhibited by Islamic banks during the financial crisis (Beck et al., 2013; Hasan and Dridi, 2010; Rosman et al., 2014; Al-Khoury and Arouri, 2016). Nevertheless, their real assets-based transactions mean that Islamic financial institutions are vulnerable to real economic downturns (Beck et al., 2013; Alqahtani et al., 2016; Olson and Zoubi, 2017).

Their institutional self-sufficiency, which stops the crisis from spreading to other financial entities (Hassan and Aliyu, 2018).

Academia has also identified some weaknesses of the Islamic banks. Chong and Liu (2009) suggest that Islamic banking in Malaysia is not very different from conventional banking, and the alleged benefits of Islamic banking exist in theory only. They also point out that the key reason for the rapid growth in Islamic banking worldwide during recent decades is unlikely to be associated with the attributes of Islamic banking; rather, it is most likely spurred by the worldwide Islamic resurgence since the late 1960s, which leads to a heightened demand by Muslims for financial products and services that conform to their religion.

In fourth place, the implementation of Governance Codes among many countries at the start of this century (Aguilera and Cuervo-Cazurra, 2009) fostered a very prolific stream of research.

While the literature on this topic dates back to the early 1990s, most of the related empirical research ignores banks (Adams and Mehran, 2012). However, CG of banks has become an important area that calls for further attention at a global level. Due to their systemic nature, banking downturns affect not only a huge number of stakeholders, but also the stability of other banks through, among other factors, the inter-bank market. As De Haan and Vlahu (2015) assert, financial institutions are highly interconnected due to globalization, technological developments and financial liberalization policies, which inevitably exposes the banking sector to greater risk. In this regard, the Basel Committee on Banking Supervision (2006)¹ points out:

¹ The Basel Committee on Banking Supervision (BCBS Enhancing corporate governance for banking organisations, 2006, p.4).

“effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole”.

Despite this warning, the crisis that hit financial institutions around 2008 reached systemic levels. Some scholars pointed out that one of the reasons this crisis was so long and hard-hitting was the poor CG in the banking system (Berger et al., 2014; Peni and Vähämaa, 2012; Erkens et al., 2012; Adams and Mehran, 2012; Ling et al., 2013; Grove et al., 2011) and that banks' CG was ineffective at preventing detrimental lending practices (Grove et al.2011). In the aftermath of this financial crisis, regulatory bodies and standard-setters issued certain measures such as the implementation of independent compensation committees and stronger governance policies (Section 952 of the Dodd–Frank Act of 2010; the 2010 UK Governance Code; Good Governance Code of Listed Companies in Spain, 2015). Against this backdrop, Islamic banks exhibited greater resilience and stability than their conventional counterparts. However, there is scarce literature addressing the governance of Islamic financial institutions.

And last but not least, Islamic banks are unique in that they implement a compulsory multi-level governance system where religious elements play a major role. Although CG issues related to non-financial companies based in developed countries have been the focus of much attention from academia and regulatory bodies, there has been scarce research on the Islamic banking industry. However, the link between traditional CG mechanisms and performance might differ due to the regulatory environment and unique nature of the banking business (Mülbert, 2009) and, therefore, further investigation would be helpful.

This research aims to fill this gap by exploring the impact of several CG mechanisms on Islamic banks' performance. Specifically, we test:

The impact of the Shariah board characteristics. The Islamic financial industry presents a unique multi-layer CG structure that includes not only traditional governance but also the Shariah board, whose main role is to ensure that the financial services delivered by the bank comply with Shariah Law. Although this distinctive governance body of Islamic financial institutions has been proven to reduce information asymmetry, moral hazard, agency problems and the severe effect of excessive risk-taking (Hamza and Saadaoui, 2013), little is known about the impact, if any, of the Shariah board characteristics on Islamic banks' performance.

Additionally, we also explore the moderating effect of the ownership structure on Islamic banks' performance. Previous studies have argued that the relationship between ownership concentration and firm performance is complex and empirical studies have reported mixed results (Demsetz, 1983; Demsetz and Lehn, 1985; Shleifer and Vishny, 1986; Iannotta et al., 2007; Haw et al., 2010; Busta et al., 2014). In the banking field, some studies have investigated whether state banks contribute positively to financial development and economic growth although decisive conclusions have been elusive. However, the recent global financial crisis has prompted a need for further investigation about the influence of ownership characteristics and bank performance. This study aims to shed some light on this relevant issue in the Islamic banking industry.

To achieve our main research goals, the thesis is structured in six different parts: Chapter 1 explains the concept of Islamic finance and the main similarities to and differences from conventional finance. Chapter 2 discusses the concept of CG and reviews its main characteristics in conventional banking. Then, we explain the specific features of CG in Islamic financial institutions to provide a better understanding of the role of the Shariah supervisory board as an essential body for ensuring good governance in these institutions. Chapter 3 presents an extensive review of the relevant literature related to the subject of study, highlighting the main theories and findings about the composition of the boards of directors, the ownership structure and their impact on the performance of Islamic and conventional banks. The research hypotheses are also set out in this chapter. Chapter 4 details the methodology used in order to test the research questions. It also describes the sample selection process and analyses its composition. Chapter 5 is devoted to presenting the results of the empirical analysis. Finally, Chapter 6 is dedicated to the conclusions reached, the limitations inherent to the research work and potential future research issues.

CHAPTER 1

ISLAMIC FINANCE

1.1. Introduction

Research on Islamic financial institutions often brings up questions such as What is Islamic finance? How does it differ from conventional finance? What services are provided by Islamic financial institutions? or How important Islamic finance is in the global financial context?

In this chapter, we aim to answer those questions and thus facilitate an understanding of the range of typical financial activities provided by Islamic financial institutions, how they are regulated and why. To that end, we first explain the concept of Islamic finance. We then present a brief history of the emergence of Islamic banks around the world, followed by an overview of the activities of the Islamic banks. We end this chapter by illustrating the current state of Islamic finance.

1.2. The concept of Islamic finance

As the name suggests, religion plays a key role in the concept and development of Islamic finance. Islamic finance emerges from the attempt to comply with the principles of Islamic faith and it is aimed at providing a variety of religiously acceptable financial services to Muslim communities.

Islamic finance refers to the provision of financial services in accordance with Islamic Shariah Law (International Monetary Fund, 2017). Shariah involves a series of prohibitions as well as prescriptions regarding the practice of finance (Gheeraert, 2014). The financial services also need to be in compliance with the Muslim holy book (*Quran*) and the Prophet Mohamed's actions (*Sunnah*), which provide general guidelines for different concepts in life and therefore cover economic activities. Additionally, financial products must comply with the jurisprudence or opinions of qualified Muslim scholars (*Fatwas*).

Among other issues, Shariah does not allow either the receiving or paying of interest (*riba*), excessive uncertainty (*gharar*), gambling (*maysir*) or illegitimate transactions considered to be detrimental to society, such as those involving alcohol or tobacco (International Monetary Fund, 2017). Therefore, speculation and short-sale practices are not allowed (Hussain et al., 2016).

Additionally, in order to comply with the principles of fairness and justice, the Muslim community promotes business transactions that yield rewards and profits for both parties (the bank and the customer). Hence, Islamic banks are based on the principle of profit-and-loss sharing, where both the shareholders and depositors should share the risks of financing business ventures (Johnes et al., 2014; Di Mauro et al., 2013).

Moreover, exploitation is unacceptable under Islamic Law; thus, Muslims reject the interest-based commercial banking system, where all the pressure is on the borrower to pay back the loan with the agreed interest, regardless of the success or failure of his project (Beck et al., 2013). They also consider that making profits

by demanding customer repayments over a long period is unacceptable exploitation (Zaher and Hassan, 2001; Di Mauro et al.2013).

Nowadays, these principles constitute the basis of the contemporary Islamic banking range of Islamic financial products and services (Di Mauro et al.2013; Khan, 2010). Therefore, the range of financial operations available is different from those delivered by conventional banks. Islamic financial transactions are mostly asset-based rather than debt-based (Hassan and Aliyu, 2018). Overall, Islamic banks are expected to have long-term sustenance and prosperity that will improve social well-being and the environment (Aliyu et al., 2017).

Below, we briefly describe how Islamic finance and, in particular, the Islamic banking industry was established in the two most important geographical regions in the Islamic world, that is, the Middle East and South Asia.

1.3. The emergence of Islamic banks

According to Wilson (2002), the first Islamic financial institution was established by Dr. Ahmed Alnjar in Mit Ghamr in Egypt around 1963. It was a local savings bank that provided basic interest-free services to its customers. Since then, the growth and spread of Islamic financial institutions around the world has been indisputable.

Below, we attempt to illustrate the emergence of the Shariah-compliant financial industry around the world. To that end, we have grouped the countries hosting Islamic banks by geographical region: the Middle East, South Asia and Europe.

1.3.1. The emergence of Islamic banks in Middle Eastern countries

In early 1970, oil was discovered in the Middle East, which helped Islamic banks to spread into different countries. Hence, in the late 1970s, the first—and what would turn out to be the most important—Islamic banks were established.

The 1980s witnessed the opening of more Islamic banks, in Sudan, Iran and Pakistan (Khan, 2010; Maali et al., 2006).

The first Islamic bank in Bahrain, named Bahrain Islamic Bank, was established in 1978 and the country is nowadays considered the home of Islamic banking practice, regulations, research, innovation and scholarship. Currently, it hosts the largest number of Islamic financial institutions and other supporting bodies in the world. The Islamic banking assets in Bahrain represent 93% of total Islamic banking assets (Islamic Financial Services Industry Stability Report 2016) and its 33 Islamic financial institutions raised a total capital of USD 2.24 billion in 2006 (Khan and Bhatti, 2008).

In Egypt, *Faisal Bank* was launched in 1979 and it now constitutes one of the country's biggest financial institutions.

The National Commercial Bank, also known as AlAhli Bank, is the leading bank in the Kingdom of Saudi Arabia, the largest bank by assets in the Arab world and one of the world pioneers in Islamic banking and finance. It was formed in 1953 by Royal Decree as a general partnership (Lone and Alshehri, 2015). Later, the Islamic Development Bank was launched in 1975. Nowadays, many banks in Saudi Arabia are restructuring their operations along Islamic lines. Bank Al Jazira

has recently completed its gradual conversion into a fully Islamic entity (Khan and Bhatti, 2008). Al Rajhi is the third-largest Saudi bank, and the world's largest Islamic financial institution with total assets of USD 33.3 billion recorded at the end of 2007 (Tabash and Dhanakar, 2014).

Dubai Islamic Bank, established in 1975, is the first Shariah-compliant Islamic bank in the United Arab Emirates (UAE). At present, it has a network of 30 branches across the country (Khan and Bhatti, 2008). There are three other fully dedicated Islamic banks in the UAE, namely, Sharjah Islamic Bank, Emirates Islamic Bank and Abu Dhabi Islamic Bank. Sharjah Islamic Bank started serving the general public in 1975 and converted to Islamic banking in 2002.

In Qatar, the Qatar Islamic Bank was founded in 1982. It was established with a paid-up capital of QAR 25 million. In 1989, the Qatar Islamic Bank introduced its 30%-owned subsidiary, Al Jazeera Finance, thus introducing Qatar's first Islamic non-bank financial institution. Qatar's second Islamic bank, Qatar International Islamic Bank, was established in a period of economic slowdown and extensive budget revision by the Qatari government following the fall in oil prices in 1986, and it was the only bank established until 1993 (Qatar Islamic Finance Report, 2017).

Kuwait hosts the largest number of Islamic financial institutions. It has been ranked third in terms of global Islamic banking assets, holding 10.1% of the total in 2016 (World Islamic Banking Competitiveness Report 2016). Its first Islamic bank, Kuwait Finance House, was established in 1977, and it is one of the largest institutions providing Islamic banking services worldwide. In the first decade of

the new millennium, two Islamic banks were opened: Boubyan Bank, opened in 2004 under Islamic Banking Law No. 33 of 2003; and Bank Warba, established in 2009. The National Bank of Kuwait and some other conventional banks also offer a wide range of Islamic financial products and services (Khan and Bhatti, 2008).

Jordan Islamic Bank was established in 1978, as a public shareholding limited company, to carry out all kinds of banking, financing and investment business operations in compliance with the Islamic Shariah. In 1997, another Islamic bank, Islamic International Arab Bank, was launched. In 2010, Safwa Islamic Bank began operations, in accordance with Islamic Shariah principles and the instructions of the Central Bank of Jordan and the Banking Law of Jordan (Safwa Islamic Bank, website).

In Sudan, Faisal Islamic Bank was officially registered in 1977. It is worth noting that in 1989, the government decided to change the whole banking system to an Islamic Banking system, in line with the Islamic orientation of the entire country. The first step was changing the regulation of the Central Bank of Sudan to become Islamic. The decision took effect in 1991 when the Bank of Sudan issued the Banking Business Act, which stated that all banking finance transactions for all banks in Sudan must be managed according to Shariah (Zaher and Hassan, 2001).

In sum, within the Middle East region, two periods seem to be milestones in the Islamic finance industry. The first was the late 70s when the first Islamic banks were founded in Saudi Arabia, Bahrain, Kuwait, the UAE, Egypt and

Jordan. The second was the spread of Islamic banks in the late 20th and early 21st centuries.

1.3.2. The emergence of Islamic banks in South Asian countries

The Islamic banking industry is spreading throughout South Asia (SA) and has become a vital part of their financial markets. Indonesia, Malaysia and Singapore aim to use Islamic banking and finance as a powerful tool to attract business and investments from the Middle East and Muslim world (Khan and Bhatti, 2008).

In Malaysia, the presence of Islamic banking and financial services responds to the growing Muslim population in this country. The first Islamic organization was founded in 1963, when the Malaysian government launched the institution called Lembaga Urusan Tabung Haji, whose main mission was to provide financial support to poor people wishing to make the pilgrimage to Mecca.

Later, Bank Negara Malaysia (Central Bank of Malaysia) implemented the Islamic Banking Act of 1983. The case of the Public Islamic Bank in Malaysia is noteworthy in that it was initially launched as a conventional bank, it opened a window for Islamic products in 1993, and became a fully Islamic bank in 2008. Its total capital rose from 30 million Ringgit (RM) in 1993 to 2.6 billion RM in 2013 (Venardos, 2005).

Nowadays more than 10 Islamic banks operate in Malaysia, as reported by its central bank (Bank Negara Malaysia, Financial Stability and Payment Systems

Report 2015), and it has one of the most developed Islamic financial systems in the world (How et al., 2005).

Although Indonesia has the largest Islamic population in South Asia, with around 205 million Muslims, its Islamic banking system is not as well developed as Malaysia's (Khan and Bhatti, 2008). The history of Islamic banking in Indonesia dates back to 1990, when the Indonesian Jurist Council conference addressed Indonesian Muslims' demand for an interest-free banking system provided by the banks operating in Indonesia. Two years later, the Central Bank of Indonesia issued new regulation (Banking Act No. 7/1992) allowing Islamic banks to open in the country. Three months later, Bank Muamalat Indonesia was opened, supported by the Association of Indonesian Muslim Intellectuals and a number of Muslim entrepreneurs. The share value of this bank rose exponentially between 1992 and 2014, with total assets growing from 12 million Indonesian rupiah in 2008 to 62 million in 2014 (Bank Muamalat Annual Report 2008, 2014).

Since June 1990, commercial banks in Singapore have been able to deliver Islamic banking services. In 1998, some conventional banks opened Islamic windows (Gerrard and Cunningham, 1997). The Monetary Authority of Singapore joined the Islamic Financial Services Board (IFSB) in Malaysia in 2005 and there are now six Islamic banks operating in Singapore, with OCBC Bank being the biggest.

In recent years, Singapore has collaborated with Malaysia and Indonesia to become the international centre for Islamic financial services in view of the

industry's success in Southeast Asia (Venardos, 2005; Gerrard and Cunningham, 1997).

In Brunei, the first Islamic bank, called Tabung Amanah Islam Brunei, was established in 1991 by Sultan Haji Hassanal Bolkiah. In 2005, this bank merged with the Islamic Development Bank of Brunei to become the country's largest bank and one of its flagship Islamic financial institutions.

Since there is no central bank in Brunei, the banks are regulated under the Banking Act by the Ministry of Finance, through the Brunei Currency Board, the institution that monitors banks and financial companies (Ebrahim and Joo, 2001).

In sum, there are four countries that have a well-developed Islamic financial industry, namely, Malaysia, Indonesia, Singapore and Brunei, with Malaysia's being the biggest in terms of financial assets.

1.3.3. The emergence of Islamic Banks in Europe

Islamic finance has established a link between Arab banks and European banks in Europe (Wilson, 2007). In the early 80s, the British government allowed some Islamic investments in London, with the first being Islamic Banking International Holding. It was not until 2004 that we witnessed the first Islamic bank in Europe, Islamic Bank of Britain. It was founded in the UK, with an authorised share capital of £5 million. By 2014, this capital had risen to £121,218,700 (Islamic Bank of Britain Annual Report 2004, 2014).

Later, the British government granted a licence to open Islamic windows in conventional banks such as HSBC Amanah, ABC International bank, Deutsch Bank and Citi Bank. Nowadays, there are 22 Islamic banks operating in the UK.

However, this is not the only European country where Islamic financial assets have grown in recent years. In Italy, the deposits from Muslims in Islamic retail banking reached USD 5.8 billion and generated USD 218.8 million by 2015, and this figure is expected to rise to USD 33.4 billion by 2050 (Di Mauro et al., 2013).

We also find Islamic banks in other European countries: 3 in France, 4 in Switzerland, 2 in Germany, 1 in Luxembourg and 1 in Ireland. In 2013, the *Research Centre of Studies in Economics and Islamic Finance* was opened in Spain, with the main goal of opening communication between researchers, investors and various institutions interested in Islamic finance (Di Mauro et al., 2013).

1.4. Islamic financial activities

There are five principles in Islamic finance that mark the point where it diverges from conventional finance (Chong and Liu, 2009; Azmat et al. 2015; Olson and Zoubi, 2017):

- the prohibition of interest (*usury*) in all transactions;
- the prohibition of *ghara* (excessive uncertainty) under which the details of the sale contract cannot be unknown or uncertain;

- the prohibition on financing illicit industries
- the principle of profit-and-loss sharing;
- all transactions have to be backed by a real economic transaction that involves a tangible asset;

The implementation of these Islamic principles has shaped the economic transactions allowed under the Islamic perspective. Islamic financial services providers make use of contracts acceptable under traditional Islamic legal doctrine and adapt conventional financial contracts so that they are in compliance with the tenets of Shariah (Di Mauro et al., 2013). However, this procedure sometimes becomes complex and the institutions need the assistance of Shariah scholars (Solé, 2007).

Following, we explain the main financial activities that the Islamic financial industry is currently delivering, namely, insurance services, mutual and collective investment funds and banking activities:

- *Takaful* is the Arabic name for insurance based on Shariah rules; it literally means solidarity. An Islamic insurance policy is a collective protection scheme and it is an important part of the Islamic financial system (El-Hawary et al., 2007). The participants in the *Takaful* pay a sum of money (*tabarru'* in Arabic) to a mutual cooperative fund, which will be used for compensation should this be necessary. The Islamic insurance industry has expanded in recent years from USD 18.3 billion in 2013 to USD 23.2 billion in 2015 (Islamic Financial Services Industry Stability Report, 2013; 2015).

- The Shariah guidelines and principles govern several aspects of an Islamic mutual fund, including its asset allocation (portfolio screening), investment and trading practices, and income distribution (Di Mauro et al., 2013; Maysami and Williams, 2006). Thus, the fund cannot be invested in conventional bonds, warrants, preferred stock, certificates of deposit and certain derivatives (Hoepner et al., 2011).
- In the same vein, collective investment funds are managed under the principles of Shariah law. For instance, a *sukuk* can be considered an Islamic version of a conventional bond but the debt cannot be repaid at a specified interest rate given the prohibition on interest (Azmat et al.2017). While conventional bond issuers pay interest to investors at regular intervals, sukuk issuers avoid this type of interest since they are based on sharing profits and losses between the parties in a business transaction (Reboredo and Naifar, 2017). Rather, they are similar to a trust certificate with proportional or undivided interest in an asset or a pool of assets (Naifar et al., 2016).

1.4.1. Islamic Bank activities

The main differences between Islamic and conventional banks are rooted in the five principles and prohibitions of Shariah law, although some academics argue that Islamic and conventional banks are similar in the substance and different in the format (Beck et al., 2013).

The majority of Islamic banks perform two basic functions, namely, investment management and commercial banking (Karim, 2001), through the following banking contracts.

1.4.2. Islamic bank contracts

Under the principle of profit-and-loss sharing, the typical Islamic banking contracts are partnership loans between bank and borrowers, namely *Mudarabah* contracts (profit-sharing) and *Musharakah* contracts (joint venture). The common feature of these contracts is that the bank shares the risk with the depositor.

Under **Mudarabah** contracts, the bank provides the entire capital needed for financing a project, while the customer offers his labour and expertise. The profits from the project are shared between the two (bank and customer), at a predetermined ratio; however, in the case of loss, it is exclusively borne by the bank (Beck et al., 2013; Khediri et al., 2015; Archer and Karim, 2012). The entrepreneur (*Mudarib*) has the ultimate control over the business, while the investment decisions, including the participation of other investors, should be approved by the bank (El-Hawary et al. 2004).

Under **Musharakah** contracts (similar to a joint venture), the bank is not the sole provider of funds but rather more partners will contribute to financing the project. Profits and losses are shared between both parties (bank and partners) in proportion to the capital contributed. This contract is usually the instrument used to finance long-term investment projects (Hasan and Dridi, 2010). There are two types of Musharakah contract: the first is the *Permanent Musharakah*, according to which the bank's share in the capital is constant as long as the Musharakah

continues; the second is called *Diminishing Musharakah*, where the bank's share decreases gradually as a result of a gradual sale of its shares to the customer against the payment of instalments. Hence, the ownership of the project will be transmitted to the person or the company involved in this contract (Doumpos et al., 2017). The bank makes a profit by selling the share at a price higher than its original value.

Through the *Murabaha* contract (mark-up) the bank purchases a single good, or a consignment of products, on behalf of a customer, who repays the cost plus a mark-up. Repayments, including the mark-up, are usually made according to a pre-arranged schedule from the bank (Vinnicombe, 2010).

The main features of this contract are: (a) the cost and the mark-up must both be known to the bank and the client; (b) the bank must assume the ownership of the goods prior to reselling them to the client (bearing all the ownership risks in the interim); (c) the client's promise to buy the goods purchased on his order by the bank may or may not be binding (in most jurisdictions it is binding); (d) no interest is imposed for late payments but the bank could require a collateral International Monetary Fund (2017, p.36).

Istisna consists of a manufacturing contract which allows one party to obtain industrial goods with either an upfront cash payment and deferred delivery or deferred payment and delivery. The bank acts as intermediary; firstly, the bank agrees to receive payments from the client on a longer-term schedule and, secondly, the bank (as buyer) agrees to pay all expenses related to this commodity sold to the customer for a sum that includes a profit margin (Hussain et al., 2016).

The *Ijarah* contract is the Islamic version of renting and leasing contracts. While in both cases the client pays a certain fixed rent, only in the latter is the ownership transferred at the end of the specified period (Zaher and Hassan, 2001).

However, according to International Monetary Fund (2017, p.11), the financing items, that is sales and lease-based contracts (Murabaha and Ijarah, respectively) account for about 70% of total assets. The profit-and-loss sharing contracts only account for 5% of Islamic banks' aggregate assets and mostly comprise Musharakah contracts. However, there are some countries (e.g., Indonesia, Iran, Pakistan, and Sudan) with a higher level of profit-and-loss sharing contracts (PLS). In Iran and Indonesia, Musharakah contracts account for 29% and 63%, respectively, while the corresponding figures in Pakistan and Sudan are 11% and 13%, respectively. Mudarabah contracts average around 5% of assets in Indonesia, Iran, and Sudan.

1.5. Differences and similarities between Islamic and conventional bank operations

To illustrate the influence of Shariah Law in the provision of banking services, we describe below the most common banking transactions in Islamic finance and the main differences with their conventional counterparts.

Since it is not the ultimate goal of this thesis to compare Islamic and conventional banks, we do not attempt to present an exhaustive description of the differences between all the activities carried out by the two types of institutions. Rather, we aim to provide some insights in order to facilitate an understanding of the financial products offered by the Islamic banking industry.

1.5.1. Deposits

The most common financial resources for Islamic banks are current accounts, investment accounts and issuing shares of common equity.

The investment accounts are in most cases based on profit-sharing and loss-bearing (Mudarabah contract). The bank (*Mudarib*) manages the funds on behalf of their holders (Archer and Karim, 2012) and the profits and losses are shared between the bank and the investment account holders. Conceptually, this means that the investment account holders' risk is similar to that of the shareholders of the Islamic institution who bear the risk of losing their capital as investors. Hence, the Islamic bank, as *mudarib*, owes a fiduciary duty to the investment account holders under the Mudarabah contract, which is parallel with their duty to their shareholders. In consequence, they must provide investment account holders access to all relevant information in relation to their investment accounts.

Typically, the bank offers several options, such as investing the money in a *Restricted Investment Account*, under the terms of which the depositors stipulate the period and the purpose of the investment (type of asset and economic sector). With the Mudarabah contract, the Islamic bank invests the funds of Restricted Investment Account holders in an asset pool that is separate from the bank's own funds. The Restricted Investment Account holders do not have the right to interfere in the management of the funds; another agent is appointed by shareholders to manage and monitor their funds (Graiss and Pellegrini, 2006).

The second option is to invest in an *Unrestricted Investment Account*, where the depositors do not have the right to specify the purpose of the investment. The

customers authorize the bank to invest the funds under the Mudarabah contract in a manner in which the bank deems appropriate, without any restrictions as to where, how and for what purpose the funds should be invested. Under this arrangement, the bank can commingle the investment account holder's funds with its own funds and with other funds with prior permission from the investors. The bank has the right to manage their funds like an agent and share the returns with them according to a predetermined ratio. However, with Unrestricted Investment Accounts, any losses incurred are borne by the holders, except in the case of mismanagement or manipulation on the part of the bank. The account holders have the option to withdraw their funds whenever they want, as long as they give notice to the bank before the withdrawal date (Kuwait Finance House Bank Annual Report, 2013, and Bank Negara Malaysia, 2014).

The third option is for customers to keep their deposits in a *Current Account*, from which they can withdraw their deposits whenever they want (Iqbal et. al 2002).

In short, both Islamic and conventional banks handle their clients' deposits, but there are some differences between them: Firstly, in conventional banks, the bank allows overdrafts on the current account and it will charge the depositors interest at a fixed rate, while Islamic banks do not offer their depositors overdraft facilities on current accounts. If the depositors face financial difficulties that are beyond their control, such as illness, the bank will offer them an interest-free loan (*quard Hassan*) (Iqbal et. al 2002).

1.5.2. Housing finance

There are also some differences between Islamic and conventional banks when it comes to housing finance (mortgages): The customers that have taken on a mortgage with a conventional bank make monthly interest and repayment instalments, usually by direct debit from their current accounts into which their salaries or incomes are paid. These payments extend over a long period with interest charged at a rate that is either fixed for the duration of the loan or variable at a premium over interbank rates. The bank usually requires the clients to take out mortgage insurance, so that should the borrower dies during the mortgage repayment period, the insurance company will cover the full payment.

In the case of housing finance, the Islamic bank uses the *Diminishing Musharakah* mode, whereby the bank buys the property on behalf of the clients and resells it at an agreed price (Iqbal et. al 2002; Wilson, 2007). The clients have to pay a percentage of the purchase price in cash and continue to pay the remaining amount over a determined period of time. At the end of the contract, the clients possess the property.

1.5.3. Consumer finance

Both Islamic and conventional banks finance clients' purchase of durable goods (cars, furniture, among others). However, while conventional banks offer loans with fixed or variable interest over a short period of time, which the bank will take from their current accounts, Islamic banks buy the consumer durables and resell them to the clients on a hire-purchase (istisna contract); lease (ijarah

contract) basis and mark-up sales (murabaha contract) (Wilson, 2007; Chong and Liu, 2009; Iqbal et. al 2002).

1.5.4. Small business finance

Conventional banks often expand their investments by financing small businesses. The clients borrow the money with fixed or variable interest and they present guarantees to cover this loan (properties or other entities' guarantees). If the client fails to pay, the bank will hold the property the client has presented as a guarantee until the customer pays the full loan.

Islamic banks share the success of the enterprise with the clients (Musharakah or Mudarabah contract). The bank strives to ensure the success of the venture because it will bear part of the losses (Iqbal et. al 2002).

1.5.5. Financing of long-term loans

The conventional bank offers companies or individual investors credit facilities over a long period with variable interest, and it gets guarantees from the customer. In the case of Islamic banks, this type of operation is rarely used, because of the risk and uncertainty related to this type of investment. Instead, the Islamic bank shares the investment with the company or individuals through a Musharakah, Mudarabah or Istisna contract. Frequently, rather than signing a long-term loan, the bank will offer the asset instead of the cash.

1.5.6. Savings accounts

From the Islamic perspective, the savings account is an account in which the client (who owes the money) shares the profits of their investments with the bank (who is responsible for investing the funds by means consistent with Islamic law). The distribution of profits between the bank and the client is made on the basis of the rate of profit declared by the bank every six months. Any losses incurred are borne by the clients.

The savings accounts in Islamic banks are designed specifically to meet the needs and requirements of the customers who authorize the bank to invest their money deposited under a Mudarabah contract (Iqbal et. al 2002).

The difference between savings accounts in Islamic banks and conventional banks is that the clients in Islamic banks have the right to decide whether or not to invest their money and can withdraw the money at any time without receiving any interest. In conventional banks, on the other hand, the clients receive interest on their deposits and they cannot withdraw their deposits at any time; they must give the bank notice before withdrawing (some banks require three months' notice and others six months).

1.5.7. Islamic bonds

The Islamic bond or *Sukuk* differs from the conventional bond in that the debt cannot be repaid at a specified interest rate given the prohibition on interest (Azmat et al., 2017). Sukuk is based on sharing profits and losses between the parties in a business transaction (Reboredo and Naifar, 2017) and is defined

officially by the Auditing and Accounting Organization of Islamic Financial Institutions as “*certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in ownership of the asset of a particular project or special investment activity*” (Shariah standard No.17).

The Auditing and Accounting Organization of Islamic Financial Institutions standard distinguishes sukuk from stocks, bonds and the conventional process of securitization, emphasizing that sukuk are not debt certificates with a financial claim to cash flow and also underlining that they may not be issued on a pool of receivables. Rather, they are similar to a trust certificate with proportional or undivided interest in an asset or a pool of assets (Naifar et al.2016). The Islamic bonds increased from USD 245.3 USD billion in 2013 to USD 290.6 USD billion in 2015 (Islamic Financial Services Industry Stability Report 2013 and 2015).

To sum up, by comparing Islamic and conventional banks, we can conclude that both institutions have the same goal, which is to generate profits through different type of contracts over short or long periods.

Additionally, in conventional banks, the depositors borrow money (typically, short- and long-term loans and overdrafts) from the bank to finance their business at a pre-determined interest rate. If clients default on their repayments, the bank will charge them, without considering whether the depositors’ business is successful. Conversely, the Islamic bank does not offer loans; the only loan that they are allowed to offer is an interest-free loan called *qarad Hassan*, for charitable purposes, such as to help people suffering from an illness or to help students fund their studies.

To summarize the abovementioned activities and illustrate the typical transactions of an Islamic Bank, in Figure 1.1 we present the most common items included on its Balance Sheet:

Figure 1. 1: Islamic Bank Balance Sheet

Assets	Equity and Liabilities
Cash and balance with Central banks Islamic financing and Investing assets <ul style="list-style-type: none"> • Mudarabah contracts • Musharakah contracts • Istisna contracts Investment properties <ul style="list-style-type: none"> • Ijarah • Murabaha contracts Investments in Islamic bonds (Sukuk). Ijarah rental receivables	Liabilities Customer deposits: <ul style="list-style-type: none"> • Current accounts • Unrestricted investment accounts • Restricted investment accounts Placements from financial institutions Sukuk issued Payable Zakat Payable and other liabilities Equity <ul style="list-style-type: none"> • Shares • Reserves • Retained earnings

Islamic banks are investment and retail or consumer banks. They provide services to the general public, such as savings or transactional accounts, as well as housing and consuming finance (Ijarah and Murabaha contracts). However, they also deliver financial services to companies, other banks or governmental institutions through Mudarabah and Musharaka contracts.

The provision of Islamic financial products is offered not only through Islamic financial institutions, but also through the “dual-window concept”, which is an “Islamic window” opened in a conventional bank (Amin et al., 2011).

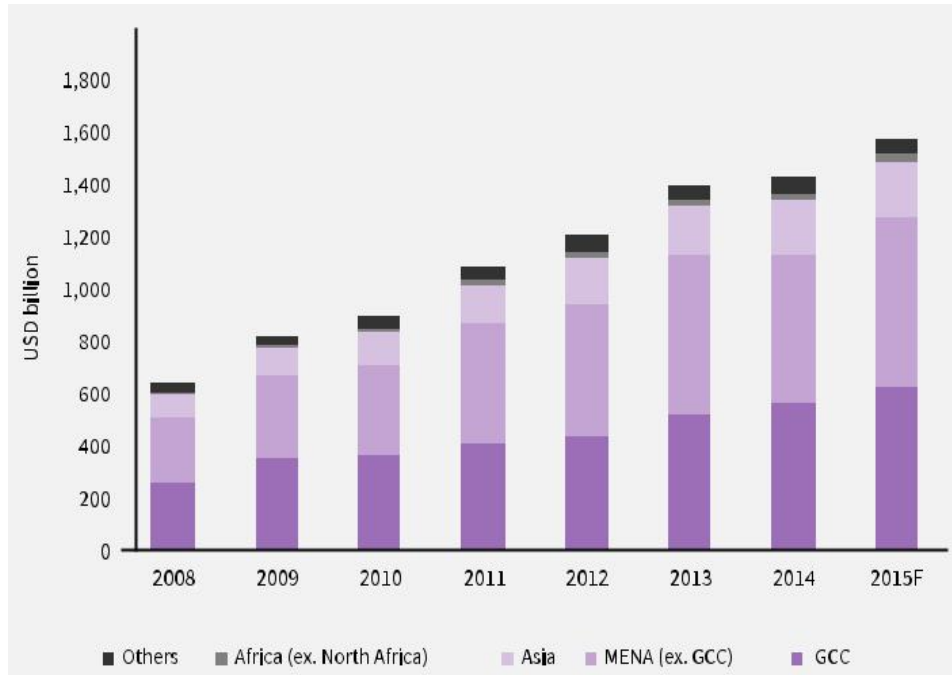
Another distinguishing feature of Islamic banks is the *Zakat*. Originally, it consisted of the private donations made by Muslims to help poor people meet their urgent needs. This *Zakat* was distributed by the Muslim Money House. It has since become an expense deducted from financial operations in Islamic banks. Through a special social committee, the Islamic bank allocates the *Zakat* to the poor and to people who have urgent needs (illness, marriage or tuition fees).

1.6. The current state of the Islamic banking industry

There has been a rapid expansion of Islamic financial institutions in recent decades. Between 2008 and 2014, the total Islamic banking assets of 59 banks in 11 markets expanded at a compound annual growth rate (CAGR) of 15.4%.

Figure 1.2. illustrates the growth in assets in Islamic banks from USD 600 billion in 2008 to approximately USD 1.5 trillion in the first half of 2015 (1H2015).

Figure 1. 2: Islamic Banking Assets Growth Trend (2008–2015)



Source: Islamic Financial Services Industry Stability Report (2016)

However, according to the Islamic Financial Services Industry Stability Report (2016), the growth rate during this period is uneven. It reached 17.1% between 2008 and 2011, falling to 13.8% in the last three years (2011–2014). The growth rate between 2013 and 2014 barely reached double digits, at 10%. There has, however, been something of a revival in 2015: the first six months of the year registered a 7.96% growth in assets.

The slowdown in asset growth is attributable to several factors, with variations across countries, including the exchange rate depreciation in emerging markets, the slowdown in global economic growth performance, prolonged low energy prices and generally weaker investor and consumer confidence in the global economy.

Table 1.3 illustrates the growth rate for the period 2014-2016 in different economic and geographical regions.

Table 1. 1: Islamic Banking Assets by Region (2014 – 2016, USD billion)

Region	2014	2015	2016	Growth rate (2014-16)
Asia	192.30	209.30	218.60	13.68%
GCC	490.30	598.80	650.80	32.74%
MENA	518.30	607.50	540.50	4.28%
Sub-Saharan Africa	20.60	24.00	26.60	29.13%
Others	62.20	56.90	56.90	-8.52%
Total	1,283.70	1,496.50	1,493.40	16.34%

Source: Islamic Financial Services Industry Stability Report (2014, 2015 and 2016)

Regarding the distribution among economic regions (Table 1.3), the Gulf Cooperation Council (GCC) countries exhibit the highest growth rate with 32.74%, followed by the countries of Sub-Saharan Africa (29.13%) and Asian countries. The Middle East and North Africa excluding GCC countries (MENA) are fourth in the ranking with a 4.28% growth rate.

The banking assets distribution by geographical region (Figure 1.4) shows that almost half of the banking assets are owned by the GCC countries, followed by the MENA region. In Asia, the percentage is also high, with 15% of the total assets located in this region.

Figure 1. 3: Islamic Banking Assets distribution by region in 2016

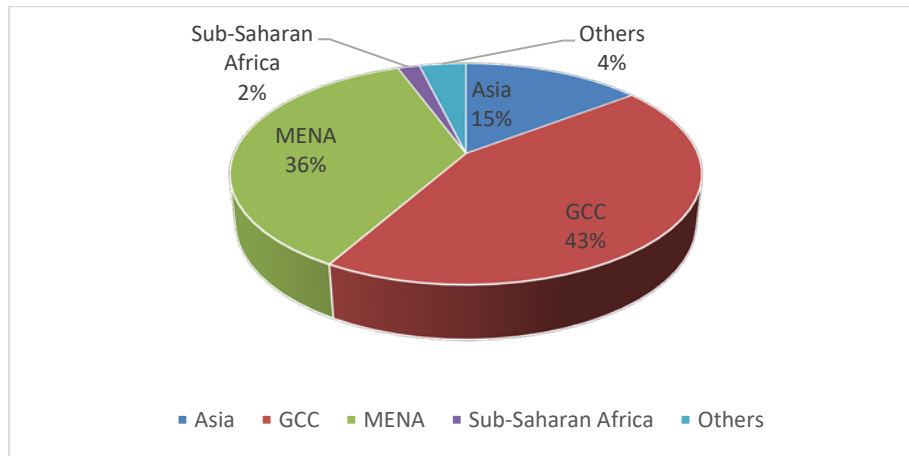
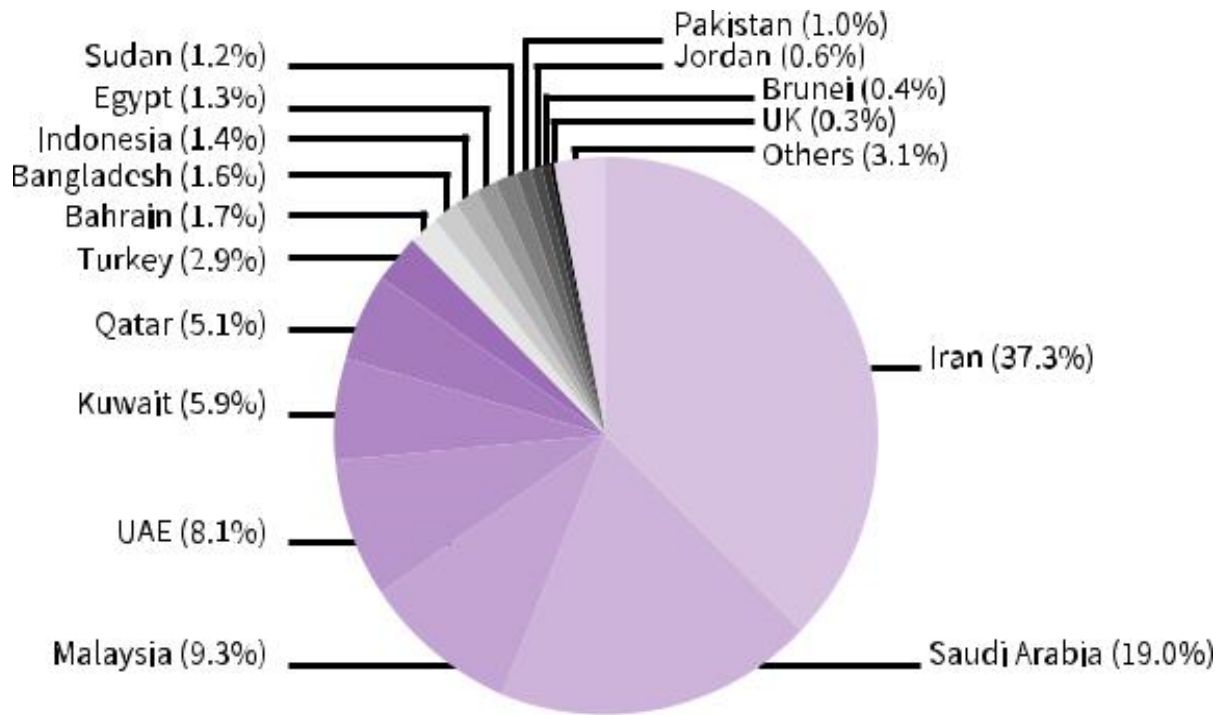


Figure 1.5 displays the assets distribution by country in 2016. Iran represents the largest share of Islamic banking assets, accounting for 37.3% of the global Islamic banking industry. It is followed by Saudi Arabia with almost half of Iran's share (19.0%). Malaysia and the United Arab Emirates (UAE) have similar shares, with 9.3% and 8.1%, respectively. They are followed by Kuwait (5.9%) and Qatar (5.1%), with the remaining countries responsible for less than 3% of total Islamic banking assets.

Figure 1. 4: Distribution of Islamic Banking Assets by countries in 2016



Source: Islamic Financial Services Industry Stability Report (2016)

CHAPTER 2

COPORATE GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS

2.1. Introduction

The purpose of this research is to identify the associations, if any, between CG mechanisms in Islamic banks and their performance. Thus, the main aim of this chapter is to present a brief review of the CG concept, the main CG structures and the monitoring mechanisms in both conventional and Islamic banking firms.

To that end, we discuss the concept of CG and review the main characteristics of CG in conventional banking. Then, we explain the specific features of CG in Islamic financial institutions to provide a better understanding of the role of the Shariah board as an essential body for ensuring good governance in these institutions.

2.2. Corporate governance definitions

The term CG has gained prominence in recent decades, but even though a substantial volume of literature has become available on the subject (Claessens and Yurtoglu, 2013), its ramifications have yet to be fully spelled out.

The most widely-used definition of CG is "*the system by which companies are directed and controlled*" (Cadbury Committee, 1992). This definition implicitly relates to the existence of conflicts of interest between insiders and company management on the one hand, and outsiders, on the other. Such conflicts arise from the separation of ownership and control.

John and Senbet (1998) provide a more comprehensive definition of CG when they explain that it is the system under which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected. They include all stakeholders, not just shareholders, even non-financial stakeholders, such as employees, suppliers, customers and other interested parties.

In the same vein, the definition given by the Organisation for Economic Co-operation and Development (OECD) (2004) embraces all parties when it states that CG is the "*set of relationships between a company's management, its board, its shareholders and other stakeholders*". This definition could be considered as "value neutral" because it does not indicate the objective of CG, which is to be value oriented.

Bhatti et al. (2010) recall the definition given by former World Bank President James Wolfensohn, which emphasized the ethical aspect of CG by indicating that the ultimate goal of such structures is to ensure "fairness" to all stakeholders, through greater transparency and accountability. In the case of shareholders, fairness may also be taken to imply a "fair" growth in the value of their equity.

This value-oriented definition of CG is crucial for the understanding of the Shariah governance system required in Islamic financial institutions, which we present below.

2.3. The role of Islamic religion in the governance of Islamic Financial Institutions

The Islamic economy emerges in response to the social commitments and ethical norms established under Shariah law, which originates from the Muslim holy book (*Quran*) and the actions of the prophet Mohammed (*Sunnah*). In this vein, the main reason for the development and spread of Islamic financial institutions around the world is to make it easier for the Muslim population to comply with the *Quran* and the *Sunnah*. The Shariah, as a code of conduct, encourages people to be honest and fair in their business activities (Abu-Tapanjeh, 2009; Syed and Metcalfe, 2015).

The main aim of Islamic banks is not only to seek profits for shareholders, but also to perform a wealth redistribution role and adhere to the principle of social justice that contributes to the improvement and well-being of society. They thus strive to achieve a balance between providing sufficient returns to their shareholders and depositors on the one hand, and their commitments to their social responsibilities and various stakeholders, on the other (Haniffa and Hudaib, 2007; Khan, 2010).

Thus, an important factor generating major differences between CG in conventional and Islamic banks is that while the objective of the former is to

maximize shareholder profits, the main goal of the latter is to safeguard the welfare of every level of society at the same time as maximizing benefits (Abdullah et al.2015).

Abdullah et al. (2015) conclude that the governance model in the Islamic financial system is designed to protect the rights of all parties.

To achieve this goal, the CG mechanisms in Islamic financial institutions monitor the executive managers to ensure that:

They provide only the ex-ante approved products and services conforming to Islamic law;

They help their employees to adhere to moral principles rather than personal interests and greed.

They promote collective actions from all stakeholders to improve the bank's reputation and to benefit all parties

In addition, the Holy Quran calls for consultation between Muslims to identify their needs and problems and to find solutions:

“Those who hearken to their Lord, and establish regular Prayer; who (conduct) their affairs by mutual Consultation” (Holy Quran, Surah, Alshura: verse 38).

Hence, under the *Shura* (consulting) principle, which emphasizes the role of the individual in society, all stakeholders in the bank are given full rights and responsibility to participate and convey their ideas about how to ensure better CG.

To achieve those objectives, Islamic banks are subject to a multi-level governance system, with religious elements playing a notable role in the governance structure. Below, we present the main characteristics of the Shariah governance system that is required in every Islamic financial institution.

2.4. Shariah Governance System

All Islamic financial institutions must implement a Shariah governance system, and the particular structure of this system is a distinguishing feature of Islamic business organizations (Quttainah 2013).

The IFSB has defined the Shariah governance system in the following terms:

“Shariah Governance System refers to the set of institutional and organizational arrangements through which an Institution offering Islamic financial services ensures that there is effective independent oversight of Shariah compliance”²

² IFSB-10 (December 2009) Guiding Principles on Shariah Governance Systems for Institutions offering Islamic Financial Services.

CG in Islamic institutions is unique (Safieddine, 2009), in that they are guided by a particular control body, namely, the Shariah Supervisory Board (SSB).

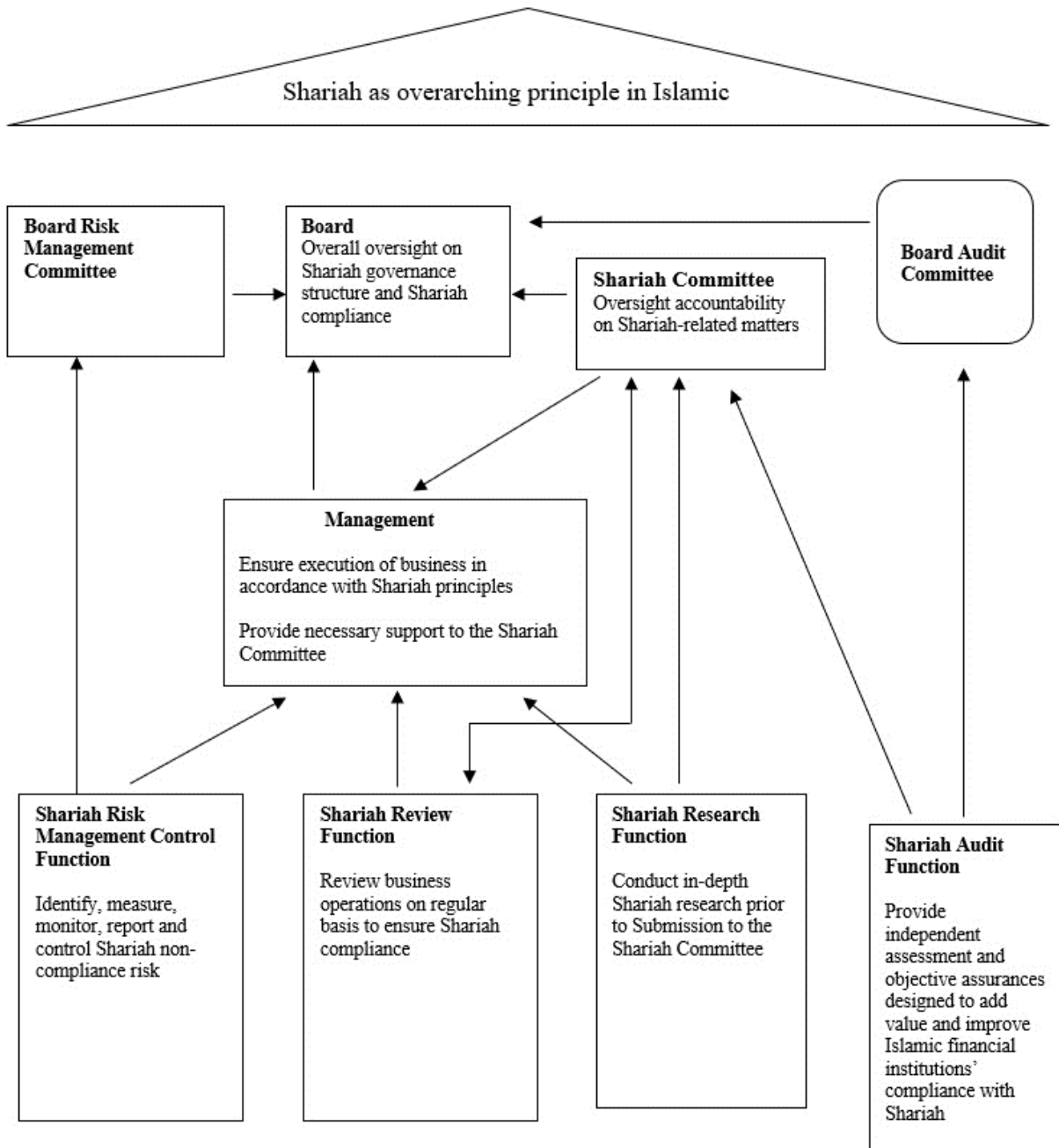
According to Principle 3 on CG defined by the IFSB:

“Institutions offering Islamic financial services shall have in place an appropriate mechanism for obtaining rulings from Shariah scholars, applying fatwa and monitoring Shariah compliance in all aspects of their products, operations and activities”³.

The SSB monitors and controls the board of directors and executive managers to ensure that they only provide the ex-ante approved products and services. The Shariah board helps Islamic banks to adhere to principles of morality and ethics rather than personal interests and greed. Figure 1 depicts a schematic representation of the roles, functions and relationships of key organs in Islamic financial institutions and illustrates the Shariah governance framework.

³ IFSB-3, (December 2006) Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services, Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds.

Figure 2. 1: General Model of the Shariah Governance Framework for Islamic Financial Institutions



Source: Bank Negara Malaysia (Shariah Governance Framework for Islamic Financial Institutions, p.8).

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), based in the Kingdom of Bahrain, and the IFSB in Malaysia are the two main standard-setters for Islamic financial institutions. Both of these bodies have compiled a list of guiding principles for Shariah governance.

These standards refer to the appointment, composition and tasks of the SSB, with the main requirements being independence, competence, confidentiality, consistency, and disclosure. According to the IFSB (IFSB-10, December 2009) and the AAOIFI (AAOIFI No. 1, 1997), the SSB should consist of at least three members who are recommended by the board of directors before they are appointed by the shareholders of the Islamic bank.

These members are religious Shariah scholars with experience in the field of accounting and finance. They might issue fatwas (legal opinions) according to Islamic law on commercial transactions (*fiqh al-muamalat*)⁴ within the Islamic religion. The SSB meets several times a year.

Despite the guidelines issued by the AAOIFI and the IFSB, there is a wide range of Shariah governance models in terms of both the implementation of those governance codes (on a voluntary basis in many countries) and the presence of a Shariah authority at national level. We present these different models in the following section.

⁴ *Fiqh* is knowledge of the legal rule pertaining to conduct, which has been derived from specific evidence in the Shariah. *Fiqh al-muamalat* is a branch of Islamic jurisprudence that deals with commercial and business activities in an economy.

2.5. Shariah Governance regulation

The Shariah board can be categorized at the macro and the micro levels. At the macro level, in some countries, such as Malaysia, there is a Shariah board attached to the central bank or at regulatory authority level. Shariah boards at this level play a significant role in terms of harmonization and standardization of fatwas. Moreover, they act as the highest Shariah authority for Islamic financial institutions.

At the micro level, it is compulsory for every Islamic financial institution to establish a Shariah board. The micro-level Shariah board has responsibilities such as participating in product development and structuring activities, reviewing and approving matters related with Shariah, issuing fatwa and Shariah auditing.

Regarding the internal auditing function of the Shariah, according to AAOIFI Governance Standard (1999) No. 3, part of Shariah governance involves establishing an internal Shariah compliance system: “the internal Shariah review shall be carried out by an independent division/department or part of the internal audit department, depending on the size of the Islamic financial institution”.

In the same vein, the IFSB in Malaysia recommends establishing an Internal Compliance Department in every Islamic financial institution, in addition to the Shariah board. This department is responsible for customers’ day-to-day questions about Islamic products, Islamic transactions and matters of religious principles. The employees working in this department have experience in finance and are well versed in questions of Islamic law.

Abu-Tapanjeh (2009) offers a comparison of Islamic CG principles and the revised OECD principles⁵. He concludes that the OECD principles have been successfully implemented and are a very effective CG tool compared to Islamic CG principles. Conversely, Grassa (2013) finds that national Shariah authorities need to play a greater role in monitoring and ensuring a well-adapted CG practice in Islamic financial institutions. Additionally, this author asserts that international Islamic financial organizations should make further efforts to improve the effectiveness of the Shariah governance system and to persuade other organizations to adopt it.

There is a wide variety of Shariah governance models across countries. Below, we classify all countries of the sample into two categories: those countries with high regulatory intervention and a national Shariah authority (that is, a centralized model); and countries where the national Shariah authority is either non-existent or is only required to solve disputes among the Shariah boards of different Islamic banks (the decentralized model).

2.5.1. Shariah governance regulation at the national level

The map of Shariah governance systems presents considerable diversity. First, we present and comment on the regulatory specifications in countries where the Shariah Committee plays a significant role at the national level.

⁵ OECD Principles of Corporate Governance, 2004.

Malaysia

This model is considered the most comprehensive of all the national models. In 1997, the Central Bank of Malaysia (Negara Bank) established the national Shariah Advisory Council on Islamic banking and other Islamic institutions, such as Islamic insurance institutions (*Takaful*) and Islamic collective investment schemes, which are based on Shariah principles. All such activities are supervised and regulated by the Negara Bank.

The Shariah Advisory Council is the highest authority on Islamic finance in Malaysia under section 51 of the Central Bank of Malaysia Act 2009. The president of the country appoints this board on the advice of the Minister of finance after consultation with the central bank. It consists of 10 members, all of whom are qualified Shariah scholars or experts in Shariah and banking, finance and law. The Shariah Advisory Council is responsible for validating all Islamic financial products to ensure their compatibility with Shariah principles. The courts also refer to this Council in disputes involving Shariah issues in Islamic banking and financial cases.

The Shariah Advisory Council operates as an independent body and its members are not allowed to work in any Shariah Committee in any Islamic financial institutions, in order to avoid conflicts of interest.

The main role of the Shariah Advisory Council is:

- To advise the central bank on any Shariah issues relating to Islamic financial business, activities or transactions it makes.

- To ascertain the Islamic law on any financial matters.
- To advise to any Islamic financial institutions about Shariah matters.
- To issue Shariah legal opinions (fatwas).

Indonesia

The Act of the Republic of Indonesia No. 21 of 2008 establishes a national Shariah Banking Committee. It is a forum comprising experts in the field of Islamic commercial jurisprudence, as well as economic, financial, and banking experts.

The Indonesian Ulema Council issues the *fatwas* relating to banking operations (Grass, 2015) and the Shariah Banking Committee is tasked with assisting the Bank of Indonesia in implementing those fatwas.

The Bank of Indonesia is a member of the AAOIFI in Bahrain and is therefore encouraged to refer to AAOIFI pronouncements, but they are not compulsory.

Pakistan

Following the Regulatory Framework issued in 2016, the State Bank of Pakistan has appointed its own Shariah board composed of six members: three Shariah scholars; a chartered accountant; a lawyer; and one other member, namely,

the Director of the Islamic Banking Department at the State Bank of Pakistan, representing the bankers.

All board members, excluding the ex-officio member, have a term of two years and are eligible for reappointment. The main role of this board is as follows (Grass, 2015):

- To review and approve as Shariah compliant the products/services developed by the State Bank of Pakistan.
- To advise the State Bank of Pakistan on regulations developed for the Islamic banking sector.
- To approve proper criteria for the appointment of Islamic financial institutions' Shariah advisors.
- To advise the State Bank of Pakistan on the Shariah ruling in cases of conflict arising from the Shariah audit of Islamic financial institutions' activities.
- To advise the State Bank of Pakistan on the Shariah rulings in cases of conflicting Shariah opinions on Islamic banking products.

Brunei Darussalam

In 2006, Negara Brunei Darussalam established the Shariah Financial Supervisory Board as the authority tasked with ascertaining Islamic law for the purpose of Islamic financial business. The board consists of:

- the permanent secretary, Minister of Finance ex-officio, who is the chairman;

- the Mufti of the kingdom ex-officio; and
- no fewer than six other persons.

The Sultan appoints the board members on the recommendation of the religious council. Of the six appointed members, at least four have to be Shariah scholars and experts in Islamic finance, and the other two have to be Muslims experienced in banking, economics, finance, law or any other related discipline. All members are appointed for a period of three years.

The board should have no fewer than six meetings during the year (Negara Brunei Darussalam, Supplement to Government Gazette, Part II, 2006). This board has a mandate to ascertain the Islamic law on any financial matter, to issue rulings on matters referred to it, and to advise on any Shariah issues relating to Islamic financial business, activities or transactions.

The United Arab Emirates (UAE)

Art. 5 Federal Law No. 6 of 1985 of the Central Bank of UAE requires the establishment of a Higher Shariah Authority to supervise Islamic banks, financial institutions and investment companies. It is the ultimate authority in Shariah matters in Islamic banking and finance and is attached to the Ministry of Justice and Islamic affairs.

Recently, the UAE Government, the Central Bank of the UAE and the UAE Banks Federation worked together to set up the guidelines for a Higher Shariah Authority. As a result, in May 2016, the Government launched the Higher Shariah Authority as a national regulator to set standards for Islamic finance products.

Sudan

In 1992, the government established the High Shariah Supervisory Board at the central bank to ensure the compatibility of financial practices with Islamic principles (Art. 7 of 1992 Act). The Bank of Sudan Act (2003) specifically stipulates that the bank will abide by Islamic Shariah principles in the performance of its duties and objectives and in the exercise of its functions and supervision of the banking systems (Hamza, 2013).

The body is a centralized national Shariah advisory council and is the sole authority in matters pertaining to Islamic finance with the power to issue religious opinions (fatwas).

The High Shariah Supervisory Board oversees the Shariah Supervisory Boards of Islamic banks and it has the final decision in cases where there are different opinions on an issue specific to banking. It also acts as an intermediary in disputes between various Islamic Banks and the Bank of Sudan (The Banking Business Act, 2003, Chapter III).

The High Shariah Supervisory Board includes 11 members, the majority of whom are Shariah scholars. All members are appointed by the President of the country on the recommendation of the Bank of Sudan's governor and the Minister of Finance. The members are allowed to sit on both the High Shariah Supervisory Board and the Shariah boards of Islamic banks.

Main functions of the Shariah board at the national level

Under the centralized approach, there is a Shariah board in the governance structure of the Central Bank. Each Islamic Bank has its own Shariah board, but it must comply with the rules set by the Shariah board of the Central Bank.

This model is used in Malaysia, Indonesia, Pakistan, Brunei Darussalam, UAE and Sudan.

Table 2. 1: Shariah Committee regulation at national level

Country	Banking regulation	Name	Attached to	Appointment by	Min. number of members	Qualifications required	Functions
Malaysia	Laws of Malaysia, Act 701. Central Bank of Malaysia Act 2009, part VII, chapter 1	Shariah Advisory Council	Federal Court	The President of the country on the advice of the Minister after consultation with the Central Bank	10	Qualified in Shariah or experts in Shariah and banking, finance and law	Advise Central Bank on any Shariah issues relating to Islamic financial business, activities or transactions made by the Central Bank. Ascertain Islamic law on any financial matters. Advise any Islamic financial institutions about Shariah matters. Issue the Shariah legal opinions (fatwas)
Indonesia	Act of the Republic of Indonesia number 21 of 2008 concerning Shariah (Islamic) Banking	Shariah Banking Committee	Indonesian Ulema Council	Bank of Indonesia	11	Comprising experts in the field of Islamic transactions/commercial law Economic, financial and banking experts	Assist the Bank of Indonesia in implementing fatwas issued by the Indonesian Ulema Council Develop Shariah banking
Pakistan	State Bank of Pakistan, 2016, Regulatory Framework http://sbp.org.pk/IB/shariah.asp	State Bank of Pakistan Shariah Board	Shariah Federal Court	State Bank of Pakistan	6	Three Shariah scholars, one lawyer, one accountant and one banker.	Review and approve as Shariah compliant the products/instruments developed by the State Bank of Pakistan. Approve the fit and proper criteria for the appointment of institutions' Shariah board members. Advise the State Bank of Pakistan (SBP) in case of any difference of opinion between an Islamic banking institution and the SBP inspection. Perform such other functions as may be assigned from time to time, by the SBP.

Table 2. 1: Shariah Committee regulation at national level (cont.)

Country	Banking regulation	Name	Attached to	Appointment by	Min. number of members	Qualifications required	Functions
Brunei Darussalam	Negara Brunei Darussalam established, Supplement to government Gazette, Part II, 2006.	Shariah Financial Supervisory Board	Ministry of Finance	The Sultan on the recommendation of the Religious Council.	8	At least four Shariah scholars and experts in Islamic finance Two Muslims experienced in banking, economics, finance, law or any other related discipline.	Ascertain the Islamic law on any financial matter in any financial institutions Issue rulings on matters referred to it Advise on any Shariah issues relating to Islamic financial business, activities or transactions
UAE	Central Bank of the U.A.E, Federal Law No. 6 of 1985, Regarding Islamic Banks, Financial Institutions and Investment companies	High Shariah Authority	Ministry of Justice and Islamic affairs	Formed by cabinet decision	Not specified	Shariah scholars and experts on the banking system	Oversee banks, financial institutions and Islamic investment companies to verify the legitimacy of their transactions in accordance with the provisions of Shariah law Express opinions on the issues presented from Islamic institutions during the exercise of their activities
Sudan	The Banking Business Act, 2003, Chapter III	High Shariah Supervisory Board	Central Bank of Sudan	The President of the country on the recommendation of the Bank of Sudan's governor and the Minister of Finance	11	Shariah science, and experts in economics, exchange and law; provided that the majority of them are Shariah scientists.	Issue the legal opinions about Shariah matters for the Central Bank any other Islamic institutions. Assist the technical control organs at the financial institutions, in performing the tasks in accordance with the ordinances of Islamic Shariah. Assist the research administrations and sections to promote scientific research and encourage publication. Consider and solve any Shariah disputes arising between the financial institutions about Shariah matters. Any other functions, as the Commission may deem necessary to meet the objectives.

From Table 2.1., we can see that the Shariah board is an independent body of the Central Bank whose members are either qualified Shariah scholars or experts in economics, finance, law or banking—or both. The main responsibilities of the Shariah Committee at the national level are the following:

1. Advise the Central Bank on Shariah issues
2. Issue legal religious opinions (fatwas) on financial matters
3. Review and approve the Shariah compliant financial products
4. Assist the Shariah Supervisory Boards in every Islamic bank
5. In some cases (Malaysia, Pakistan and Indonesia), the Shariah Committee either approves or recommends appointments to Islamic financial institutions' Shariah boards.

2.5.2. Shariah board regulation at the Islamic financial institution level

2.5.2.1. Countries with a centralized model

As depicted in Table 2.1, under this approach, Shariah boards in Islamic financial institutions have an advisory function in their bank's business operations. They also endorse Shariah compliance manuals for the institution and submit annual reports to the board of directors on its Shariah compliance.

Below, we specify the regulatory framework and the main functions of the Shariah board at the financial institution level for those countries with a centralized model.

Malaysia

Bank Negara Malaysia has published the *Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions* (2004). These guidelines require every Islamic financial institution to establish a Shariah Committee and define the relationship and working arrangements between a Shariah Committee and the Shariah Advisory Council of Bank Negara Malaysia.

The board of directors, on the recommendation of a nomination committee, should appoint the members of the Shariah Committee. The board of directors should then submit their applications for appointments to the Shariah Advisory Council of Bank Negara Malaysia. This appointment is valid for a renewable term of two years.

The Shariah Committee shall consist of a minimum of three members, one of whom is the Officer, a Shariah scholar, who will serve as the secretariat to the Shariah Committee. The main duties and responsibilities of the Shariah Committee according to the *Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions* of Bank Negara Malaysia (2004) are:

- To advise the Board on Shariah matters in its business operations.

- To endorse Shariah compliance manuals (specifying the manner in which a submission or request for advice be made to the Shariah Committee).
- To ensure that Islamic financial institutions' products comply with Shariah principles.
- To assist related parties with advice on Shariah matters on request.
- To advise the Islamic financial institution to consult the Shariah Advisory Council on any Shariah matters.
- To prepare written Shariah opinions in some circumstances (e.g., when the Islamic financial institution refers to the Shariah Advisory Council or when it submits an application for approval of a new product to Bank Negara Malaysia).

Indonesia

Although Indonesia does not yet have a Shariah Governance Framework, according to Art. 32 of Act of the Republic of Indonesia No. 21 of 2008, all Islamic banks and conventional commercial banks with Islamic windows must implement an SSB. The SSB is appointed at the General Meeting of the shareholders, on the recommendation of the national Shariah Committee called the Indonesian Ulema Council.

The task of the SSB is to give advice and recommendations to the board of directors and supervise the bank activities to ensure that they are in accordance

with Shariah principles (Act of the Republic of Indonesia No. 21 of 2008 concerning Shariah (Islamic) Banking).

The Indonesian Ulema Council issues the *fatwas* relating to banking operations (Grass, 2015). They coordinate with the Bank of Indonesia, which is a member of the AAOIFI in Bahrain. The Bank of Indonesia, as a member of this organization, is encouraged to refer to AAOIFI pronouncements, but they are not compulsory.

Pakistan

Every Islamic bank is required to have a Shariah board comprising at least three Shariah scholars appointed by the board of directors. The appointment of the Shariah board members is subject to prior written clearance of the State Bank of Pakistan. The Shariah board is empowered to consider, decide and supervise all Islamic bank operations. Therefore, all decisions, rulings, and fatwas of the national Shariah Committee are compulsory, and the individual Shariah boards must implement them. Each individual Shariah board is responsible and accountable for all its Islamic bank's Shariah-related decisions (State Bank of Pakistan, Instructions for Shariah Compliance in Islamic Banking Institutions, Annex 1 of IBD Circular No. 2 of 2008).

Islamic banks may, in consultation with the Shariah board, also seek the services of or engage lawyers, accountants, economists and other professionals to assist and advise the Shariah board on banking, legal, financial, economic and other relevant matters. The engagement of such members is however of an advisory nature and they do not have any voting rights in the meetings of the

Shariah board (State Bank of Pakistan, Shariah Governance Framework for Islamic Banking Institutions, IBD Circular No. 3 of 2014).

Brunei Darussalam

An internal Shariah Advisory Body within each Islamic financial institution is comprised of at least three members, all of whom must be religious scholars. The role of this board is to ensure that all bank operations comply with Shariah law (Laws of Brunei, chapter 168, Islamic banking arrangement of sections, 1999).

The United Arab Emirates (UAE)

The SSB in every financial institution consists of at least three members, appointed by the board of directors. The role of this board is to review all bank activities and ensure their compliance with Shariah law (Central Bank of the U.A.E, Federal Law No. 6 of 1985, Regarding Islamic Banks, Financial Institutions and Investment companies). They follow the AAOIFI pronouncements, although it is not compulsory.

Sudan

In Sudan, there is no specific regulation governing Shariah boards in Islamic financial institutions.

2.5.2.2. Countries with a non-centralized model

Under this structure, there is no effective national Shariah board at the level of the central bank. Instead, there are only individual Shariah boards in each

Islamic Bank. Hence, the permissibility of contracts and the Shariah compliance of financial products is decided at the level of these institutions by their own Shariah Committees, because every Shariah board is independent of the central bank. This is the typical model implemented in some countries of the Gulf Cooperation Council and certain other states. Such a model can be found in Kuwait, Saudi Arabia, Bahrain, Qatar, Oman, Bangladesh, Singapore, Thailand, Jordan and Indonesia.

In some countries, the Shariah boards are influenced by the AAOIFI standards related to size, composition and meetings frequency (Song and Oosthuizen, 2014).

Bahrain

There is a Shariah board in the Central Bank of Bahrain but its supervisory role is limited to the products and transactions of the central bank and it does not cover individual Islamic institutions. The members of the National Shariah Board can also join the board of any other financial institution (Hamza, 2013; Grass, 2015).

The Central Bank of Bahrain requires all Islamic banks working in Bahrain to establish an independent Shariah Supervision Committee complying with the AAOIFI standards. Therefore, in every bank, the Shariah Supervisory Committee must comply with all AAOIFI accounting standards as well as Shariah pronouncements issued by the Shariah board of the AAOIFI (Khan, 2007). The SSB comprises at least three members appointed at the shareholders' annual general meeting, on the recommendation of the board of directors (Central Bank

of Bahrain, Islamic Banks, Part A, High Level Standards of Shariah Governance, 2017).

The Shariah Supervisory Committee members are specialized in Islamic commercial jurisprudence (*fiqh al-muamalat*). The main role of this board is:

- To monitor and review transactions to ensure full compliance with Shariah law.
- To approve the internal Shariah audit annual plans.
- To notify the Central Bank of Bahrain in case of any failure by the board of directors to effectively deal with any major Shariah non-compliance.
- To review all relevant documentation for new products and services.
- To review and approve Islamic bank annual charity (*Zakat*) calculations on behalf of the shareholders.
- Submit annual reports on Shariah oversight to the board of directors

Qatar

In the Qatar model, there is no Shariah Advisory Board in the Qatar Central Bank. Nevertheless, in accordance with Art. 106 of Qatar Central Bank Law (2013), an independent consultation board referred to as the Shariah Supervisory Board must be formed in each Islamic financial institution in order to supervise the institution's activities.

The SSB must have no fewer than three members and should be appointed by the institution's general assembly on the recommendations of the board of directors. The appointment of the Shariah board members is restricted to a renewable term of three years. The bank's board of directors must inform the Central Bank of Qatar of its decision to appoint or dismiss the Shariah board members. The board consists of scholars specialized in jurisprudence, Islamic Shariah and financial operations, activities and services.

There are independence restrictions because, according to Art. 107 of Qatar Central Bank Law, "A member of the Shariah board shall have no employment function at the Islamic financial institution and shall not provide any operation to the institution. A member shall not be a shareholder of the institution, nor shall any of his relatives until the fourth degree have any related interests whatsoever in the Islamic financial institution."

The main function of the Shariah board in accordance with Circular No. 108 of Qatar Central Bank, 2013 is:

- 1- Review the bank's operations and activities and supervise it with regards to its compliance with Shariah.
- 2- Review any matters assigned to it by the board of directors or pursuant to the Qatar Central Bank instructions, to ensure that the products of the Islamic financial institutions comply with Shariah principles. (The Central Bank of Qatar, Instructions of Supervision and Control, Financing Policies in Islamic Banks, 2013, Art.105 of QCB Law, page 217).

Kuwait

Articles 93 and 97 of Law No. 32 of the Central Bank of Kuwait (1968) state that "The board of directors of each bank shall nominate the members of the Shariah Supervisory Board for the approval of their appointment by the bank shareholders general meeting. Those members should be Islamic Shariah scholars of recognized efficiency and experience, especially in the area of transactions jurisprudence" (Central Bank of Kuwait, Instructions for Islamic Banks, Instructions No. 2/IBS/100/2003).

There should be no fewer than three SSB members, and they should not be members of the bank's board of directors or executive management, nor any shareholder of effective influence who owns 5% or more. It is worth noting that for the meeting of the SSB to be duly held, all members must attend the meeting. The main functions of the SSB are:

- To review the bank's operations and provide opinions on the bank's compliance with Shariah rules in all of its operations. The SSB has the right to inspect all contracts, agreements, policies and transactions of the bank with other parties to ascertain its compliance with Shariah.
- To prepare and submit the annual report to the bank's board of directors. This report includes:
 - The scope of the SSB, describing the nature of the work carried out and assuring that the appropriate examinations and

procedures have been performed and the work has been appropriately monitored.

- The SSB opinion as to whether the contracts, documents and transactions executed by the bank are compliant with the rules and principles of Shariah.
- To publish the fatwa (legal opinion) and resolutions passed by the SSB by printing booklets or bulletins and making them available to different parties in the bank (Central Bank of Kuwait, Instructions for Islamic Banks, Instructions No. 2/IBS/100/2003).

Saudi Arabia

In Saudi Arabia, Shariah law is the main source of regulation of all aspects of life, including civil law. The Shariah court is the highest court in the jurisdiction system; however, there is a special commercial court for the commercial sector, which functions as the highest court related to all commercial matters, including Islamic finance.

The Central Bank of Saudi Arabia, which is called the Saudi Arabia Monetary Agency, was founded in 1952. The role of the Saudi Arabia Monetary Agency includes issuance of national currency, bank governance, management of foreign exchange reserves, service provider for commercial banks, and handling monetary policy, among others (Saudi Arabia Monetary Agency, 2012).

However, the country's Islamic banks are not monitored by the Saudi Arabia Monetary Agency. Instead, all Islamic financial institutions are under the supervision of the Saudi Ministry of Commerce (Al-Azizah et al. 2017) because they are considered, by nature, commercial companies.

In Saudi Arabia, there is no organization that acts a national Shariah board authority. The Banking Disputes Committee, launched in 1987 by the Saudi Arabia Monetary Agency, is the specialized institution for solving banking sector disputes, although the government issues no specific laws or guidelines about Islamic finance.

Jordan

In 2016, the Central Bank of Jordan issued *Amended Instructions of Corporate Governance for Islamic Banks (64/ 2016)* for Shariah compliant banks.

Under Art. 58 of Banking Law 28 of 2000 and its amendments, banks must comply with the following rules:

1. The members of the Shariah board must be appointed by the nomination and compensation committee based on the recommendations of the board of directors, for a renewable term of four years.
2. The bank must appoint a local SSB of no fewer than three members for foreign Islamic bank branches operating in Jordan, to ensure the application of the conditions and duties stipulated in these instructions.

3. A commitment message must be signed between the SSB and the bank, specifying the scope of the Shariah board's actions as well as its duties and fees.
4. The Shariah board must prepare a guide to its procedures, covering the working system of the Shariah board and its specializations and responsibilities; the organization of its relationship with the board and the executive management; the mechanism for preparing its reports submitted to management, the board, and the shareholders; its approach to Shariah supervision; and procedural information on holding meetings.
5. The Shariah board should comply with the bank's Code of Conduct.

The role of the Shariah board is:

1. To supervise the bank's work and activities in terms of being compliant with and not in breach of the provisions of Shariah law.
2. To give an opinion of and approve all contracts, transactions, agreements, products, services, investment policies and the policy that governs the relationship between the shareholders and the investment account holders.
3. To provide consultation to the parties that deal with the bank such as auditors, lawyers, counsellors and customers.
4. To submit semi-annual reports to the board of directors and the annual report to the general assembly of shareholders, and a copy of each to the

Central Bank. (*Amended Instructions of Corporate governance for Islamic (Shariah compliant) Banks No. (64/2016) Dated 25/9/2016*).

Oman

The Sultanate of Oman has recently implemented a Shariah governance system in the banking industry. Each bank must establish its own Shariah board (Central Bank of Oman, Islamic banking regulatory framework, 2012) and they follow the AAOFI on a voluntary basis. This board is an independent body of shariah scholars specialized in Islamic commercial jurisprudence (*fiqh al-muamalat*), however SSB members may include one or more members who are not specialized in Islamic commercial jurisprudence, but with experience in Islamic banking or related areas (economics, finance, accounting, etc). The SSB must comprise a minimum of three members. The general assembly of the bank is responsible for appointing the SSB members, who will serve a maximum initial term of three years, which can be renewed for another three-year term. Members can serve a maximum of two consecutive terms in an institution, but are not allowed to work in competing institutions in the country. The SSB is the ultimate responsible authority for all Shariah-related matters in the bank. The main role of the Shariah supervisory board is:

- To advise the board of directors and management on shariah matters in the day-to-day business
- To review and approve all the policies, procedures, products, systems, contracts and agreements for their Shariah compliance.

- To provide written Shariah opinion on Shariah matters to board of directors and the management of the bank.
- To submit a report to the board of directors on Shariah compliance to be published as part of the annual report.
- Document its Shariah rulings and guidelines, which are then kept centrally for ready reference, and are disseminated and implemented.
- Explain any legitimacy issue about the bank's operations to the management or customers.

Bangladesh

In 2009, Bangladesh Bank issued guidelines to provide an operational framework for Islamic banking. The guidelines cover Shariah and CG mechanisms, product definition and operational framework, alternative investment modes, and procedures for converting a conventional bank to an Islamic bank. However, these guidelines have certain shortcomings. A major issue is that, under these guidelines, it is optional for an Islamic bank to have a Shariah board, which contradicts global practice (Global Islamic Finance Report, 2011).

The board of directors of each bank is responsible for ensuring that its activities and products are Shariah compliant. The boards of Islamic banks, subsidiary companies or conventional commercial banks with Islamic branches should therefore comprise directors with the requisite knowledge and expertise in Islamic jurisprudence. The board may put together an independent Shariah

Supervisory Committee made up of people with experience and knowledge of Islamic jurisprudence. However, the board is responsible for any lapses/irregularities on the part of that committee (Bangladesh Bank, Guidelines for Islamic Banking, Appendix I, 2009).

Bangladesh Bank guidelines establish stringent criteria for the qualities and competencies required of a member of a Shariah Supervisory Committee. Notably, candidates should have (Bangladesh Bank, 2009):

- a postgraduate qualification in a relevant field—such as Islamic studies, Arabic studies, Islamic law, Islamic economics or Islamic banking—and a good knowledge of the Arabic language;
- a minimum of three years' experience in teaching or conducting research in the field of Islamic jurisprudence or Islamic finance;
- three years' experience as a member of any board issuing Shariah resolutions for Islamic financial matters; or published either three articles in recognized journals or three books in the field of Islamic jurisprudence or Islamic finance.

Bangladesh Bank does not have a Shariah board to supervise Islamic banks in Bangladesh. However, there is a private non-corporate body called the Central Shariah Board for Islamic Banks of Bangladesh (CSBIB), which embraces almost all Islamic banks in Bangladesh. It consists of several prominent Bangladeshi scholars and arranges regular meetings to discuss Shariah issues related to the country's Islamic banking industry. The main role of this board is:

- To provide cooperation and necessary advice to member banks on following the same procedure and practice of Shariah policy, and to supervise the implementation of Shariah principles in member banks.
- To conduct activities aimed at generating public awareness and interest in managing financial transactions according to Shariah.

It also conducts research and publishes books and journals to serve its members (Global Islamic Finance Report, 2011; CSBIB, website). However, Shariah resolutions issued by the CSBIB are not mandatory for Islamic financial institutions; it only provides advisory services. Nevertheless, no Islamic bank in Bangladesh contravenes the resolutions of the CSBIB due to reputational risks (Abdullah and Rahman, 2017).

Thailand

There is one Islamic bank in Thailand, set up by the Islamic Bank of Thailand Act B.E. 2545 (2002), as a state enterprise under the Ministry of Finance, administered by a board of governors, with an advisory council on Islamic banking. The bank operates in accordance with the rules of Shariah (Grais and Pellegrini, 2006).

This bank has a Shariah Advisory Council appointed by the board of directors, the main role of which is to provide advice and suggestions to the bank's board, to help it fully comply with Shariah principles, and to approve the bank's financial products and services (Islamic Bank of Thailand, Annual Report, 2008).

Singapore

In the case of Singapore, the country adopted the decentralized Shariah governance structure, which means that the Shariah committees are nominated at the institutional level, and their decisions are only binding to their respective Islamic financial institutions. In addition, the country's regulatory framework is also silent about the body that has the ultimate authority to decide on Islamic finance matters. Overall, a flexible Shariah governance structure is in place, with the country leaving Shariah governance matters to the industry players (Monetary Authority of Singapore, Guidelines on the Application of Banking Regulations to Islamic Banking, 2010).

There are no specific provisions of law or guidelines on the Shariah governance process. Instead, a mandate is given to the respective Islamic financial institutions to establish their own policies or best practices on this matter. Shariah governance is regulated in the form of specific guidelines and circulars issued by the Monetary Authority of Singapore. Each Islamic bank has to appoint its internal Shariah board and has to consider the best mix of Shariah scholars to maintain the confidence of its customers.

2.5.2.3. Main functions of the Shariah board at the Islamic financial institution level

One of the most relevant characteristics of CG is the board size. As depicted in Table 2.2., the minimum number of Shariah board members at the institutional level varies:

- The most common number is three (in Malaysia, Pakistan, Brunei Darussalam, UAE, Bahrain, Qatar, Kuwait, Oman, Jordan)
- In Indonesia, the minimum is two with a maximum of five
- In the remaining countries, the size is either left open to choice (Bangladesh) or it is not specified.

In relation to the Shariah board members' education, they are often required to be a qualified Shariah scholar and /or expert on different subjects such as accounting, economics and financial matters.

The Shariah board is tasked with a number of duties related with the following roles:

- **Informative.** In general, the Shariah board is requested to submit an annual report about the Shariah compliance of the Islamic bank to the board of directors. In the case of Jordan, they also need to report to the general assembly of shareholders. Indonesia, Pakistan and Jordan also require the Shariah board to report to the National Shariah Board or to the Central Bank.
- **Monitoring.** They generally review and approve all the bank's policies, procedures, products, systems, contracts and agreements for their Shariah compliance.
- **Advisory.** They provide consultation about Shariah matters to all parties that deal with the bank such as auditors, lawyers, counsellors and customers.

- Jurisprudence. In some cases, for example in Indonesia, they give legal opinions about financial matters.

Table 2. 2. Shariah Committee regulation at the Islamic financial institution level

Country	Regulation	Name	Appointment by/Period	Minimum number of members	Qualifications required	Following AAOIFI	Functions
Malaysia	Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions, 2004. (BNM/RH/GL/012-1)	Shariah Committee	Board of directors on the recommendation of the Nomination Committee	Three	Islamic jurisprudence Islamic transaction/commercial law (<i>fiqh al-Muamalat</i>)	No	Advise the board on Shariah matters in business operations Endorse Shariah Compliance Manuals Assist related parties with advice on Shariah matters on request Advise the institution on matters to be referred to the National Shariah Committee Submit annual report to the board of directors on Shariah compliance
Indonesia	Investment Guide to Islamic Banking in Indonesia, Bank Indonesia, 2007) Bank of Indonesia regulation number: 10/32/PBI/2008 concerning Shariah banking committee	Shariah Supervisory Board	The General Meeting of shareholders on the recommendation of the Indonesian Ulama Council	Two (and no more than five)	Not specified	Yes/ Not compulsory	Monitor the compliance of bank operations with Shariah law Evaluate the Shariah legal aspects of the bank's operational guidelines and products Issue Shariah legal opinion on the overall conduct of bank operations Submit semi-annual and annual reports on Shariah oversight to the board of directors, the National Shariah Board and the Bank of Indonesia
Pakistan	State Bank of Pakistan, Instructions for Shariah Compliance in Islamic Banking Institutions, Annex 1 of IBD Circular No. 2 of 2008. State Bank of Pakistan, Shariah Governance Framework for Islamic Banking Institutions, IBD Circular No. 3 of 2014	Shariah Advisory Board	The board of directors / renewable three-year term	Three	Post-graduate degree in Science of Shariah with a minimum GPA of 3.0 or equivalent	No	Supervise all Shariah related matters of the bank. Develop a comprehensive Shariah compliance framework for all operations of the bank Submit annual reports on Shariah oversight to the board of directors and the National Shariah Board in the SBP

Table 2.2. Shariah Committee regulation at the Islamic financial institution level (continued)

Brunei Darussalam	Laws of Brunei, chapter 168, Islamic banking arrangement of sections, Part II, 1999	Shariah Advisory Body	Not specified	Three	Religious Muslim scholars	No	Monitor the compliance of bank operations with Shariah law
UAE	Central Bank of the U.A.E, Federal Law No. 6 of 1985, Regarding Islamic Banks, Financial Institutions and Investment companies	Shariah Supervisory Board	High Shariah Authority	Three	Not specified	Yes/Not Compulsory	Ensure that bank's operations conform with Shariah law.
Sudan	There is no specific regulation	Shariah Supervisory Board	Not specified	Not specified	Not specified	Not specified	Not specified
Bahrain	Central Bank of Bahrain Volume 2, Islamic Banks, Part A, High Level Standards, SG Shariah Governance, 2017	Shariah Supervisory Board	Shareholders annual general meeting on the recommendation of the board of directors	Three	Specialized in Islamic jurisprudence commercial (<i>fiqh al-muamalat</i>)	Yes/Compulsory	Monitor and review transactions to ensure full compliance with Shariah law. Approve the internal Shariah audit annual plans. Notify the Central bank of Bahrain in case of any failure by the board of directors to effectively deal with any major Shariah non-compliance. Review all relevant documentation for new products and services. Review and approve Islamic bank annual charity (Zakat) calculations on behalf of the shareholders. Submit annual reports on Shariah oversight to the board of directors.
Qatar	The Central Bank of Qatar, Instructions of Supervision and Control, Financing Policies in Islamic Banks, 2013, Art. 105 of QCB Law	Shariah Supervisory Board	General Assembly following a proposal by the board of directors/ renewable three-year term	Three	Scholars specialized in jurisprudence and Shariah and financial operations, activities and services	Yes/Not compulsory	Conduct Shariah supervision on the institution's operations and activities with regards to their compliance with Shariah. Express binding opinions with regards to the extent of compliance of the Islamic financial institution's operations. Review any matters assigned to it by the Islamic financial institution's board of directors. Submit annual reports on Shariah oversight to the board of directors.

Table 2.2. Shariah Committee regulation at the Islamic financial institution level (continued)

Kuwait	Central Bank of Kuwait, Instructions for Islamic Banks, Instructions No. 2/IBS/100/2003	Shariah Supervisory Board	General Meeting of shareholders on the recommendation of the board of directors	Three	Islamic Shariah scholars of recognized efficiency and experience, especially in the area of transactions jurisprudence.	Yes/ Not compulsory	Responsible for providing opinion on the bank's compliance with Shariah law in all of its operations. Inspect all contracts, agreements, policies and transactions of the bank with the other parties. Submit annual reports on Shariah oversight to the board of directors.
Saudi Arabia	There are no specific regulations for Shariah governance.	Shariah Board	Not specified	Not specified	Not specified	Not specified	Not specified
Oman	Central bank of Oman, Islamic banking regulations framework, 2012	Shariah Supervisory Board	General Assembly/ renewable three-year term	Three	Degree in in Islamic jurisprudence commercial (<i>fiqh al-muamalat</i>). Knowledge about banking and Islamic finance.	Yes/Not compulsory	Advise the board of directors and management on Shariah matters. Review and approve all the bank's operations. Provide written Shariah opinion on Shariah matters. Submit annual report to the board of directors on Shariah compliance. Explain any legitimacy issue about the bank's operations to the management or customers.
Jordan	Amended Instructions of Corporate Governance for Islamic Banks (64/2016) for Shariah compliant banks	Shariah Supervisory Board	The nomination and compensation committee/ renewable four-year term	Three	Bachelor's degree, as a minimum, in Shariah science in the fields of commercial jurisprudence (<i>fiqh al-muamalat</i> , Islamic economics, or Islamic finance.	No	Review and approve all the bank's operations. Provide consultation to parties related to the bank. Submit semi-annual report to the board of directors and the annual report to the general assembly of shareholders and a copy of each to the central bank.

Table 2.2. Shariah Committee regulation at the Islamic financial institution level (continued)

Bangladesh	Bangladesh Bank, Guidelines for Islamic Banking, Appendix I, 2009	Shariah Supervisory Committee	Board of directors	Voluntary size	Postgraduate qualification in a relevant field of Islamic studies, Arabic studies, Islamic law, Islamic economics or Islamic banking and good knowledge of the Arabic language. A minimum of three years' experience in teaching or conducting research in the field of Islamic jurisprudence or Islamic finance.	No	Not specified
Singapore	There are no specific regulations for Shariah governance.	Shariah Supervisory Board	Not specified	Not specified	Not specified	No	Not specified
Thailand	There are no specific regulations for Shariah governance.	Shariah Advisory Council	Not specified	Not specified	Not specified	No	Not specified

2.6. Shariah governance models

As stated above, the existing framework for Islamic finance in various countries demonstrates diverse practices and models of Shariah governance systems. Following Al-Azizah (2017), we identify the following Shariah governance models:

2.6.1. Minimalist approach

This model is mainly used by the GCC countries except for Oman and Saudi Arabia. Unlike the reactive approach, the minimalist model allows minimal intervention from regulatory authorities. The regulatory authorities expect Islamic financial institutions to have proper Shariah governance systems in place, without specifying the requirements in detail. There is no restriction on Shariah board members being appointed to seats in various institutions at the same time. Some jurisdictions in the GCC countries, such as Bahrain, Dubai and Qatar, favour the adoption of the AAOIFI Governance Standards. Under the minimalist approach, it is preferable for the market to develop its own Shariah governance system rather than greater intervention on the part of regulators (Al-Azizah, 2017).

2.6.2. Proactive approach

This model is the one adopted by the Malaysian regulatory authority. Proponents of this model have a strong faith in the use of a regulatory-based approach to strengthen the Shariah governance framework. Accordingly, the Malaysian regulator is responsible for implementing a comprehensive Shariah governance framework with respect to both regulatory and non-regulatory aspects.

Several laws have been passed and amended by the parliament, such as the Islamic Banking Act 1983, the Takaful Act 1984, the Banking and Financial Institutions Act 1984 and the Securities Commission Act 1993. The Central Bank of Malaysia Act 2009 confirms the status of the National Shariah Advisory Council (SAC) as the sole authoritative body in Islamic finance. Furthermore, the Bank Negara Malaysia has issued Guidelines on the Governance of the Shariah Committee for Islamic financial institutions known as the BNM/GPS1. To complement this, the Securities Commission of Malaysia issued the Registration of Shariah Advisers Guidelines 2009, which sets out the criteria for the registration of a Shariah adviser in the capital market sector (Hassan et al. 2016).

2.6.3. Reactive approach

This model is more prevalent in non-Islamic legal environment countries such as the United Kingdom and Turkey. Although several Islamic banking licences have been issued to Islamic financial institutions, the regulatory authority is silent on the Shariah governance framework. Like any other conventional banks, Islamic financial institutions are required to comply with existing legislation and regulations. On top of that, they have a duty to make sure that all their business operations and products are Shariah compliant. There is no specific legislation governing Islamic financial institutions, nor any directives specifying the Shariah governance framework. At this point, the regulators will only react and intervene in Shariah governance matters if they involve a significant issue which may affect the industry. For instance, the UK Financial Services Authority holds that the role played by the Shariah board of Islamic financial institutions should be advisory and supervisory rather than executive in nature.

2.6.4. Interventionist approach

The interventionist model only applies to Pakistan. The interventionist model allows third-party institutions to make decisions on Shariah matters pertaining to Islamic finance. In the case of Pakistan, the Shariah Federal Court is the highest authority in matters involving Islamic finance, despite the establishment of the Shariah board at the level of the State Bank of Pakistan (Pita, 2014).

2.6.5. Passive approach

This model is exclusive to Saudi Arabia. The Saudi Authority Monetary Agency treats Islamic financial institutions as equal to their conventional counterparts and has yet to issue legislation pertaining to Islamic finance or guidelines on a Shariah governance system. There is no national Shariah advisory board or any institutions that act as the sole authoritative body in Islamic finance. The existing Shariah governance system implemented by the country's Islamic financial institutions is a product of their own initiative rather than regulatory requirement or regulator instructions (Al-Azizah, 2017).

Shariah supervision takes different forms at macro and micro levels. At the macro level, some countries have implemented Shariah Supreme Councils inside the central banks to monitor the Islamic financial institutions. At the micro level, the supervision is conducted by an SSB. In general, in Islamic financial institutions, the Shariah body is the common form of Shariah supervision and derives its importance from five sources: religious, social, economic, legal, and governance (Garas and Pierce, 2010; Grassa, 2015).

Table 2.3 below illustrates the main similarities and differences among the models described above:

Table 2.3: Shariah governance models

Approach	Countries	Regulatory intervention	AAOIFI pronouncements	Individual development of Shariah Governance System
Minimalist	Some GCC countries (Qatar, Kuwait, the UAE, Indonesia)	Minimal	Recommended	Yes
Proactive	Malaysia, Sudan, Indonesia	High	Malaysia does not follow/ recommended in Indonesia and Sudan	Yes
Reactive	UK, Turkey, among others	Only when Shariah Governance affects industry	Not following	Yes
Interventionist	Pakistan	Yes, Shariah at Central Bank and Shariah Federal Court	Recommended	No
Passive	Saudi Arabia, Oman, Jordan, Bangladesh, Brunei Darussalam, Singapore and Thailand	None	Not following	Yes

Based on Al-Azizah (2017)

CHAPTER 3

LITERATURE REVIEW AND RESEARCH HYPOTHESES

3.1. Introduction

The purpose of this research is to identify the associations, if any, between CG mechanisms in Islamic banks and their performance. Board of director performance, accountability, and the effectiveness of governance mechanisms continue to attract the attention of researchers.

This chapter presents an extensive evaluation of the literature on this subject, highlighting the main findings of all relevant experimental studies. The aim of the chapter is twofold: to introduce the main research terms, and to contextualize the present research topic within the wider field. A special focus is placed on CG in the Islamic banking system.

This investigation is framed within agency theory, although we aware that its application to the banking industry raises serious concerns because several studies have failed to find evidence to support its postulates (Grove et al., 2011). Moreover, other theories might also suit our objectives, such as stewardship theory or stakeholder theory.

Within the framework of agency theory, we address three CG mechanisms designed to mitigate agency conflicts, which have been widely addressed in prior literature:

- The Shariah board.
- The ownership structure.

3.2. Research paradigms and CG theories

The accounting and finance literature offers a widespread, and sometimes inconsistent, use of the terms paradigms and theories.

Kuhn (1962) described a research paradigm as a set of practices that define a scientific discipline during a particular period of time. It frames what is to be studied, what kind of research questions are supposed to be formulated in relation to these subjects, what methods should be used to conduct these studies and how their results should be interpreted.

More recently, Jonker and Pennink (2010) state that a research paradigm is a set of fundamental assumptions and beliefs as to how the world is perceived, which then serves as a thinking framework that guides the behaviour of the researcher.

Within the functionalist paradigm, there are several key theories that frame current research on CG, which we explore below.

3.2.1. Agency theory

The mainstream research on CG in financial institutions is framed within the agency theory. The agency theory is a theoretical model developed by Jensen and Meckling (1976) and extended by Fama (1980) and Fama and Jensen (1983). It addresses the separation of ownership and control in the modern corporation, attempting to explain the incentives and relationships triggered by a principal-agent contract. Under the agency contract, the principal delegates the management of an economic activity to the agent, and the management commits to act on behalf of the principal. However, this contract entails several problems, called agency problems or agency costs, which have been widely discussed by accounting, economics and finance scholars in different research areas:

- a) One problem arises due to the divergence of the principal's and the agent's interests. While the principal is mainly interested in maximizing the performance, profitability or utility of the economic unit (the company), the agent will try to maximize his/her individual benefit; that is, his/her own wealth (Fama, 1980; Bebchuk and Fried, 2003). This suggests that there is always a conflict of interest between the principals and the agents (Hill and Jones, 1992; Obid and Naysary, 2014), which may arise in different contexts:
 - CG literature has predominantly tackled the manager-owner relationship. According to the agency approach, managers of the firm are the agents who make decisions on behalf of the shareholders (principals), who supply the capital. However, shareholder and

manager interests may not be aligned. It is assumed that shareholders maximize returns at a reasonable risk, focusing on high dividends and rising stock prices. Conversely, managers may prefer growth (as it can generate prestige or higher salaries), may be lazy or fraudulent, or may maintain costly labour or product standards above the competitive minimum (Aguilera and Jackson, 2003). Prior empirical evidence (Almazan et al. 2005; Pucheta-Martínez and Bel-Oms, 2015; López Iturriaga et al., 2015) confirms that board members representing blockholders effectively control and monitor managers and, therefore, are effective in reducing agency costs.

- More recently, CG research has also investigated the agency conflicts between the majority and the minority shareholders. The ownership structure is one focus of agency theory and influences CG practices, as costs can increase when firms have a complicated and highly concentrated ownership structure. Majority shareholders might expropriate minority wealth (*tunnelling* effect) through hostile takeovers, for instance.
- The relationship between the shareholders and the remaining stakeholders is another agency problem. Shareholders are primarily interested in maximizing the company's profitability, while the employees, suppliers, or debt holders are concerned with other financial and non-financial variables.

- Kapopoulos and Lazaretou (2007) observe that when family members occupy positions in the top management levels, there is an additional layer of agency behaviour; moreover, the opportunity for free and objective consultation which can otherwise exist in a board of directors is lost.
- b) The second agency problem is information asymmetry. Commonly, information is unevenly distributed between the agent (better informed) and the principal (worse informed) and so there is uncertainty and risk associated with the decision-making based on that information.

According to agency theory, there are three basic mechanisms to mitigate the agency problems:

- a) Incentivising the agent, through a reward scheme to align the agent's preferences with the principal's preferences and to mitigate potential conflicts of interest.
- b) Supervising the agent, through direct control over his/her behaviour, implementation of codes of conduct and ethical codes, monitoring his/her compliance and sanctioning any misconduct.
- c) Improving the information systems to diminish the information asymmetry problems. This is one of the biggest problems in the agency contract because the higher the quality of the information, the easier it is to monitor the agent. In particular, within the financial markets, these information asymmetry problems trigger the so-called "adverse selection" risk and the "moral hazard problem. The adverse selection risk refers to the probability of financing less profitable projects because they are less risky. The moral

hazard problem concerns the probability that the agent will act in his/her own interests by investing funds in projects other than those they were permitted to invest in by the principal.

The agency theory approach has not been free of criticism. In the first place, it assumes that managing firms in shareholders' best interests requires maximizing their wealth. This view is often called "shareholder primacy", in order to contrast it more directly with its main rival, "stakeholder theory". Aguilera and Jackson (2003) also state that agency theory fails to account for key differences across countries. Donaldson and Davis (1991) criticize agency theory on the grounds of its methodology, individualism, narrow definition, disregard for other research, organizational economics, CG defensiveness and ideological framework, such that it focuses only on individual rather than organizational behaviour.

3.2.2. Stakeholder theory

This theory was first put forward by Freeman in the 1980s (Freeman, 1984; Freeman and Reed 1983), and then refined by Freeman and various collaborators over the next 30 years (see, e.g., Freeman et al., 2010). Freeman (1984) suggested that the firm is accountable for creating wealth for owners. He developed the theory to address the interests of a wider range of stakeholders and to protect the interests of other non-financial stakeholders. According to stakeholder theory, managers should seek to balance the interests of all stakeholders, where a stakeholder is anyone who has a "stake", or interest (including a financial interest) in the firm that affects the decision-making process and the outcomes of the firm. Based on those definitions, stakeholders may be either external or internal. Internal stakeholders are employees, managers and owners, while external stakeholders are

customers, shareholders, suppliers, creditors, government and society (de Chernatony and Harris, 2000). Moreover, Greenwood (2007) defined stakeholders as those who are located in the community and have the power to affect corporate activities or can be affected by corporate operations.

The rationale for managing firms in the interests of all stakeholders is that balancing stakeholders' interests is better for the firm strategically than maximizing shareholder wealth (Freeman, 1984). All stakeholders form part of a network within the organization to serve the business goals (Freeman, 1999). Freeman pointed out that the company has a binding fiduciary duty to put stakeholders' needs first and increase value for them, rather than just concentrating on increasing value for shareholders. The company's owners and managers must therefore consider the legitimate interests of those groups and individuals who can affect their activities. Post et al. (2002) asserts that the traditional role of organizations is to create wealth for all stakeholders.

Stakeholder theorists reject the three main propositions of the shareholder system and argue for the following: (1) all stakeholders have a right to participate in corporate decisions that affect them, (2) managers have a fiduciary duty to serve the interests of all stakeholder groups, and (3) the firm's objective should be to promote the interests of all stakeholders and not only those of shareholders (Freeman and Reed, 1983; Donaldson and Preston, 1995). Maak (2007) and Du et al. (2010) agree on the idea of a broader set of stakeholders, all of which are important, with no interest groups being dominated by others.

Stakeholder analysts argue that all people and groups with legitimate interests in participating in an enterprise must get the same benefits. Managers should develop relationships, inspire their stakeholders, and create communities where everyone strives to give their best to deliver the value the firm promises. Good relationship between stakeholders is the main reason for the success the firm (Friedman and Miels, 2002; Freeman et al., 2004).

Scholars such as Burchell and Cook (2006) and Cooper and Owen (2007) have extensively reviewed and supported this theory in order to explain the behaviour of an organization towards its stakeholders. However, other scholars such as Sundaram and Inkpen (2004) argue that stakeholders require management's attention. Conversely, Donaldson and Preston (1995) assume that all groups of stakeholders are involved in the business activities to obtain benefits.

To its critics, stakeholder theory seems to be both insufficiently articulated and weakly defended. With respect to the former, Orts and Strudler (2009) claim that there is no clear identification of the groups of stakeholders that should be considered. The groups most commonly identified are shareholders, employees, the community, suppliers, and customers. But other groups have stakes in the firm, including creditors, the government and competitors, and it makes a great difference where the line is drawn.

Regarding the latter, the concepts of stakeholder, stakeholder model, stakeholder theory, stakeholder management and stakeholder society are explained and used by various authors in very different ways, and supported with diverse and often contradictory evidence and arguments (Donaldson and Preston,

1995). Wheeler et al. (2002) argued that stakeholder theory incorporates sociological and organizational disciplines. Viewed thus, it is a broad theory derived from a combination of many subjects such as philosophy, ethics, politics, economics and law (Abdullah and Valentine, 2009).

Freeman and collaborators state that stakeholder theory is simply “the body of research ... in which the idea of ‘stakeholders’ plays a crucial role” (Jones et al., 2002). According to Norman (2013), stakeholder theory is best regarded as “mindset”, i.e., a way of looking at the firm that emphasizes its embeddedness in a network of relationships.

Stieb (2009) criticizes this theory, arguing that Freeman’s (1984) proposition focuses on the protection of the interests of all stakeholders and is aimed an unmerited transfer of decision-making power and wealth. The propositions of stakeholder theory can be divided into three main approaches, which are descriptive, normative and instrumental (Freeman, 1999; Jawahar and McLaughlin, 2001; Hendry, 2001). The descriptive approach plays a more informative role as it is concerned with real corporate actions with respect to a firm’s stakeholders and reports what is actually happening in the organization.

Donaldson and Preston (1995) argue that the descriptive aspect can be used as a guide by managers in order to ensure that corporations operate in such a way that all stakeholders benefit. The normative approach, which is supported by Freeman (1994), is central to stakeholder theory; this approach considers the ethical issues that an entity should take into account, regarding what is morally

right or wrong. The other two approaches rely on the decisions involved in the normative stage (Introna and Pouloudi, 1999).

Neville and Menguc (2006) argue that stakeholders' reactions are affected by management decisions on specific organizational behaviour, which can be viewed as either instrumentally or normatively motivated. Wood and Jones (1995) note that stakeholder theory is helpful for predicting stakeholders' actions as well as reactions. In addition, Mitchell et al. (1997) suggest that this theory is concerned with which groups of stakeholders deserve or require managerial attention.

3.2.3. Stewardship theory

Stewardship theory posits that managers are essentially trustworthy individuals and so are good stewards of the resources entrusted to them (Donaldson, 1990; Donaldson and Davis, 1991). Davis et al. (1997) provide an interesting explanation on the basis of stewardship theory: *“a steward protects and maximizes shareholders' wealth through firm performance, because by so doing, the steward's utility functions are maximized”*. The theory assumes that managers can be good stewards of corporations by acting in the best interests of their principals (Ramdani and Witteloostuijn, 2010). Therefore, the theory holds that there is no conflict of interest between managers and owners, and the goal of governance is to find the mechanisms and structure that facilitate the most effective coordination between the two parties (Donaldson, 1990). Under this theory, company executives are not motivated by individual goals, but rather are stewards whose motives are aligned with the objectives of their principals. Hence, managers are motivated to act in the best interests of their principals, to protect the

interests of the shareholders and to make decisions on their behalf, because their only objective is to create and maintain a successful organization that allows the shareholders to prosper.

Stewardship theorists argue that the performance of a steward depends on whether the structural situation facilitates effective action (Davis et al., 1997). The steward differs from the agent in that the steward is trustworthy and will make decisions in the best interests of the organization, whereas an agent needs to be incentivized or controlled to do this. This theory assumes that the behaviour of stewards is collective because they seek to attain the objectives of the organization and govern it through purely trust-based governance mechanisms (Joslin and Müller, 2016; Müller et al., 2016).

Stewardship theory is related to psychology and sociology. There are psychological factors that predispose the executive to becoming a steward. Some of these factors include having higher-order motivations, better disposition to identify with the objectives of the firm, valuing commitment and greater use of personal power as a basis to influence others (Davis et al., 1997). The psychological and situational characteristics of the principal and the manager are antecedents for their rational choice between agency or stewardship relationships (Davis et al., 1997).

According to this theory, the primary role of the board is to serve and advise, rather than to discipline and monitor, as agency theory prescribes (Arosa et al., 2010). The CEO chair is responsible for the fate of the corporation and has the power to determine strategy (Davis et al., 1997) without fear of countermand by

an outside chair of the board. CEOs can improve firm value when they simultaneously hold the position of chair of the board; contrary to agency theory, the stewardship theory suggests a positive association between CEO duality and firm performance (Ramdani and Witteloostuijn, 2010).

Proponents of stewardship theory focus on structures that facilitate and empower rather than those that monitor and control (Albrecht et al., 2004) and emphasize that corporate performance is more strongly linked to inside directors than to outside directors, as they work to maximize profit for shareholders. This is because inside directors understand the business; they have more knowledge of the firm's operating policies and day-to-day activities than outsiders (Booth and Deli, 1996; Hossain et al., 2000). They also govern better than outside directors and so can make superior decisions (Donaldson and Davis, 1991; Kiel and Nicholson, 2003; Nicholson and Kiel, 2007).

In sum, proponents of this theory contend that superior corporate performance will be linked to having a majority of inside directors (Anderson and Reeb, 2004; Arosa et al., 2010; Segaro, 2012; Rashid, 2015) to ensure more effective and efficient decision-making (Aduda et al., 2013).

3.2.4. Institutional theory

This theory is concerned primarily with an organization's interaction with the political and economic institutional environment, the effects of institutional pressures on the organization, and the incorporation of these expectations into organizational practices and characteristics (Dillard et al., 2004). It describes how

an organization adopts practices that are considered acceptable and legitimate within its organizational field (Scott, 1995; Hessels and Terjesen, 2010).

According to Scott (2008), institutional theorists consider the processes by which regulatory, normative and cultural cognitive structures are established as “authoritative guidelines” for social behaviour and address the formal and informal rules embedded in corporations.

Scott (1995) further elaborates the three institutional mechanisms mentioned above (developed in DiMaggio and Powell, 1983) as three distinct pillars of the institutional context: regulatory (corresponding to coercive pressures), normative (related to normative pressures), and cognitive (referring to the concept of mimetic pressures). Through their response to coercion, compliance with norms and imitation, organizations demonstrate structural and procedural isomorphism, which is defined as “*a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions*” (DiMaggio and Powell, 1983, p.149).

The organizations embedded in the same environment are believed to become similar as they respond to similar institutional conditions. The constraining process reflects the adaptation of an institutional practice by the organization (Dillard et al., 2004). Institutional isomorphism leads to the acquisition of legitimacy, and thus promotes the survival and success of organizations (Michailova and Ang, 2008). Institutional theory does not consider legitimacy as a commodity to be possessed or exchanged, as it is interpreted in the bourgeois perspective of political economy theory. Instead, legitimacy is regarded

as a condition reflecting compliance with regulations or market competition, normative support, and cultural alignment (Scott, 1995, p.45). Organizations compete not just for resources and customers, but also for political power and institutional legitimacy (DiMaggio and Powell, 1983).

Institutional researchers have criticized agency theorists by showing how politics shape CG (Roy, 1999) and that national diversity reflects various institutional constraints stemming from coercive political regulation (Roe, 1997). Where institutional environments are nationally distinct, similar processes drive CG practices to become more similar within countries and to differ across countries.

Nevertheless, some scholars criticize institutional theory for the lack of explicit attention to the strategic behaviour that organizations employ in direct response to the institutional processes that affect them (Hung, 1998). Institutional theory leans toward an oversocialized perspective of organizational behaviour that is abstracted from the conflicts and coalitions between stakeholders at the firm level (Aguilera and Jackson, 2003).

3.2.5. Resource dependence theory

This theory is one of the most influential theories in organizational theory and strategic management (Hillman et al., 2009). It states that the ways in which organizations act are associated with their level of dependence on various resources (Pfeffer and Salancik, 2003). Pfeffer and Salancik (2003, p.1) posit that *“to understand the behavior of an organization you must understand the context of that behavior—that is, the ecology of the organization”*.

According to this theory, organizations interact with their environments and attempt to reduce dependency on certain resources. Organizational power, from this perspective, arises from the ability to cope with and minimize uncertainty, the control over scarce resources, and the substitutability of the controlled resources (Pfeffer and Salancik, 2003; Hillman et al., 2009).

Under resource dependence theory, a board of directors with high levels of links to the external environment would be expected to improve a company's access to various resources, thus improving CG and firm performance (Jackling and Johl, 2009).

The management literature views the board of directors as a potentially important resource for companies, and thus supports a resource dependence theory of CG (Nicholson and Kiel, 2007; Jackling and Johl, 2009). The board of directors can collectively bring to the executive management team environmental linking relationships, knowledge, financial resources or information that reduces uncertainty and adds power to the organization (Bryant and Davis, 2012). In this vein, Hillman et al. (2000) and Palmer and Barber (2001) conclude that the board of directors' main role is to be resource-providers, especially in terms of the association with the external environment.

Previous studies framed in this theory have focused on board size and composition as indicators of the board's ability to provide critical resources to the firm. Organizations need diverse boards in order to get the four types of resources: (1) advice and counsel, (2) legitimacy, (3) channels for communicating information between the firm and external organizations, and (4) assistance in

obtaining resources from important elements outside the firm (Pfeffer and Salancik, 1978; Lynall et al., 2003). This ability flows from larger rather than smaller sized boards (Zahra and Pearce, 1989; Jackling and Johl, 2009).

The positive relationship between board size and firm performance is confirmed by, among others, Hillman et al. (2009), Elsayed (2011), Tanna and Nnadi (2011), Adams and Mehran (2012), Aebi et al. (2012), and in the meta-analysis performed by Dalton et al. (1998). Table 3.1 illustrates the comparisons between CG theories.

Table 3. 1: Comparison between CG theories and implications for boards

Theory	Role of board	Implications for board
Agency	Managerial control	Independent boards are a mechanism for shareholders to retain ownership control rights and monitor performance.
Stewardship	Managerial empowerment	The board controlled by management is authorized and manages corporate assets responsibly.
Stakeholder	Serve and maintain interests of all stakeholders	Achieving benefits for all stakeholders is the board's main objective.
Resource dependence	Search for external resource	Board with high levels of links to the external environment would improve a company's access to various resources.
Institutional	Formulate and disseminate corporate goals and policies.	The board of directors is a technical instrument, designed as means to definite goals and partly adaptive vehicles shaped in reaction to the influences and constraints from the external environment.

3.3. Corporate Governance mechanisms

CG mechanisms are designed to:

- Monitor management, so as to align managers', shareholders' and other stakeholders' interests
- Mitigate information asymmetry problems
- Advise on certain issues
- Secure resources

There are several criteria used to classify CG mechanisms. Jensen (1993) identifies control markets, political and regulatory systems, the industry and the internal control systems. Gillan (2006) and Brown et al. (2011) distinguish between internal and external mechanisms. According to Denis (2001) and Allen and Gale (2001), examples of internal mechanisms are:

- The board of directors
- Other committees that support the board of directors (such as the Audit, Risk or Remuneration Committees)
- The ownership structure
- The remuneration scheme

Examples of external mechanisms, as stated by Brown et al. (2011) are:

- Regulatory and prudential framework
- Industrial regulation
- Blockholders
- Stock markets

However, there is no clear distinction between those mechanisms since the same issue (e.g. ownership structure) can be considered as an internal or an external factor (Brown et al., 2011).

In addition, there have been lively debates over the transferability of best practices (Aguilera and Jackson, 2003) and academics have not yet fully identified the main national differences in CG and how they should best be conceptualized (Shleifer and Vishny, 1997; Thomsen and Pedersen, 2000). Moreover, Claessens and Yurtoglu (2013) posit that there is a narrow definition of CG focused on the rules in capital markets governing equity investments in publicly listed firms, including listing requirements, insider dealing arrangements, disclosure and accounting rules and protections of minority shareholder rights. In the arena of finance, this CG definition covers the protection of minority rights, the strength of creditor rights and their enforcement, and the composition and rights of the executive directors, among others.

When considering CG from a cross-country perspective, the questions arises of whether the CG framework extends to rules or institutions. From one point of view, prevalent in the Anglo-Saxon countries, the framework is determined by rules and, thus, by markets and outsiders. In much of the rest of the world, banks and insiders are thought to determine the actual CG framework. In fact, both institutions and rules evolve over time and are endogenous to other factors and conditions in the country (Claessens and Yurtoglu, 2013).

Our research project is focused on two CG mechanisms, namely, the Shariah board and the ownership structure.

3.4. Literature on bank governance and performance

CG in the banking industry is a research issue that deserves further attention (Claessens and Yurtoglu, 2013). Banks are different from other companies in that they have special features that intensify governance problems and might reduce the effectiveness of standard governance mechanisms. Moreover, some authors (Grove et al., 2011) posit that CG practices may not be particularly effective at mitigating agency conflicts.

The first characteristic that sets the governance of banks apart from that of other non-financial firms is that banks have higher leverage than non-financial firms, because the bank's capital resources come from the depositors and debtholders. Gornall and Strebulaev (2018) show that the average leverage of US banks over eight years, measured as the ratio of debt to assets, is between 87%–95%, whereas the average leverage of US non-financial companies is in the range of 20%-30%.

The conflicts of interest between shareholders and debtholders in the presence of high leverage interact with the equity governance (John et al., 2016). The that top management is very closely aligned with equity interests in banks and they will have strong incentives to undertake high-risk investments, even those investments that lack positive net present value (Fahlenbrach and Stulz, 2011).

The second attribute that makes bank governance different from that of other non-financial companies is the unique nature of banking operations and assets. They perform complex financial operations where the underlying assets are difficult to identify and the risk and profitability associated with the investment difficult to estimate. Moreover, some academics claim that banks' operations are opaque and complex (Mehran et al., 2011). As such, the asymmetry of information in the context of banking makes it more difficult for equity holders to control managers and for debtholders to control banks from shifting risk from shareholders to debtholders. This difficulty of monitoring exacerbates agency costs. Complexity makes it harder to design effective incentive contracts (John et al., 2016; Levine, 2004).

In addition, banks have a wider variety and a greater number of stakeholders than in the non-banking industry, since not only investors, but also depositors, standard setters, policy makers, regulatory and prudential bodies have a direct interest in bank performance. Hence, in the European Union, banks are considered as Public Interest Entities because of their economic impact. Their systemic characteristics entail an elaborate array of accounting, taxing, financing and prudential regulations that, in some cases, overlap. Moreover, in some countries, governments own banks. The diversity and strong degree of enforcement of these

regulations makes it more difficult for stakeholders to have control over the bank's management.

The role of regulators might not be neutral; indeed, they might act in their own interests and intervene in the bank's operations, which could create more governance problems. Besides this, regulatory oversight is itself an active monitoring force and limits the incentives for boards from blockholders to monitor (Grove et al., 2011).

Within the range of regulatory changes, CG practices in the banking industry have received heightened attention in recent years (Liang et al., 2013). The OECD Steering Group on Corporate Governance argues that board failures in financial firms are a major cause of the financial crisis (Adams and Mehran, 2012). Indeed, banking regulators and central banks have stressed the need for effective CG practices in the banking system because failures and weaknesses in bank governance contribute to the development of financial crises (Basel Committee on Banking Supervision, 2010). The Sarbanes-Oxley Act of 2002 (SOX hereafter) and the financial market crisis have influenced the board structure-bank performance linkage (Pathan and Faff, 2013).

Prior studies on CG in the financial industry show that weak governance has a detrimental impact on financial companies' performance and valuation, and also influences their opportunistic manipulation of earnings (Caprio et al., 2007; De Andres and Vallelado, 2008; Cornett et al., 2009; Grove et al., 2011; Erkens et al., 2012; Fahlenbrach and Stulz, 2011). However, Diamond and Rajan (2009) find that firms with weaker CG quality may not implement adequate incentives and

controls that can increase shareholder value. As a result, financial firms will not find it advantageous to improve the quality of their governance if it does not help them to better identify project risk and potential return.

Conversely, there is also a large number of studies reporting that firms with strong CG mechanisms are generally associated with better financial performance, higher firm valuation and higher stock returns; for example, a more independent board, a higher pay-for-performance sensitivity and an increase in insider ownership is positively related to banks' crisis performance (see e.g., Gompers et al., 2003; Cremers and Nair, 2005; Core et al., 2006; Bhagat and Bolton, 2008; Bebchuk et al., 2008; Brown and Caylor, 2009; Chhaochharia and Laeven, 2009; Renders and Gaeremynck, 2012; Ammann et al., 2011). Peni and Vähämaa (2012) analyse 62 individual publicly traded US commercial banks included in the S&P 1500 index for the fiscal years 2005–2008, finding that banks with stronger CG mechanisms were associated with higher profitability in 2008. Akhigbe and Martin (2006) report that improvements in certain governance characteristics as a result of SOX in 2002 are associated with higher valuation of financial companies and reduced risk measures. Erkens et al. (2012), focusing on the 2007–2008 period, document that greater board independence and larger institutional ownership of financial firms is related to lower stock returns.

The role of CG in the banking industry has also been examined (e.g. Mishra and Nielsen, 2000; Hanazaki and Horiuchi, 2003; Pacini et al., 2005; Sierra et al., 2006; Caprio et al., 2007; De Andres and Vallelado, 2008; Cornett et al., 2009; Jiraporn and Chintrakarn, 2009; Laeven and Levine, 2009; and Cooper, 2009). Consistent with the literature on non-financial firms, these studies demonstrate

that strong CG has positive effects on the financial performance and stock market valuation of banks. More generally, the prior studies indicate that the same CG attributes that affect non-financial firms are also relevant in bank governance.

Furthermore, the relationship between CG and bank risk-taking has been examined, revealing that risk measures of financial firms vary inversely with the strength of CG; studies suggest that banks with strong governance attributes may take more risk (Pathan, 2009; Fortin et al., 2010; Akhigbe and Martin, 2008). Nevertheless, it is also conceivable that better CG practices may fail to improve the performance of financial firms because either the projects are riskier or the costs of implementing good governance exceed the market value benefits (Beltratti and Stulz, 2012; Fortin et al., 2010; Pathan, 2009).

3.5. Prior studies on CG in Islamic banks

The Shariah board is a central component of the governance system in Islamic banks. It is an independent board that monitors and audits all financial transactions to ensure that are in conformity with Shariah law (Quttainah, 2013). The integration of the Shariah Supervisory Board within the governance structure of Islamic banks is aimed at improving the reliability, legitimacy and financial performance of the banks that comply with Shariah principles (Saida, 2015; Alnasser and Muhammed, 2012; Quttainah, 2013). Thus, Shariah-compliance in Islamic institutions triggers a new principal-agent relationship between managers and stakeholders other than shareholders. Accordingly, several main agency costs can be identified:

- a) Divergence of principal-agent interests: Muslim customers and other stakeholders make investment and financing transactions with the Islamic bank on the basis that the bank is a Shariah compliant institution. Managers (agent) might pursue their own interests and settle transactions that are more profitable but do not comply with Shariah principles, while stakeholders are acting under the understanding that they are interacting with an Islamic institution. As Hasan (2009) states, the success of the Islamic financial industry relies on all stakeholders' belief that all components of the financial system comply with Shariah principles and rules.
- b) b. Information asymmetry: Managers have access to all internal information related to the financial services delivered by the bank, while the stakeholders lack the information concerning the Shariah-compliance of those financial products. Since managers are the only ones who are entitled to access the financial information, if the agent's incentives are not aligned with those of the principals, the managers who control the assets of the firms may choose to satisfy their personal ambitions rather than those of shareholders and other stakeholders (moral-hazard problem).

To mitigate these agency costs, the Shariah Governance System might adopt different structures. At the macro level, a Shariah Committee is set up to rule, monitor and oversee the Shariah-compliance of all Islamic institutions; an example is the model established in Malaysia. At the micro level, every Islamic bank has to implement a Shariah Board that commonly fulfils the following duties:

- Endorsing Shariah-compliant proceedings

- Monitoring to ensure that all financial services and products delivered by the bank comply with Shariah principles
- Advising the bank on Shariah issues
- Advising the customers about the Shariah-compliance concerns

However, there is lack of homogeneity in the Shariah Governance Systems across countries and several approaches, such as interventionist or minimalist, have been identified (Al-Azizah, 2017). Hasan (2011) reveals that there are differences in Shariah governance among Malaysia, GCC countries and the UK. He identifies shortcomings and weaknesses based on commitment to Shariah governance, regulatory framework, independence, competence and disclosure. Grassa (2013) has identified some differences between the Shariah Supervisory System in SA and GCC countries. She recommends in her study that Islamic institutions need to be more effective in establishing a good Shariah governance system. Abu-Tapanjeh (2009) provides a comparative analysis of the OECD and the Islamic principles of CG. He concludes that the OECD principles have been successfully implemented and are a more effective tool than the Islamic rules, which present wide diversity and are not well enforced.

The Islamic finance literature lacks empirical studies that specifically address the impact of the Shariah board characteristics on bank's performance. Table 3.1 summarizes prior empirical studies about CG in Islamic banks. Two studies have mainly focused on the comparison between Islamic vs Conventional banks: Grassa and Matoussi (2012) have compared governance structures between

Islamic banks (62 Islamic banks in GCC countries and 28 Islamic banks in Southeast Asian countries) and conventional banks (85 banks located in the same countries) over the period 2000-2009. The study reveals that Islamic banks are more profitable than conventional banks. However, they did not find clear evidence to confirm or reject the efficiency of the Shariah board structure in improving the Islamic bank's performance. The comparative study by Quttainah et al. (2013) concludes that Islamic banks are less likely to conduct earnings management compared with conventional banks. In addition, they find that several Shariah board characteristics (size and independence) are associated with earnings management.

Table 3. 2: Prior studies of Corporate Governance in Islamic banks

Study	Firms	Period of study	Methodology	Dependent variables	Conclusion
Matoussi and Grassa (2012)	90 large Islamic banks and 85 conventional banks	2000- 2009	Regression analysis	ROA ROE	Islamic banks are more profitable than conventional banks The Shariah Supervisory Board characteristics do not affect the financial performance of Islamic banks
Quttainah et al. (2013)	82 Islamic banks and 82 conventional banks from 15 countries	1993-2008	Regression analysis	Abnormal loan loss provision	Islamic banks are less likely to conduct earnings management compared with conventional banks Several Shariah board characteristics (size and expertise) are associated with earnings management.
Daly and Frikha (2015)	42 Islamic banks in Gulf countries and 25 Islamic banks in Southeast Asian countries	2004-2014	Regression analysis	ROA ROE	Board's fee, CEO duality and the bank's age are positively related to performance Shariah board characteristics are not associated with performance
Mollah and Zaman (2015)	147 Islamic banks in 25 countries	2005-2011	Regression analysis	ROA ROE Tobin's <i>Q</i>	Shariah boards positively influence banks' performance Board structure (size, independence, and CEO power) in Islamic banks negatively affects bank performance

Other studies have been performed over a whole sample of Islamic banks. Daly and Frikha (2015) analyse 42 Islamic banks in GCC Countries and 25 Islamic banks in South Asian countries to investigate the effect of CG variables on banks' performance by means of regression analysis. They conclude that the board's fees, CEO duality, and the bank's age have a positive relationship with the bank's performance. On the other hand, they find that Shariah board characteristics do not have any impact on the variable of interest. Mollah and Zaman (2015) find that Shariah boards significantly influence the firm's performance and they also conclude that board structure (size and independence) and CEO power in Islamic banks negatively affect bank performance.

As can be concluded from Table 3.3., empirical evidence on CG in Islamic banks is scarce and inconclusive. Therefore, we rely on the previous CG research on conventional banks to develop our research questions. Following, we present the literature covering the characteristics of the board of directors and firm performance in the conventional banking industry to support our research questions.

3.6. Literature review and research hypotheses related to Shariah board characteristics

As stated above, several theories have addressed the complex relationships among managers, owners and other stakeholders, such as the agency, stewardship, stakeholder, institutional or resource dependence theory, among others.

Although none of the abovementioned theories has received definitive empirical support (Markarian and Parbonetti, 2007), we frame our investigation within agency theory, the main stream of CG research. Nevertheless, we believe that several approaches can explain the observed empirical behaviour reported in this investigation.

The Shariah board is a unique governance body that is implemented solely in Islamic financial institutions. In addition, the implementation of CG codes is recent and uneven across countries embracing Islamic financial institutions. Therefore, although there is a novel stream of research addressing Islamic banking, empirical evidence on Islamic CG and, more specifically, on the impact of Shariah boards on banks' performance is scarce (Mollah and Zaman, 2015) and contradictory. Therefore, the impact of the Shariah governance system on banks' performance deserves further attention. To that end, we rely on CG literature on conventional banks.

According to agency theory (Jensen and Meckling, 1976; Fama, 1980; Fama and Jensen, 1983), the primary role of the board is to reduce agency costs resulting from the separation of ownership from control by overseeing managerial decisions and activities, and to align their interests with those of shareholders. Hence, the board of directors is the core CG body of any organization. It constitutes the competent corporate body for adopting, implementing and monitoring strategic objectives and policies (Staikouras et al., 2007). The structure of the board differs from country to country (Mülbart, 2009). The two most important roles of a board of directors are the monitoring and advisory functions. Under the former, the board supervises the managers to ensure that their behaviour is in line with the interests

of the shareholders (De Haan and Vlahu, 2015). Under the latter, the board helps to design the strategy of the company but also helps secure resources through its social networks. In this vein, Mishra and Nielsen (2000) demonstrates that foreign CEOs are more efficient, while other studies show that they have a positive impact on the firm's strategy (Ramaswamy and Li, 2001).

Board size and composition constitute two of the most prevalent CG factors, attracting extensive theoretical and empirical attention. Researchers have emphasized the influence of the size and the composition of the board of directors on bank performance (Staikouras et al., 2007). Following, we present a review of the most relevant contributions addressing board characteristics in the banking industry to provide support to our research questions.

3.6.1. Board size and bank performance

The optimal size of the board of directors and its influence over the firm's performance has been widely addressed in the CG literature but it still remains a controversial issue.

According to Jensen (1993), a small board is more effective than a large board since it can play a better monitoring role, as well as exercising an effective control over agency costs (Peiró and Gracia, 2017). Additionally, Pathan et al. (2007) suggest that larger boards are liable to increase agency as well as "free-rider" problems..

In addition, smaller boards are said to be more effective because decision-making costs are lower in smaller groups. However, the empirical studies that

address the relationship between board size and firm performance reveal both negative (Eisenberg et al., 1998; Staikouras et al., 2007; Pathan et al., 2007; Huang, 2010; Pathan and Faff, 2013; Mollah and Zaman, 2015) and positive associations (Malik et al., 2014; Tanna and Nnadi, 2011; Adams and Mehran, 2012; Aebi et al., 2012).

Dalton et al. (1998) summarize prior literature by applying a meta-analysis to 27 published studies, concluding that larger boards are associated with better financial performance in firms.

In the banking industry, boards tend to be bigger and more independent than those in the non-financial sector (Booth et al., 2002; Hayes et al., 2004; De Andrés et al., 2012). The main argument for the bigger size is that CEOs of complex and opaque operations may need more advice on their many segments and benefit from the experience of larger boards.

Table 3.4 summarizes prior studies on board size and bank performance. There is extensive evidence from common-law countries, such as the US, the UK and Australia. Some research papers demonstrate that bigger boards positively impact banks' performance (Adams and Mehran, 2012) and efficiency (Salim et al., 2016). However, other studies conclude that the association between the two variables of interest is concave (Grove et al; 2011), positive (Aebi et al., 2012) and negative (Wang. et al., 2012; Pathan and Faff, 2013).

Table 3. 3: Empirical studies that address the relationship between board size and firm performance in the banking industry

Author	Firms	Period of study	Methodology	Dependent variables	Conclusion
Staikouras et al. (2007)	58 large European banks	2002-2004	Regression analysis	ROA ROE Tobin's Q	Negative relationship
Pathan et al. (2007)	Local Thai commercial banks	1999–2003	Regression analysis	ROA ROE	Negative relationship
De Andres and Vallelado (2008)	69 large banks from six countries	1995-2005	Regression analysis	Tobin's Q Shareholders' Market Return	Inverted U- shaped relationship
Gust (2009)	2746 UK listed firms	1981-2002	OLS Fixed effects GMM	ROA Tobin's Q Share return	Non-significant relationship
Grove et al. (2011)	236 US banks	2005-2008	Regression analysis	Future excess ROA Nonperforming assets ratio	Inverted U- shaped relationship
Aebi et al. (2012)	All banks available in the COMPUSTAT Bank North America database	2006-2008	Regression analysis	Buy-and-Hold returns ROE	Positive relationship
Huang (2010)	41 commercial banks in Taiwan	1996-2006	Regression analysis	ROA ROE	Positive relationship
Ramadani and Witteloostuijn (2010)	Companies listed on the stock exchanges in four East Asian countries (Indonesia, Malaysia, South Korea and Thailand)	2001-2002	Quantile regression	ROA	Negative relationship

Table 3. 4: Empirical studies that address the relationship between board size and firm performance in the banking industry (Cont.)

Author	Firms	Period of study	Methodology	Dependent variables	Conclusion
Tanna and Nnadi (2011)	17 banks operating in the UK	2001-2006	DEA analysis	Technical efficiency Scale efficiency Allocative efficiency	Positive relationship between board size and bank efficiency
Mangena et al. 2012	Zimbabwe Stock Exchange (ZSE) listed firms	2000-2005	GMM model	Tobin's Q ROA	Positive relationship
Adams and Mehran (2012)	35 Bank Holding Companies in the US	1986-1999	Regression analysis	Tobin's Q	Positive relationship
Wang et al. (2012)	68 Bank Holding Companies (BHCs) in the US	Statement in 2007	DEA analysis Regression analysis	Capital Adequacy Asset Quality Earnings Liquidity	Negative relationship
Pathan and Faff (2013)	Top 300 large US bank holding companies	1997-2011	Regression analysis	Tobin's Q ROA ROE Net interest margin Pre-tax operating income Stock return	Negative relationship
Liang et al. (2013)	50 largest Chinese banks	2003–2010	Regression analysis	ROA Pre-provision profit. ratio ROE Nonperforming loan ratio The net charge-off ratio	Negative relationship
Mamatzakis and Bermpli, (2015)	23 US listed investment banks	2000-2012	GMM model Dynamic panel threshold model	ROAA ROAE Profit efficiency (EFF) Pre-tax operating income (POI)	Negative relationship
Salim et al. (2016)	11 Australian banks	1999-2013	DEA model	Technical efficiency	Positive relationship

In Europe (Table 3.4), mixed results are also reported for the impact of the board's size on the bank's performance. Staikouras et al. (2007), using a sample of 58 large European banks over the 2002-2004 period, finds that bank profitability is negatively related to the size of the board of directors, but De Andres and Vallelado (2008) report a concave relationship. Tanna and Nnadi (2011) report a positive association between board size and performance in 17 UK banks.

In Asia, Pathan et al. (2007) reveal a negative association between board size and performance in local Thai commercial banks over the period 1999-2003. Similar conclusions are offered by Wang et al. (2012), Pathan and Faff (2013), Liang et al. (2013), Pathan and Faff (2013) and Mamatzakis and Bermpli (2015). Conversely, Adams and Mehran (2012), Aebi et al. (2012), Mangena et al. 2012 and Salim et al. (2016) report a positive sign.

Finally, some authors report an inverted U-shaped relationship (De Andres and Vallelado, 2008; Grove et al., 2012), while others find a non-significant relationship (Gust, 2009).

Salim et al. (2016) find a positive relationship between board size and bank performance. They suggest that larger boards bring more knowledge into the decision-making and supervisory process. This result is in line with agency theory and stewardship theory.

Regarding Shariah board size, as discussed in the preceding chapter, the minimum recommended by the standard-setter associations (AAOIFI and IFRS)

and regulatory bodies (such as the Bank Negara Malaysia) is three members, but the size may differ across countries and financial institutions.

Prior empirical research on Shariah board size and Islamic banks reveals a positive relationship between SSB size and bank performance (Alman, 2012; Li et al., 2014; Mollah and Zaman, 2015; Farag et al., 2018 and Nomran et al., 2018). Other researchers do not find any relationship between SSB size and bank performance (Matoussi and Grassa, 2012; Daly and Frikha, 2015).

In all, prior literature reports both linear and non-linear relationships (De Andres and Vallelado, 2008; Grove et al., 2011) and heterogeneous conclusions; a plausible explanation for this is the use of different measures of firm performance. Therefore, we posit the following null hypothesis:

H1 = Shariah board size does not impact Islamic banks' performance

3.6.2. Board activity and bank performance

One of the most common board characteristics linked with performance is the intensity of the board activity, as measured by the frequency of board meetings (Jackling and Johl, 2009). One of the important duties of the board of directors is to arrange and attend periodic meetings during the year. This is considered the basic method for the directors to collect information, make decisions and monitor the management (Principle 3, Basel Committee on Banking Supervision, Guidelines: Corporate governance principles for Banks, 2014).

These meetings are also considered as an opportunity for board members to get to know each other and discuss matters relating to the organization, any problems they may face and how to solve them and prepare plans and strategies for the future development of the organization, all of which will be reflected in the performance. The active boards have good opportunities to transfer information to society (Rodrigues et al. 2017).

Hence, some researchers consider that the complexity of banking operations requires a more active board, with the number of board meetings thus being a good indicator of the quality of the board's work, which in turn will mean increased supervision of the top management (De Andres and Vallelado, 2008; García-Meca et al., 2015; Liang et al., 2013). However, the evidence reported is sometimes weak (Grove et al., 2011). Conversely, in some cases, frequent board meetings are associated with poor performance (Vafeas, 1999; Jackling and Johl, 2009). Vafeas, (1999), using financial data from a sample of 307 firms between 1990 and 1994, establishes that the annual number of board meetings is inversely related to firm value. It is worth noting that this result is driven by increases in board activity following a drop in the share price.

Agency and stewardship theories suggest that board meeting frequency is correlated with challenges, firm earnings and market performance (Hermalin and Weisbach, 2001). Frequent board meetings may be a signal of a proactive board. The more frequent the meetings, the greater the supervision of the top management and the more relevant the advisory role, which might improve firm performance (Liang et al., 2013).

In Islamic banks, the Shariah board meets regularly to carry out periodic reviews to monitor Shariah compliance of general bank operations. However, as and when necessary, the Shariah board can hold a meeting if the bank urgently requires its advice and opinion on Shariah-related matters (IFSB-10, December 2009. Guiding Principles on Shariah Governance Systems for Institutions offering Islamic Financial Services).

As far as we are aware, only one study (Shittu et al., 2016) has addressed the relationship between Shariah board meetings and bank performance, finding a positive effect. Accordingly, the following null hypotheses is formulated:

H2: Shariah board meetings do not affect Islamic bank's performance

3.6.3. Shariah board education and bank performance

According to the human capital theory (Becker, 1964), the organization can benefit from a person's stock of education, experience, and skills. In this vein, the OECD Corporate Governance Principles (Principle VI.E.3) states that "*board members should be able to commit themselves effectively to their responsibilities*". This principle suggests that board members must have a high level of education and experience in their area of specialization to be able to manage the business properly. In consequence, the firm should recruit board members with a high level of education.

The existing literature on the association between the educational backgrounds of those in the upper echelons of the firm and the firm's financial performance is largely dominated by US studies (Darmadi, 2013). Cheng et al.

(2010) show that university degrees held by the board chairman are positively associated with firm performance.

King et al. (2016) find that CEO educational attainment, level and quality positively affect bank performance. They argue that a board member with higher education has the ability to appropriately deal with any action. Berger et al. (2014) suggest that the age, gender, and education of the executive team on the board jointly affect the variability of bank performance. Directors' qualifications may influence bank performance, as a higher educational level leads to better judgments on an investment strategy and thus, to better corporate decisions (Fernandes et al., 2017). This is particularly important in the case of banks because the complexity of their activity often requires a great deal of specific knowledge.

In the case of Islamic banks, although regulation and enforcement might be different across countries, the Shariah board is commonly composed of qualified Shariah scholars and experts in business, finance and accounting. Anyone who wants to work as a member of a Shariah board should have strong skills and extensive experience in the field of accounting and finance (IFSB-10, Guiding Principles on Shariah Governance). However, the minimum academic level required is not specified.

Nomran et al. (2018) and Farook et al. (2011) argue that Shariah board members with a doctorate degree in finance and a religious degree have a positive effect on the performance of the organization. The main reason for this is that the Shariah board member will analyse the operations of the bank from a religious and

accounting point of view and, accordingly, he will write the annual report and submit it to the board in an appropriate way.

Hence, in accordance with the human capital theory and prior results, we expect a positive association between the average educational level of Shariah board members and the Islamic bank's performance. Therefore, we explore the following hypothesis in its null form:

H3: Shariah board members' education does not impact Islamic banks' performance

3.7. Literature review and research hypotheses related to Islamic banks' ownership structure

Within the good governance literature, one of the main streams of research focuses on the ownership structure. According to Claessens and Yurtoglu (2013), the nature of the CG challenges strongly depends on the countries' overall development and institutional environment, and specifically on prevailing ownership structures. Thus, the nature of a firm's agency problems is influenced by the ownership structure (John and Senbet, 1998; De Haan et al., 2016).

In the Anglo-Saxon countries, under the common-law legal system, investors are strongly protected (Porta, 1998). In those countries, such as the US, the UK, Canada or Australia, the stock markets are well developed and big companies are traditionally *public* companies, with their equity funds spread across a large number of shareholders. In this case, when a company is owned by numerous small shareholders, the traditional principal-agent conflicts of interest

arise, and monitoring managers can be difficult and costly for the firm. In this scenario, the board of directors' main role is to safeguard shareholders' interests and reduce agency problems by monitoring managers.

The main characteristics of the European continental model are that investors have lower institutional protection (Leuz et al., 2003), stock markets are less developed than those of the Anglo-Saxon countries (Millar et al., 2005) and firm ownership is highly concentrated (Cuervo, 2002).

Those shareholders with a high proportion of shares (at least 5% of a firm's outstanding shares), known as *blockholders*, often have a strong presence in the board of directors and can play an active monitoring role (Shleifer and Vishny, 1997). Under the agency framework, higher block ownership facilitates active participation in the decision-making process because such shareholders can use their influence to elect the board of directors and mitigate agency costs for several reasons: First, they have more incentives to do so because they are risking big investments (Cernat, 2004). Second, they can be more effective at overcoming the free-rider problem caused by ownership dispersion. Third, by internalizing the benefits from monitoring in proportion to their own shares, their monitoring costs become lower (Grove et al., 2011).

Under the agency framework, the most relevant agency problems are those between the majority shareholders and the minority ones, also referred to as principal-principal agency conflicts. The main risk is faced by the minority shareholders, whose wealth can be expropriated by the majority owners (*tunnelling* effect) through dividend policies or aggressive public offerings.

Porta et al. (1998) document that except for US and UK companies, where the ownership is widely dispersed and the shareholder protection is high, firms exhibit a high degree of ownership concentration.

In some countries, such as Spain, the main blockholders are institutional investors. Small shareholders enjoy less legal protection (Porta et al., 1998) and, therefore, their participation in the firm's ownership is through institutional investors (Faccio and Lang, 2002). Institutional investors have acquired an important role in the governance of companies (Ferreira and Matos, 2008; Ruiz-Mallorquí and Santana-Martín, 2009, 2011). The reason is that when such shareholders disagree with the board of directors' policies or strategies, they may sell off large amounts of shares, meaning that the company is faced with great losses.

Institutional investors participate in the governance of the company through two main mechanisms: They have the right to appoint the proprietary members of the board of directors (Boyd, 1994) and are one of the main mechanisms for controlling the executive team (Gillan, 2006). In addition, they actively participate in the governance of the companies, becoming one of the most active stakeholders influencing firm performance (Jiao and Ye, 2013), leverage (García-Meca et al., 2013) or strategic decisions (Neubaum and Zahra, 2006), among others.

When the firm's ownership is concentrated in the hands of a few owners, the most relevant agency conflicts are those generated by the relationship between majority-minority shareholders (Shleifer and Vishny, 1997).

Ownership concentration is also common in SA companies, such as those located in Hong Kong, Indonesia or Malaysia, where the biggest shareholder owns, on average, 50% of the share capital. In India and Singapore this percentage is above 50%, while in South Korea, Taiwan and Thailand, those percentages are around 20%, 30% and 40%, respectively (Claessens and Yurtoglu, 2013; Bae et al., 2008; Khanna and Yafech, 2007; Bertrand et al., 2002).

Ownership concentration can generate two opposite effects: On the one hand, through the entrenchment effect, majority shareholders may expropriate minority shareholders. On the other hand, majority shareholders usually mitigate the information asymmetry problems because they either participate in the company's management or they invest time and resources in supervising the managers, since they are facing high investment risks (Claessens and Yurtoglu, 2013).

There are few studies that address the relationship between ownership and performance in the conventional banking industry. Iannotta et al. (2007) analyse a sample of 181 large banks from 15 European countries for the period 1999–2004, concluding that ownership concentration does not significantly affect banks' profitability. However, a higher ownership concentration is associated with better loan quality, lower asset risk, and lower insolvency risk. Busta et al. (2014) use GMM dynamic estimator on a sample of European banks over a 13-year period (1993–2005). They argue that this relationship is influenced by different institutional settings and report a negative effect of ownership concentration on bank value. Haw et al. (2010) analyse a sample of East Asian and Western European banks for the years 1990–1996. They conclude that banks with

concentrated control exhibit poorer performance, lower cost efficiency, greater return volatility, and higher insolvency risk relative to those with more dispersed control.

In sum, highly concentrated ownership seems to mitigate information asymmetry problems and ease the monitoring role of shareholders over the CEO or executive team. In particular, within the banking industry, disciplinary takeovers are rare, bank directors hold small equity stakes and bank directors are less aggressive than other directors in removing poorly performing managers. Therefore, the presence of majority shareholders might impact positively on the firm's performance. However, empirical evidence on the banking industry reports either negative (Haw et al., 2010) or non-significant results (Busta et al., 2014).

Following Grove et al. (2011), we consider block ownership as a mechanism to align the interests of managers and shareholders due to increased oversight. Thus, based on the majority shareholders' incentives to avoid risk and increase their investment profitability, we posit the following null hypothesis:

H4: The level of ownership concentration is not associated with Islamic banks' performance.

Some researchers have found that banking outcomes also worsen with state ownership. Mian (2003), using data for a large set of emerging economies, finds that state-owned banks report higher loan loss provisioning and achieve lower profitability than private banks. Micco et al. (2007) report that state-owned banks located in developing countries tend to have lower profitability and higher costs than their private counterparts. Cornett et al. (2010) show that state owned-banks

in 16 Asian countries operated less profitably and had greater credit risk than privately-owned banks prior to 2001, although this performance gap was largely closed after the Asian financial crisis.

In the same vein, Berger et al. (2005) find that the performance of state-owned banks in Argentina, measured by cost efficiency, was low in the 1990s, and improved considerably after privatization. Lin and Zhang (2009) report that, the ‘‘Big Four’’ state-owned commercial banks in China are less profitable, are less efficient, and have worse asset quality than other types of banks that involve some domestic or foreign private ownership. Erkens et al. (2012) analyse 296 bank holding companies in 30 countries during the crisis period (2008-2009), concluding that banks with high institutional ownership registered worse performance, measured through stock returns, during the crisis.

Therefore, based on consistent prior evidence, we test the following hypothesis:

H5: State ownership is not associated with Islamic banks’ performance.

Some studies indicate that banks with institutional ownership (banks, companies) and foreign shareholders do not perform better (Zouari and Taktak, 2014). However other studies (Agrawal and Knoeber, 1996; Barry, et al. 2011) found that institutional ownership don not effect on the performance.

Barry, et al. (2011) used 249 banks in 16 Western European countries in the period 1999-2005 to analyse the link between ownership structure and risk in both privately owned and publicly held banks. They found that, when a bank owns

another bank, the risk–return relationship and strategies are expected to be handled by the parent company and not by its subsidiary. They also conclude that, when bank owns another bank, it doesn't seem to impact on bank's performance.

Therefore, based on consistent prior evidence, we test the following hypothesis:

H6: Bank ownership is not associated with Islamic banks' performance.

In the following chapter, we perform the statistical analysis to confirm or reject our research questions.

CHAPTER 4

RESEARCH DESIGN, SAMPLE SELECTION AND DESCRIPTION OF THE DATA

4.1. Introduction

In this chapter, we present the research design used to test the research questions and the study sample.

We have developed a performance model that comprises the exploratory variables, that is, those variables related to the Shariah board and the ownership structure, and a set of control variables typically considered in the empirical literature.

Below, we describe the sample selection process and analyse the sample composition. Also, we review the main descriptive statistics for both the dependent and the explanatory variables. We also provide a test of means to identify statistically significant differences between those banks based in countries with a national Shariah board and those where there is no such body. Finally, a correlation analysis is carried out in order to assess possible problems that could appear in the estimation of the models.

4.2. Research design

Following prior studies, and in order to test our research hypotheses, the model that we use to test the influence of our variables of interest on bank performance is built as follows:

$$\begin{aligned} \text{Bank's Performance}_{it} &= \\ &= \alpha + \sum \beta_k \text{SB Characteristics}_{it} \\ &+ \sum \beta_k \text{Ownership structure}_{it} + \sum \beta_k \text{Control Variables}_{it} \\ &+ \text{Year}_t + \varepsilon_{it} \end{aligned}$$

where i goes from bank 1 to bank 93; t refers to years from 2011 to 2016; α parameter is the estimated coefficient for the constant; the β parameters are the estimated coefficients for the explanatory variables (variables of interest and control variables); $Year$ is the time effect; and ε is the stochastic error term.

4.2.1. Specification of the dependent variable

The dependent variable in our model is Bank performance. Archival research provides a wide variety of measures with which to assess performance. As depicted in Table 4.1, we have first employed the most common one, i.e. the market-based measure Tobin's Q ratio (Q). Q is the ratio of the firm market value to the replacement cost of its assets (Lindenberg and Ross, 1981). In an equilibrium situation, the Tobin's Q ratio has a value of one. If the ratio is above one, it stimulates investment and if the value is below one, the company offers less investment opportunities (Kim et al. 1993). Following prior research (Yermack

1996; Hermalin and Weisbach, 1991; Coles et al. 2008; De Andres and Vallelado, 2008; Belkhir, 2009; Adams and Mehran 2012; Erkens, et al.2012; Peni and Vähämaa 2012), we measure it as the book value of total assets minus the book value of common equity plus the market value of common equity divided by the book value of total assets.

Tobin's Q ratio

$$Q = \frac{(\text{Book Value Total Assets} - \text{Book Value Equity} + \text{Market Value Equity})}{\text{Book Value of total Assets}}$$

Martin (1993) states that profitability measures complement rather than substitute the *Q* ratio. Thus, to better illustrate the impact of Shariah board characteristics and ownership structure on bank performance, we have also used accounting-based approaches, such as *Return on Assets* (ROA) and *Return on Equity* (ROE). Financial accounting literature offers a wide range of measures of profitability where both the numerator and denominator are computed in several ways. We measure ROA as the net income divided by the total assets and, similarly, we estimate ROE as the net income divided by total equity (such as in Grove et al., 2011; Adams and Mehran, 2012; Aebi et al., 2012).

$$\text{ROA} = \frac{\text{Net Income}}{\text{Total Assets}}$$

$$\text{ROE} = \frac{\text{Net Income}}{\text{Total Equity}}$$

4.2.2. Specification of the Shariah Board characteristics

Shariah board size

Our exploratory variables related to the Shariah Board (Table 4.1.) are Shariah Board size (*SBS*) which consists of the total number of Shariah Board members (Grassa and Matoussi, 2014; Mollah and Zaman, 2015; Matoussi and Nomran et al. 2018). In addition, in order to test the presence of an inverted U-shaped (concave) relationship between board size and performance (De Andres and Vallelado, 2008; Grove et al. 2011), the model also comprises the squared variable *SBS*².

Shariah board members = Number of members of the Shariah board.

*Shariah board members*² = Squared number of members of the Shariah board.

Shariah board activity

Shariah boards are regularly convened to carry out monitoring and advisory functions. Shittu et al. (2016) report a positive relationship between Shariah board meetings and bank performance but Matoussi and Grassa (2012) failed to find any significant association between those two variables. We measured Shariah board activity (*SBM*) through the number of Shariah board meetings in a year.

Shariah board activity = Number of Shariah board meetings in a year.

Shariah board expertise

Shariah boards with more educated scholars might lead to a better interpretation of the operations in Islamic bank, and consequently better performance (Shittu et al. 2016; Hamza, 2016; Nomran et al. 2018). Following prior research, Shariah board expertise (*SBEDU*) is operationalized through the average education of its members, that is, the number of members who hold degree in the accounting and finance field divided by the total number of Shariah board members:

Shariah board average education = Proportion of members holding a degree in accounting and/or finance field.

4.2.3. Specification of the ownership structure

The second set of exploratory variables is related to ownership structure. First, we measure the ownership concentration, labelled *Control rate*, as the percentage of shares held by the largest shareholder.

Control rate = Percentage of shares held by the largest shareholder.

In order further explore the impact of the type of blockholder on the bank's performance, we employ the dummy variable *State* that equals 1 if the largest shareholder is a governmental entity and 0 otherwise (Mian, 2003; Berger et al.2005; Micco et al.2007).

State = Dummy that equals 1 if the largest shareholder is a governmental entity and 0 otherwise.

In addition, we use a dummy variable *Bank*, which equals 1 if the largest shareholder is a bank and 0 otherwise (Shleifer, 1998; Cornett et al. 2009).

Bank = Dummy that equals 1 if the largest shareholder is a bank and 0 otherwise.

4.2.4. Control variables

In analysing bank performance, we control for other potential determinants of the dependent variable, which we group in CG and macroeconomic variables.

4.2.4.1. Corporate Governance variables

According to agency theory (Jensen and Meckling, 1976) the main role of the board of directors are to monitor managers and align their interests with those of the shareholders. In this model, we control for board characteristics that impact firm performance in line with prior published results. In particular, as depicted in Table 4.1, we include the variable board size, labelled *BoDS*, and calculated as the number of board members; board activity measured through the number of annual board meetings (*BoDM*) and board independence, which is the proportion of non-executive members of the board (*BoDIND*).

Board size

Similar to Jensen's (1993) conclusions, some studies on the banking industry found that there is a negative relationship between board size and bank performance, suggesting that larger boards are liable to increase agency as well as 'free-riding' problems (Staikouras et al., 2007; Pathan et al., 2007; Pathan and Faff, 2013; Liang et al., 2013; Ramadani and Witteloostuijn, 2010; Mollah and

Zaman, 2015). However, prior studies found that there is a positive relationship between bank size and bank performance (Malik et al., 2014; Tanna and Nnadi, 2011; Adams and Mehran, 2012; Esayed, 2011; Aebi et al., 2012). In sum, although it seems clear that board size significantly influences firm performance (Nor and Zawawi; 2016) the sign and the optimal size remains elusive. Following prior researches, we control for the number of members of the board of directors.

Board members = Number of members of the board of directors

Board activity

One of the important duties of the board of directors is to arrange and attend periodic meetings during the year. This is considered their basic means of collecting information, making decisions and monitoring management. It also represents an opportunity for board members to get to know each other; to discuss organizational matters, the problems they may face and how to solve them; and to prepare plans and strategies to develop the organization in the future; all of which will be reflected in the performance. In this regard, some researchers consider that the number of meetings of the board is a good indicator of an effective board, which will improve the monitoring of the top management (De Andres and Vallelado, 2008; García-Meca et al., 2015; Liang et al., 2013). Nevertheless, Vafeas, (1999) demonstrates that frequent board meetings may lead to poor performance. Thus, we control for the impact of board activity on bank performance through the following variable:

Board activity = Total number of meetings per year

Board independence

Board independence is a central subject in governance research. Agency theory argues that independent, non-executive directors can monitor managers more efficiently and they have more incentives to protect shareholders' interests (Jensen and Meckling, 1976; Jensen, 1983; and Fama, 1980). Moreover, the literature on non-financial firms argues that outsiders, i.e. directors who have no direct financial, family or interlock ties with management, are considered to be more effective monitors of management because they are in theory less beholden to management (e.g. Hermalin and Weisbach, 2001). They also provide expertise and experience on different backgrounds that may be valuable for advisory roles. A potential disadvantage of outside directors is that they may lack relevant firm-specific information (Adams and Ferreira, 2007).

According to Adams and Mehran (2012), it is not clear what relationship we should expect between board independence and firm performance. On the one hand, firm performance should improve with independence as a measure of the monitoring intensity of the board. On the other hand, there may be costs associated with independence due to outside directors' lack of firm-specific knowledge. Hence, the relationship between performance and independence must ultimately be determined empirically. In European banks, this ratio is lower and differs from country to country, with a very low ratio of outside directors in German banks and a very high proportion in other countries such as the United Kingdom and the Netherlands (De Haan and Vlahu, 2015).

Conversely, stewardship theory (Donaldson, 1990; Donaldson and Davis, 1991) indicates that companies with boards dominated by insiders perform better than those dominated by outsiders. The reason behind is that inside directors are better informed and have more financial knowledge about their firms than outside directors, which will boost the performance of their firms (Ramdani and Witteloostuijn, 2010).

Despite the growing number of studies pointing out the significant association between independent directors and bank performance, the sign of the relationship remains unclear. Some studies report a positive effect, e.g. Pathan and Skully and Wickramanayake (2007) show that an increased proportion of independent directors positively affect local Thai banks' performance. Liang et al. (2013) used 50 large Chinese banks over the period 2003-2010 to prove that the board's independence has a positive effect on banks' performance and asset quality. Liu et al. (2015) found that independent directors have an overall positive effect on firm operating performance in China. On the contrary, some evidence indicates that there is a negative relationship between independence of the board of directors and bank performance (Aebi et al.; De Andres and Vallelado, 2008; Wang et al., 2012; Erkens et al., 2012). Finally, Chio and Hasan (2005) and Adams and Mehran (2012) do not find any significant effect on bank performance.

In addition, banking regulations and the legal system have a significant impact on the internal governance arrangements of banks, particularly on board independence.

We identify outsiders as those members of the boards that do not hold an executive position within the bank. In particular, we measure board independence as the proportion of non-executive members over the total number of members:

$$\text{Board independence} = \frac{\text{Number of non-executive members}}{\text{Total number of board members}}$$

4.2.4.2. Non-corporate governance variables of control

In addition to CG variables, we have also considered other factors that have been shown to be significantly associated with bank profitability. However, the literature about Islamic banks' performance is still in its relatively infancy compared to studies on conventional banks, and is not conclusive yet.

Bank variables

Based on data availability constraints and prior corroborated results, we employ the following set of bank control variables: Bank_size, calculated as the natural logarithm of total assets; Bank_age; the number of the years from establishment date to the current date; year and country.

Agency theory of the firm suggests that the actions and decisions of managers are skewed towards personal gain. This implies that the managers might seek to increase the size of the bank to gain more power and earn higher salaries without considering the impact of the company's growth on its profitability. According to this theory, bank size may have a negative influence on bank profitability. However, stewardship theory suggests that managers are good

stewards of the corporate assets because they are naturally trustworthy and not liable to misuse the firm's resources (Davis et al., 1997). De Andres and Vallelado (2008) and Adams and Mehran (2012) report a negative relationship between bank size and bank performance, thus corroborating the premises of agency theory. Conversely, Faff and Pathan (2013) found a positive relationship between the two variables, as stewardship theory predicts.

To reduce variability, we have measured total bank assets in its logarithmic form:

Bank size = Natural log of total bank assets in US\$ millions

As in prior literature (Dick, 2006; Matoussi and Grassa, 2012; Hamza, 2016) we also control for bank age:

Bank age = Number of years from the establishment date

In order to control for the bank's leverage (Bonin et al.2005; Iannotta et al.2007; Lin and Zhang, 2009; Aebi et al.2012; Berger et al.2016) the model also comprises:

$$\text{Bank loans to total assets} = \frac{\text{Loans}}{\text{Total assets}}$$

Macroeconomic variables

Prior literature contemplates a wide range of macro-economic but without conclusive results. Due to data availability restrictions, we control for the following macroeconomic determinants of bank performance:

Bank's performance can be associated to the country level of income, measured as the growth rate of GDP (Bashir, 2003; Grassan and Gazdar, 2014).

Inflation has also proved to influence banks' profitability, although both a negative (Zeitun, 2012) and positive (Bashir, 2003) relationship has been reported. Our model also controls for the influence of the inflation rate on the bank's performance.

Following, table 4.1. provides the variables, labels and measurements used in our empirical analysis.

Table 4. 1: Variables of the model

Label	Variables	Definition	Hypothesis tested	Expected sign
<i>Panel A Dependent variables and control variables</i>				
Dependent variables (bank's performance)				
<i>Q</i>	Tobin's Q (<i>Q</i>) ratio	Book value of total assets minus the book value of common equity plus the market value of common equity divided by the book value of total assets.		
<i>ROA</i>	Return on assets	Net income divided by total assets		
<i>ROE</i>	Return on equity	Net income divided by total equity		
Experimental variables related to Shariah Board characteristics				
<i>SBS</i>	Shariah Board Size	Number of Shariah board members	H1	+
<i>SBS²</i>	Shariaz Board Size ²	Squared number of Shariah board members	H1	-
<i>SBM</i>	Shariah Board Meetings	Number of Shariah board meetings per year	H2	+
<i>SBEdu</i>	Shariah Board Education	Average number of Shariah board members which are holding a degree in finance science	H3	+
Experimental variables related to ownership structure				
<i>Control rate</i>	Main shareholder	Largest percentage of shares	H4	+
<i>State</i>	Government is the main shareholder	Dummy that equals 1 if the largest shareholder is a governmental entity and 0 otherwise	H5	-
<i>Bank</i>	Bank is the main shareholder	Dummy that equals 1 if the largest shareholder is a bank and 0 otherwise	H6	+
Control variables				
<i>BoDS</i>	Board Size	Number of Board of Directors members		
<i>BoDM</i>	Board Meetings	Number of Board of Directors meetings per year		
<i>BoDIND</i>	Board Independence	Fraction of Non-executive board members		
<i>Bank_size</i>	Bank Size	Natural logarithm of total assets		
<i>Bank_age</i>	Bank Age	Number of years from the establishment dated until current date.		
<i>Loansta</i>	Loans-to-Assets	The ratio loans to total assets		
<i>GDP_growth</i>		Growth rate in the income of an economy		
<i>Inflation</i>		Growth rate in price level of goods and services in an economy		

4.3. Statistical methods

Performance models usually suffer from problems of endogeneity (companies that perform better also implement better CG mechanisms) and the existence of unobservable fixed effects associated with explanatory variables.

In order to address the endogeneity concerns, also called reverse causality, we need an instrumental variable that is correlated with board size but uncorrelated with performance. In the context of governance regressions, it is difficult to come up with valid instruments that exhibit sufficient variation over time. The factors that are arguably most closely correlated with the endogenous variable are other governance or firm characteristics that are already (or should be) included in performance regressions. For example, Eisenberg et al. (1998) use firm age and group membership as instruments for board size in performance regressions; Coles et al. (2008) use three-stage least squares but do not explain the validity of their instruments for board size, which are firm age and CEO tenure. Lehn et al. (2009) use 5-year lagged performance as an instrument for board size, but lagged performance is potentially correlated with performance.

Following Arellano and Bover (1995); Blundell and Bond (1998) and De Andres and Vallelado (2008), we apply the Generalized Method of Moments (GMM) from Arellano and Bond (1991) to control for unobservable panel-level effects derived from the linear models and to ensure correlation with the lagged dependent variables does not produce inconsistent estimators. Therefore, to control for the endogeneity of some variables, we use 2 to 4 lags of board of director variables (Board Size and Board Meetings) as instrumental variables, as

well as controlling for dynamic adjustment by considering the lagged dependent variables during 2 periods. Furthermore, by using the dynamic dimension of panel data, we can check response processes across time and identify how the characteristics of the board of directors affect bank performance.

Finally, the model also incorporates the correction proposed by Windmeijer (2000) for small samples, due to the relatively few observations related to South Asian Islamic banks. To test the validity of the model we calculate AR1 and AR2 tests for first- and second-order autocorrelation.

4.4. Sample selection

The sample and the main financial information were sourced from Bankscope database. The data related to the Shariah board were mostly hand-collected from individual banks' annual reports and, additionally, from other sources such as stock markets websites. Other sources of financial and non-financial information used in this study are:

- ORBIS. This database provided financial information such as return on assets and return on equity.
- Annual Accounts and Corporate Governance Annual Reports of the banks, released on their official websites, which provided additional information about the Shariah board and board of directors.

- Official websites of the Stock Exchanges database of Gulf countries and Southeastern Asian countries and World bank, which have been used to supplement the data.

Initially, the period of study was from 2008 to 2016 but, as depicted in Table 4.2, we lacked relevant financial data from 2008 until 2010. The missing data during this period is likely associated with the financial crisis in the Islamic banking industry (Grassa and Matoussi, 2014). Thus, we dropped 279 bank-year observations and investigated bank performance from 2011 to 2016. The final sample consists of 93 banks and 558 bank-year observations. The sample includes unlisted banks, so we could only calculate Tobin's Q ratio for 50 banks, yielding 300 observations.

Table 4. 2: Sample of the study

Variables	Banks	Observations
Initial samples	93	837
Lack of Information (2008-2010)		279
Final sample for 2011-2016	93	558
Lack of information related to <i>Q</i> ratio (non-listed banks)	43	258
Final sample for listed banks for 2011-2016	50	300

Our sample comprises banks based in 15 countries. We test our hypotheses on the full sample, but also on two groups of countries: those whose system can be classified as Centralized (central Shariah board plus Shariah board in financial institutions); and Non-Centralized (Shariah board only in financial institutions). Hence, we present in Table 4.3 the distribution of the banks and observations for each region and country.

Table 4. 3: Distribution of the sample by geographical region and country

Country	Number of banks	Number of observations
Non-Central Shariah Board Countries	46	276
Bangladesh	7	42
Bahrain	14	84
Jordan	3	18
Kuwait	6	36
Oman	2	12
Qatar	4	24
Saudi Arabia	8	48
Singapore	1	6
Thailand	1	6
Central Shariah Board Countries	47	282
Brunei Darussalam	3	18
Indonesia	8	48
Malaysia	12	72
Pakistan	11	66
Sudan	5	30
UAE	8	48
Total	93	558

As depicted in Table 4.3, within the countries without a national Shariah board, Bahrain and Saudi Arabia have the largest number of Islamic banks: 14 and 8 respectively. Within the group of countries with a national Shariah board, Malaysia and Pakistan have the largest number of Islamic banks (12 and 11, respectively).

Notably, the sample in both groups is evenly distributed: out of 93 banks (558 observations), 46 banks (276 observations) are based in the non-centralized Shariah board countries and 47 banks (282 observations) are located in the centralized Shariah board countries.

4.5. Descriptive analysis

Table 4.4 shows the descriptive statistics of the variables. Regarding the dependent variables, performance measured through the Q ratio reaches, on average, the value 1, while the mean of ROE (7.2%) remains higher than the mean of ROA (0.6%). The Shariah board, on average, consists of 4.4 members and ranges from 2 to 12 members. They meet more than 5 times per year, although the range is very wide: some banks' Shariah board only met once in a year (e.g. Tamweel PJSC; Dubai Islamic Bank PJSC, First Security Islami Bank Limited; PT Bank BNI Syariah or Hong Leong Islamic Bank Berhad) whereas the Alrajhi Bank in Saudi Arabia met 45 times in one year. The reason for this unusually high activity is that in 2016 the Shariah board had to deal with 450 phone and 83 mail inquiries from the customers and issued 15 decisions and 240 guidelines. In addition, the Shariah board prepared a number of educational manuals and also organized 13 Shariah courses for new employees, and held 19 workshops for branch managers, both in collaboration with the Training Centre.⁶

⁶ As reported in the Alrajhi Bank Annual Report, 2016.

Table 4. 4: Descriptive statistics

Variables	Observations	Mean	Median	SD	Min	Max
<i>Q</i>	275	1.000	0.996	0.185	0.397	3.150
ROA	458	0.006	0.010	0.031	-0.357	0.217
ROE	458	0.072	0.086	0.157	-1.160	1.980
SBS	516	4.410	4.000	1.730	2.000	12.000
SBM	514	5.120	4.000	4.860	1.000	45.000
SBEDU	502	0.286	0.330	0.224	0.000	0.870
BoDS	520	9.223	9.000	3.038	3.000	24.000
BoDM	487	10.400	7.000	9.200	3.000	74.000
BoDIND	487	0.717	0.750	0.231	0.182	1.000
Control_rate	534	52.700	49.100	34.000	0.001	100.000
State	527	0.245	0	0.430	0	1
Bank	527	0.326	0	0.469	0	1
Bank_size	458	21.900	22.000	1.580	16.400	25.500
Bank_age	521	24.700	21.000	15.100	1.000	75.000
Loansta	451	0.579	0.619	0.170	0.016	0.974
GDP_growth	558	0.044	0.044	0.100	-0.313	0.357
Inflation	558	4.860	3.170	6.150	-0.900	37.400

The table shows the mean, median, standard deviation, minimum, and maximum values of the following variables: Tobin's Q proxy (*Q*), return on assets (ROA), return on equity (ROE), Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), Non-executive members (BoDIND), Bank size (Bank_size) and Bank age (Bank_age), the ratio loans to total assets (Loansta), the percentage held by the major shareholder (Control_rate), the major shareholder is the government (State), the major shareholder is a financial institution (Bank).

Regarding the average education variable, there are some Shariah boards that do not have any members educated in accounting and/or finance, while in other Shariah boards 87% of their members hold a degree in those disciplines. On average, 28.6% of the Shariah board members hold a degree in accounting and/or finance.

Board of director characteristics show higher average values in terms of size (9.223) and meetings (10.400) than the corresponding Shariah board values. The most active board is the one pertaining to the BNI Shariah Bank in Indonesia, who met 74 times in 2013. According to the BNI Shariah Bank Annual Report (2013), this frequency is the consequence of the BNI Shariah Bank policy and the strategic

decision to increase the number of board meetings in order to improve the performance of the board. Additionally, the average ratio of non-executive members on Shariah boards is 0.717.

The Islamic banks in the sample show a mean bank size of 21.900 (logarithm of total assets), with a minimum value of 16.400 and a maximum of 25.500. The banks' experience represented by the bank age displays a mean of 24.7 years. The oldest bank (75 years) is the Habib Bank Limited established in Pakistan in 1941.

Finally, regarding the ownership structure, the smallest main shareholder owns 0.001% of the total shares (Tadamon Islamic Bank, Al Hilal Bank, Ajman Bank, Emirates Islamic Bank, Mashreq Bank, Dubai Bank, Sharjah Islamic Bank, ABC Islamic Bank, Kuwait Finance House and Bahrain Islamic Bank), but, on average, the main shareholder owns 52.7% of the shares. Furthermore, we can see that the major shareholder is the government in 24.5% of the cases, whereas 32.6% of Islamic banks have other financial institutions as their major shareholder. So, for the remainder (42.9%), the major shareholder of the Islamic bank is either a private firm or a family.

Table 4.5 reports the descriptive statistics by country and regions. Results show that banks based in countries without a centralized Shariah board show, on average, higher performance values from a market perspective than those with a centralized Shariah board, i.e. a Q ratio of 1.021 for the former and 0.977 for the latter. However, the results for accounting-based performance measures

demonstrate that ROA and ROE are higher for countries with a centralized Shariah board, i.e. an ROA of 0.3% (0.9%) and an ROE of 6.3% (8.0%).

The Islamic banks with the highest Q ratio are based in Jordan, Oman, Qatar and Saudi Arabia (within the countries without a centralized Shariah board); and Pakistan in the group of countries with a centralized Shariah board. For the former group of countries, banks based in Qatar and Saudi Arabia show the highest ROA (1.80%) and ROE (11.5% and 12.8% respectively). Whereas for the second group of countries, banks located in Sudan are the most profitable in terms of ROA (2.7%) and ROE (19.3%) followed by those located in Brunei Darussalam with ROA of 1.5% and an ROE of 9.0%.

Descriptive statistics show that those countries without a central Shariah board have, on average, bigger Shariah boards (4.601 members) and boards of directors (10.187 members) and a higher proportion of Shariah board members with a degree in accounting and/or finance (31.3%) than countries with a centralized Shariah board. Conversely, in countries with a central Shariah board, both governance bodies exhibit higher activity levels (on average, the Shariah board and the board of directors holds 5.291 and 11.245 annual meetings, respectively) than those that only have a bank-level Shariah board.

Moreover, Islamic banks based in countries without a central Shariah board are, on average, larger and more experienced financial entities than those in the other group of countries. Conversely, in those countries with a central Shariah board, the mean control rate for the major shareholder is higher (63.6%), with the main shareholder being a governmental body or another financial institution in

25.8% or 42.4% of the observations, respectively. Therefore, in the remaining 31.8% of the observations, the highest proportion of shares is in the hands of a family or a private company.

Table 4. 5: Descriptive statistics per country

Country	Q	ROA	ROE	SBS	SBM	SBEDU	BoDS	BoDM	BoDIND	Bank_Size	Bank_age	Loansta	GDP_growth	Inflation	Control_rate	State	Bank
Non-Central SB countries	1.021	0.003	0.063	4.601	4.957	0.313	10.187	9.673	0.697	21.938	26.420	0.596	0.046	3.319	41.516	0.232	0.228
Bangladesh	0.950	0.000	0.095	7.760	3.740	0.476	14.738	19.400	0.690	21.200	27.600	0.703	0.108	7.190	44.500	0.000	0.286
Bahrain	0.948	-0.005	-0.011	3.670	3.740	0.322	8.974	5.440	0.693	20.700	19.900	0.458	0.037	2.160	46.300	0.039	0.234
Jordan	1.010	0.009	0.100	3.390	3.670	0.216	8.833	6.440	0.816	21.500	39.200	0.717	0.070	2.460	72.700	0.000	0.667
Kuwait	0.984	0.006	0.061	4.430	8.370	0.079	9.033	8.800	0.758	22.800	28.500	0.640	0.002	3.360	31.600	0.533	0.200
Oman	1.010	-0.028	-0.054	4.000	4.900	0.452	8.200	7.400	0.811	20.000	18.600	0.559	0.024	1.730	22.000	0.500	0.000
Qatar	1.120	0.018	0.115	3.000	4.420	0.413	9.625	10.300	0.773	23.200	24.300	0.564	0.038	2.460	14.400	0.500	0.000
Saudi Arabia	1.150	0.018	0.128	4.210	7.430	0.289	9.667	6.670	0.467	24.000	40.300	0.608	0.042	3.430	42.200	0.375	0.125
Singapore	.	-0.034	-0.044	9.000	3.000	0.330	14.667	26.300	0.922	19.300	6.500	0.357	0.040	2.030	50.000	0.000	1.000
Thailand	.	-0.040	0.061	5.000	3.000	0.020	8.667	20.000	1.000	21.800	11.500	0.764	0.033	1.700	48.500	1.000	0.000
Central SB countries	0.977	0.009	0.080	4.221	5.291	0.259	8.288	11.245	0.739	21.880	23.061	0.564	0.043	6.370	63.559	0.258	0.424
Brunei Darussalam	.	0.015	0.090	5.670	2.000	0.047	7.000	5.000	0.563	22.400	10.500	0.391	-0.023	0.252	42.000	1.000	0.000
Indonesia	0.963	0.003	0.061	2.880	4.600	0.492	6.290	26.100	0.826	21.200	20.500	0.660	0.037	5.390	79.200	0.042	0.708
Malaysia	.	0.005	0.076	5.140	7.890	0.124	8.640	9.770	0.815	22.100	20.200	0.612	0.027	2.390	87.200	0.167	0.667
Pakistan	1.020	0.007	0.053	4.020	3.360	0.333	9.303	6.360	0.608	21.800	27.500	0.388	0.078	7.130	50.200	0.100	0.300
Sudan	0.852	0.027	0.193	4.460	9.380	0.190	9.967	17.100	0.914	20.200	30.100	0.421	0.067	26.800	8.870	0.000	0.250
United Arab Emirates	0.985	0.012	0.077	4.000	3.020	0.235	7.230	6.000	0.733	23.000	23.800	0.660	0.036	1.780	64.400	0.714	0.143
Total Sample	1.000	0.006	0.072	4.410	5.120	0.286	9.210	10.400	0.717	21.900	24.700	0.579	0.044	4.860	52.700	0.245	0.326

The table shows the average values per country of Tobin's Q proxy (Q), return on assets (ROA), return on equity (ROE), Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), Non-executive members (BoDIND), Bank size (Bank_size) and Bank age (Bank_age), the ratio loans to total assets (Loansta), the percentage held by the major shareholder (Control_rate), the major shareholder is the government (State), the major shareholder is a financial institution (Bank).

4.6. Correlation analysis

Table 4.6 presents Pearson pairwise sample correlations between variables. Regarding our key test variables, the correlations between Shariah board characteristics and all bank performance measures are not statistically significant. The correlations between Shariah board meetings and all bank performance measures are not statistically significant. The correlations between Shariah board average education and bank performance measures are not statistically significant. The size of the board of directors is positively and statistically significantly correlated with ROA and ROE, though the correlation with Q is not statistically significant. The board of directors' meetings is positively and statistically significantly correlated with ROE, though the correlation with Q and ROA is not statistically significant. The number of non-executive members is positively and statistically significantly correlated with ROE, though the correlation is not statistically significant with Q and ROA. Bank Size shows a significant positive correlation with all bank performance measures. Bank age is positively and statistically significantly correlated with ROA and ROE, though the correlation with Q is not statistically significant.

Although the correlation coefficients between some variables are statistically significant, they do not show multicollinearity. However, we detect a significant and positive correlation between the size of Islamic financial institutions and their performance and SBM , but a negative correlation between size and the education of Shariah board members.

Table 4. 6: Pearson pairwise sample correlations

	<i>Q</i>	ROA	ROE	SBS	SBM	SBEDU	BoDS	BoDM
<i>Q</i>	1.000							
ROA	0.293 *** (0.000)	1.000						
ROE	0.224 *** (0.000)	0.551 *** (0.000)	1.000					
SBS	-0.051 (0.393)	0.014 (0.764)	0.077 * (0.097)	1.000				
SBM	0.078 (0.194)	0.048 (0.303)	0.065 (0.165)	0.069 * (0.058)	1.000			
SBEDU	0.076 (0.219)	0.021 (0.659)	0.026 (0.587)	-0.003 (0.932)	-0.115 *** (0.002)	1.000		
BoDS	0.067 (0.255)	0.107 ** (0.021)	0.135 *** (0.003)	0.526 *** (0.000)	-0.054 (0.136)	0.115 *** (0.002)	1.000	
BoDM	-0.058 (0.343)	0.022 (0.647)	0.093 * (0.050)	0.271 *** (0.000)	0.111 *** (0.003)	0.223 *** (0.000)	0.211 *** (0.000)	1.000
BoDIND	-0.051 (0.404)	-0.004 (0.928)	0.0572 (0.231)	0.104 *** (0.005)	0.158 *** (0.000)	-0.153 *** (0.000)	-0.083 ** (0.025)	0.161 *** (0.000)
Bank_Size	0.287 *** (0.000)	0.210 *** (0.000)	0.251 *** (0.000)	-0.008 (0.864)	0.095 ** (0.041)	-0.106 ** (0.025)	0.070 (0.131)	-0.042 (0.378)
Bank_Age	0.007 (0.912)	0.162 *** (0.001)	0.150 *** (0.002)	-0.028 (0.453)	0.110 *** (0.003)	-0.064 * (0.087)	0.062 * (0.091)	0.007 (0.854)
Loansta	0.003 (0.960)	0.119 ** (0.010)	0.078 * (0.093)	0.133 *** (0.004)	-0.042 (0.368)	0.067 (0.161)	0.020 (0.675)	0.163 *** (0.001)
GDP_Growth	-0.207 *** (0.000)	0.045 (0.326)	0.064 (0.169)	0.063 * (0.098)	-0.056 (0.142)	0.113 *** (0.004)	0.103 *** (0.007)	0.102 *** (0.009)
Inflation	-0.147 ** (0.013)	0.145 *** (0.002)	0.179 *** (0.000)	0.046 (0.203)	0.089 ** (0.014)	0.048 (0.187)	0.115 *** (0.001)	0.105 *** (0.005)
Control_Rate	-0.075 (0.214)	-0.008 (0.871)	-0.033 (0.484)	-0.033 (0.459)	-0.027 (0.546)	0.025 (0.585)	-0.217 *** (0.000)	0.119 *** (0.009)
State	0.215 *** (0.000)	0.062 (0.187)	0.047 (0.317)	-0.048 (0.284)	0.095 ** (0.035)	-0.074 (0.104)	-0.160 *** (0.000)	-0.080 * (0.082)
Bank	-0.008 (0.896)	-0.026 (0.579)	0.002 (0.959)	0.042 (0.356)	0.036 (0.419)	-0.095 ** (0.038)	-0.075 * (0.096)	0.166 *** (0.000)

Table 4.6: Pearson pairwise sample correlations (continued)

	BoDIND	Bank_Size	Bank_Age	Loansta	GDP_Growth	Inflation	Control_Rate	State
BoDIND	1.000							
Bank_Size	-0.024 (0.6176)	1.000						
Bank_Age	-0.141 *** (0.000)	0.465 *** (0.000)	1.000					
Loansta	0.033 (0.495)	0.074 (0.113)	-0.038 (0.431)	1.000				
GDP_Growth	-0.072 (0.855)	-0.081 * (0.081)	-0.014 (0.709)	-0.104 ** (0.026)	1.000			
Inflation	-0.083 (0.822)	-0.268 *** (0.000)	0.121 *** (0.001)	-0.200 *** (0.000)	0.117 *** (0.001)	1.000		
Control_Rate	0.056 (0.218)	-0.087 * (0.064)	-0.183 *** (0.000)	0.263 *** (0.000)	-0.023 (0.590)	-0.239 *** (0.000)	1.000	
State	-0.021 (0.655)	0.378 *** (0.000)	0.093 ** (0.039)	0.050 (0.298)	-0.083 * (0.058)	-0.226 *** (0.000)	-0.236 *** (0.000)	1.000
Bank	0.196 *** (0.000)	-0.223 *** (0.000)	-0.291 *** (0.000)	0.172 *** (0.000)	-0.004 (0.933)	0.015 (0.740)	0.547 *** (0.000)	-0.396 *** (0.000)

The table shows Pearson pairs-wise sample correlations. Bold text indicates statistically significant at 1% level. See table 4 for variables definitions

4.7. Univariate analysis

In chapter 2, we identified two different Shariah governance systems, that is, with a national-level central Shariah committee and without such a committee. We have tested whether there are statistical differences between the two groups of countries. To that end, we performed a test of means. Results are reported in Table 4.7.

Table 4. 7: Test of Means according to Central Shariah Board and Non-Central Shariah Board countries

Variables	Central SB countries	Non-central SB countries	Mean Diff	Sig
<i>Q</i>	0.977	1.021	-0.044	**
ROA	0.009	0.003	0.006	*
ROE	0.080	0.063	0.017	
SBS	4.221	4.601	-0.380	***
SBM	5.291	4.957	0.334	
SBEDU	0.259	0.313	-0.054	***
BoDS	8.343	10.261	-1.918	***
BoDM	11.245	9.673	1.571	*
BoDIND	0.754	0.693	0.061	***
Bank_Size	21.880	21.938	-0.058	
Bank_Age	23.061	26.420	-3.360	***
Loansta	0.564	0.596	-0.032	**
GDP_growth	0.043	0.046	-0.003	
Inflation	6.370	3.319	3.050	***
Control_rate	63.559	41.516	22.043	***
State	0.258	0.232	0.026	
Bank	0.424	0.228	0.196	***

The table shows the T-test of mean for South Asian countries and Gulf countries. of Tobin's Q proxy (*Q*), return on assets (ROA) and return on equity (ROE). Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), Non-executive members (BoDIND), Bank size logarithm of total assets at book value in US \$ millions (Bank_size) and Bank age (Bank_age).

Regarding performance, the group of countries with a non-central Shariah board exhibits a significantly higher Q ratio (1.021) than the other group (0.977) with a 5% level of statistical significance. Profitability measured through ROA is statistically higher (at 10%) in central-Shariah board countries, but when it is measured through ROE there are no significant differences between the two groups.

The results demonstrate that, on average, Islamic banks based in countries that follow a centralized model have a Shariah board that is smaller but more educated in finance and accounting than the other group. Boards of directors in Islamic banks from countries with a centralized model are, on average, significantly smaller but more independent and also more active (although the level of significance of this last characteristic is only 10%). Additionally, Islamic banks are older and have a higher debt ratio in the non-centralized model than in the centralized model. Finally, regarding ownership structure variables, those banks based in countries with a centralized Shariah board show a significantly higher percentage held by the major shareholder, as well as a higher proportion of financial institutions being the major shareholder.

CHAPTER 5

ANALYSIS AND DISCUSSION OF THE RESULTS

5.1. Introduction

In this chapter, we present the outcome of the statistical analyses performed to test the hypotheses related in chapter 3.

In first place, we have explored the influence of Shariah Supervisory Board and ownership characteristics. Following, we present the additional analyses and the robustness tests.

5.2. Hypotheses testing and discussion of the results

Table 5.1 displays the coefficients and standard errors from the robust one-step estimators of the Arellano and Bond (1991) dynamic model. This model deals with unobserved heterogeneity, a common problem in CG research. The model displays the coefficient of two period lagged dependent variables, the coefficients of explanatory variables, as well as the year dummies. The model also includes the first- and second-order correlation tests (AR1 and AR2). The AR1 and AR2 show that serial correlation does not invalidate our results, as well as confirming the absence of second-order serial correlation, which implies that the instruments, employed to correct the possible endogeneity problem, are valid. The results also show that the Wald Chi2 tests are highly significant for all models.

The results related to the whole sample suggest that Shariah board characteristics affect significantly (at 1% level) the performance of financial institution according to the Q ratio but they do not influence the accounting measures (ROA and ROE), consistently with De Andres and Vallelado (2008). Therefore, those results reject the first hypothesis ($H1$), in other words, the Shariah Board Size significantly impact Islamic bank's market performance. Moreover, the Shariah Board size presents a concave or U-inverted relationship with bank's performance. Thus, the higher number of members of Shariah board, the higher of the Q ratio. This result corroborates that big boards benefits from higher diversity of skills and competences provided by a higher number of board members. Nevertheless, the negative coefficient displayed by the shariah board size squared (SBS^2) suggests that excessive large boards difficult the coordination and the communication among members, triggering at the same time the aggravation of free-riding problems (Adams and Mehran, 2012; De Andrés and Vallelado, 2008).

We have estimated the optimal number of Shariah Board members through the following equation 5.1:

$$f'(SBS) = \beta_{SBS} + 2 \cdot (\beta_{SBS^2})SBS = 0 \quad (5.1)$$

The optimal size of Shariah Board is around 12 members, in the case of Q ratio, because it did not show statistical significance for the accounting measures.

Regarding the market-based model (Q), we also find a positive relation between Shariah board meetings and the banks' performance. These results highlight the relevance of banks having a proactive board (De Andrés and

Vallelado, 2008; Liang et al., 2013; García-Meca et al., 2015). For Islamic banks, the number of meetings of the Shariah board seems to reflect a more proactive than reactive behaviour, which improves significantly the performance of the Islamic bank (therefore, we can reject the second null hypothesis, H2).

In this sense, both a larger size and a regular activity of Shariah board seems to stimulate the advantages (advising and monitoring Islamic bank operations), increasing the pool of expertise (Dalton, 1998), to the detriment of disadvantages (lack of coordination and decision-making deficiencies).

Additionally, the average education shown by members of Shariah Board impacts significantly and positively bank's performance. That is consistent with the human capital theory and prior studies (Nomran et al. 2018 and Farook et al. 2011) proving that educational issues turn usually into a higher quality of performance. According to those results we can reject the null H3, that is, the Shariah Board members' education impact Islamic bank's performance.

On the other hand, Shariah Board characteristics are not relevant in terms of accounting-based performance measures. A plausible explanation might be rooted in the main role of the Shariah board: Since all Islamic banks' governance systems include a Shariah Board that oversight bank's operations, the range of allowed bank transactions do not differ significantly in terms of profitability. However, a *better* Shariah Board in terms of size, activity and education is perceived by the investors in a positive way and, therefore, positively impacts the Islamic bank's market value.

Regarding Board of Directors, the higher number of independent members triggers lower levels of performance in terms of Q ratio, ROA and ROE. Bank age is negatively associated to both performance and return on assets, but with a low level of significance (10%). Conversely, the level of debt, measured through *Loansta*, is positively associated with both accounting measures of profitability, ROA and ROE suggesting positive financial leverage.

Once we have tested the bank's performance models for Shariah Board characteristics, we employ the same model in order to analyse the possible influence of ownership structure on Islamic Bank's performance. Table 5.2 reports the multivariate analysis using one-step system estimator of the Arellano-Bond model (1991) for the bank's performance regarding the ownership characteristics.

Neither the measure related to ownership concentration (the percentage of shares hold by the major shareholder) nor the interaction with the identity of largest owners (either the state or bank) has significant implications for profitability (similar conclusions are reached by Thomsen and Pederson, 2000; Zouari and Taktak, 2014). Therefore, we cannot reject H4 and we cannot assert that the level of ownership is positively associated with Islamic bank's performance.

Table 5. 1: Shariah Board characteristics. One-step model for all observations

VARIABLES	Model (1) <i>Q</i>	Model (2) ROA	Model (3) ROE
<i>Q</i> _{t-1}	0.252 *** (2.892)		
<i>Q</i> _{t-2}	-0.27 *** (-3.122)		
ROA _{t-1}		-0.38 ** (-2.194)	
ROA _{t-2}		0.194 (1.241)	
ROE _{t-1}			0.156 (0.644)
ROE _{t-2}			-0.049 (-0.986)
SBS _t	0.284 *** (3.602)	0.009 (0.498)	0.047 (1.085)
SBS _t ²	-0.012 ** (-2.357)	-0.001 (-0.531)	-0.004 (-1.186)
SBM _t	0.006 *** (4.117)	-0.000 (-0.340)	-0.001 (-0.552)
SBEDU _t	0.593 *** (3.628)	-0.020 (-0.537)	0.008 (0.058)
BoDS _t	0.003 (0.517)	0.002 (0.898)	0.007 (1.211)
BoDM _t	-0.001 (-0.784)	0.000 (0.757)	0.001 (1.257)
BoDIND _t	-0.083 *** (-2.799)	-0.025 ** (-2.225)	-0.067 * (-1.956)
Bank_size _t	-0.052 (-0.768)	0.036 (1.339)	0.095 * (1.840)
Bank_age _t	-0.001 * (-1.799)	-0.001 * (-1.669)	-0.001 (-0.273)
Loansta _t	-0.175 (-1.343)	0.136 ** (2.257)	0.264 ** (2.094)
GDP_growth _t	-0.155 (-1.589)	-0.008 (-0.323)	-0.017 (-0.260)
Inflation _t	0.001 (0.575)	0.001 ** (2.325)	0.002 (0.822)
Constant _t	1.194 (0.750)	-0.823 (-1.326)	-2.219 ** (-1.975)
Year dummy	YES	YES	YES
Observations	105	176	176
AR1	-2.065 **	-0.093	-1.436
AR2	0.547	-0.330	-0.944
Wald Chi2	718.550	28.230	154.29

The table shows the One-step GMM system estimator in all observations (Central and Non Shariah Board countries). The variables are Tobin's *Q* proxy (*Q*), return on assets (ROA), return on equity (ROE), Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), fraction of non-executive members (BoDIND), logarithm of total assets at book value in US \$ millions (Bank_size), Bank age (Bank_age), the ratio loans to total assets (Loansta), the growth rate of gross domestic product (GDP_growth), the inflation index (Inflation). ***, ** and * denotes statistical significance at 1% , 5% and 10% level, respectively.

Table 5. 2: Ownership structure and bank performance. One-step model for all observations

VARIABLES	Model (1) <i>Q</i>		Model (2) ROA		Model (3) ROE
<i>Q</i> _{t-1}	0.169 *				
	(1.887)				
<i>Q</i> _{t-2}	-0.263 ***				
	(-2.696)				
ROA _{t-1}			-0.425 ***		
			(-2.857)		
ROA _{t-2}			0.182		
			(1.065)		
ROE _{t-1}					0.135
					(0.526)
ROE _{t-2}					-0.053
					(-0.992)
Control_Rate _t	0.529		0.192		0.234
	(1.158)		(1.332)		(0.651)
State _t	-0.551 **		-0.041		0.067
	(-2.421)		(-0.697)		(0.187)
Bank _t	0.006		-0.032		0.050
	(0.102)		(-0.960)		(0.558)
Control_Rate*State	1.467		0.142		-0.281
	(1.348)		(0.509)		(-0.151)
Control_Rate*Bank	-0.073		0.117		-0.076
	(-0.277)		(1.085)		(-0.308)
SBS _t	0.308 ***		0.008		0.041
	(4.446)		(0.393)		(0.924)
SBS _t ²	-0.012 ***		-0.001		-0.003
	(-2.976)		(-0.425)		(-0.980)
SBM _t	0.006 ***		-0.000		-0.001
	(4.938)		(-0.215)		(-0.612)
SBEDu _t	0.584 ***		-0.023		0.050
	(4.020)		(-0.651)		(0.349)
BoDS _t	0.004		0.001		0.007
	(0.873)		(0.411)		(1.208)
BoDM _t	-0.000		0.000		0.001
	(-0.121)		(0.318)		(1.077)
BoDIND _t	-0.048		-0.029 **		-0.074 *
	(-1.221)		(-2.245)		(-1.824)
Bank_size _t	-0.016		0.039		0.1 *
	(-0.254)		(1.431)		(1.949)
Bank_age _t	-0.001 *		-0.001		-0.001
	(-1.956)		(-1.558)		(-0.276)
Loansta _t	-0.069		0.147 **		0.277 **
	(-0.395)		(2.232)		(2.087)
GDP_growth _t	-0.122		-0.023		-0.018
	(-1.295)		(-0.707)		(-0.239)
Inflation _t	0.000		0.001 *		0.002
	(0.123)		(1.695)		(0.865)
Constant _t	0.246		-0.958		-2.445 **
	(0.159)		(-1.414)		(-2.062)
Year dummy	YES		YES		YES
Observations	100		171		171
AR1	-1.805 *		0.198		-1.438
AR2	-0.091		-0.446		-0.853
Wald Chi2	4,997.830		45.810		178.480

The table shows the One-step GMM system estimator in Gulf countries. The variables are Tobin's Q proxy (*Q*), return on assets (ROA), return on equity (ROE), Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), fraction of non-executive members (BoDIND), logarithm of total assets at book value in US \$ millions (Bank_size), Bank age (Bank_age), the ratio loans to total assets (Loansta), the growth rate of gross domestic product (GDP_growth), the inflation index (Inflation), the percentage held by the major shareholder (Control_rate), the major shareholder is the government (State), the major shareholder is a financial institution (Bank).

***, ** and * denotes statistical significance at 1% , 5% and 10% level, respectively.

In order to test H5 and H6, we categorize the identity of the major shareholder by using two dummy variables. State is the first dummy that identifies whether the major shareholder is the government, and Bank is the second dummy that identifies whether the major shareholder is another financial institution. Only the fact that the main shareholder is a governmental institution has a negative impact on the Islamic bank's performance. Therefore, it seems that the remaining investors do not perceive the high governmental participation in the Islamic Bank in a positive way. A plausible explanation could be related to the fact that the monitoring activity of government is less intensive than private firms, as concluded by Demsetz and Villalonga (2001); Beck et al. (2013); Micco et al. (2007); Iannotta et al. (2007) and Cornett et al. (2010). However, the accounting measures do not support this idea because ownership structure characteristics have no significant effect on profitability. According to those results we can reject the fifth hypothesis (H5) but not the sixth one (H6). Therefore, we can assert that the state-owned banks (*ceteris paribus*) perform worse than non-state-owned banks but the main shareholder being another bank does not seem to influence market performance.

Table 5.3. summarizes the main results regarding the hypotheses developed in Chapter 3. It presents the tested dependent variables, the exploratory variables related with the hypotheses of the present investigation and the final results.

Table 5. 3: Main results

Label	Variables	Definition	Hypothesis tested	Final result
<i>Dependent variables and control variables</i>				
Dependent variables (bank's performance)				
<i>Q</i>	Tobin's Q (<i>Q</i>) ratio	Book value of total assets minus the book value of common equity plus the market value of common equity divided by the book value of total assets.		
<i>ROA</i>	Return on assets	Net income divided by total assets		
<i>ROE</i>	Return on equity	Net income divided by total equity		
Experimental variables related to Shariah Board characteristics				
<i>SBS</i>	Shariah Board Size	Number of Shariah board members	H1	Inverted U relationship with <i>Q</i> and not significant with ROA and ROE
<i>SBM</i>	Shariah Board Meetings	Number of Shariah board meetings per year	H2	+ with <i>Q</i> ratio. Not significant with ROA and ROE
<i>Q</i>	Shariah Board Education	Average number of Shariah board members which are holding a degree in finance science	H3	+ with <i>Q</i> ratio. Not significant with ROA and ROE
Experimental variables related to ownership structure				
<i>Control rate</i>	Main shareholder	Largest percentage of shares	H4	Not significant
<i>State</i>	Government is the main shareholder	Dummy that equals 1 if the largest shareholder is a governmental entity and 0 otherwise	H5	- with <i>Q</i> ratio. Not significant with ROA and ROE
<i>Bank</i>	Bank is the main shareholder	Dummy that equals 1 if the largest shareholder is a bank and 0 otherwise	H6	Not significant

5.3. Additional analysis

5.3.1. Central vs Non-Central Shariah Board

To further explore the impact of the Shariah Board models described in Chapter 2, we split the sample into two groups, those IBs settled on countries following a centralized model (results displayed in Table 5.4.) and those that do not have a national Shariah Board (Table 5.5.).

For the subsample of countries with a Shariah Board at national level (Table 5.4), the Q ratio is positively affected by the Shariah Board size and the relationship is concave or u-inverted. However, Shariah Board education drops its significance and the number of meetings is significant, but with a weak 10% level of significance.

Regarding to the set of control variables, Board of Directors size and meetings affect significantly the Islamic bank's ROE in a negative and positive way, respectively. The number of outsider is negatively related to the bank's performance. Bank_size, bank_age and the level of debt (Loansta) negatively impact Islamic bank's Q ratio.

Table 5. 4: One-step model for Central Shariah Board countries

VARIABLES	Model (1) <i>Q</i>	Model (2) ROA	Model (3) ROE
<i>Q</i> _{t-1}	0.281 *** (4.264)		
<i>Q</i> _{t-2}	-0.234 *** (-5.039)		
ROA _{t-1}		0.008 (0.053)	
ROA _{t-2}		-0.287 (-1.403)	
ROE _{t-1}			0.112 (0.795)
ROE _{t-2}			-0.48 *** (-4.385)
SBS _t	2.514 *** (3.656)	-0.005 (-0.191)	-0.346 (-1.420)
SBS _t ²	-0.324 *** (-3.552)	0.000 (0.182)	0.035 (1.448)
SBM _t	-0.067 * (-1.864)	0.001 (0.895)	0.001 (0.286)
SBEDu _t	0.000 (0.990)	-0.027 (-0.741)	-0.431 (-1.446)
BoDS _t	-0.009 (-1.250)	-0.002 (-1.205)	-0.01 * (-1.832)
BoDM _t	-0.005 (-0.958)	0.001 (1.520)	0.003 ** (2.560)
BoDIND _t	-0.087 ** (-2.430)	-0.011 (-1.085)	-0.039 (-0.709)
Bank_size _t	-0.125 *** (-2.582)	0.027 (1.095)	0.091 * (1.708)
Bank_age _t	-0.002 *** (-3.879)	-0.000 (-1.341)	-0.006 ** (-2.449)
Loansta _t	-0.143 ** (-2.312)	0.088 (1.563)	0.202 ** (2.261)
GDP_growth _t	-0.115 ** (-2.078)	-0.055 (-1.200)	-0.355 * (-1.919)
Inflation _t	-0.002 (-1.615)	-0.000 (-0.579)	-0.002 (-0.807)
Constant _t	0.000 (0.990)	-0.550 (-0.976)	-0.798 (-0.647)
Year dummy	YES	YES	YES
Observations	35	92	92
AR1	.	-1.090	-2.116 **
AR2	.	0.538	1.513
Wald Chi2	33,718.640	567.930	18,968.640

The table shows the One-step GMM system estimator in Central Shariah Board countries. The variables are Tobin's Q proxy (*Q*), return on assets (ROA), return on equity (ROE), Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), fraction of non-executive members (BoDIND), logarithm of total assets at book value in US \$ millions (Bank_size), Bank age (Bank_age), the ratio loans to total assets (Loansta), the growth rate of gross domestic product (GDP_growth), the inflation index (Inflation). ***, ** and * denotes statistical significance at 1%, 5% and 10% level, respectively.

When there is no Shariah board at national level (results reported in Table 5.5), the Shariah Board characteristics do not affect either the market or the accounting performance measures, suggesting that the market does not value a *good* Shariah Board.

Board of Directors size positively affect IBs profitability (either ROA or ROE), but regarding its independence it seems that the Stewardship theory prevails, since it impacts significantly but negatively bank's profitability, so inside background of the Board of Director's members contribute to better managerial decisions.

Finally, it is worth noting that regardless the model used (full sample and the Central/Non-central Shariah Board subsamples), AR1 and AR2 tests confirm the validity of instrumental variables and the lack of second-order serial correlation.

Table 5. 5: One-step model for Non-Central Shariah Board Countries

VARIABLES	Model (1) <i>Q</i>	Model (2) ROA	Model (3) ROE
<i>Q</i> _{t-1}	0.416 *** (4.520)		
<i>Q</i> _{t-2}	-0.394 *** (-3.172)		
ROA _{t-1}		-0.553 *** (-5.888)	
ROA _{t-2}		0.296 * (1.742)	
ROE _{t-1}			-0.163 * (-1.712)
ROE _{t-2}			-0.086 *** (-4.057)
SBS _t	0.200 (0.787)	-0.001 (-0.069)	0.035 (0.842)
SBS _t ²	-0.008 (-0.530)	0.001 (1.292)	0.001 (0.165)
SBM _t	0.003 (1.280)	-0.000 (-0.386)	-0.000 (-0.220)
SBEDu _t	0.385 (1.494)	0.032 (0.856)	0.163 (1.387)
BoDS _t	0.006 (0.716)	0.004 (2.690)	0.015 (3.162)
BoDM _t	-0.001 (-0.549)	-0.000 (-0.394)	0.000 (0.285)
BoDIND _t	-0.074 (-1.245)	-0.054 *** (-4.417)	-0.123 *** (-3.114)
Bank_Size _t	0.005 (0.047)	-0.008 (-0.527)	0.021 (0.383)
Bank_age _t	0.071 * (1.699)	0.023 *** (2.892)	-0.024 (-1.119)
Loansta _t	-0.425 (-1.386)	0.09 ** (2.571)	0.289 ** (2.259)
GDP_growth _t	-0.196 * (-1.682)	-0.006 (-0.458)	-0.094 ** (-2.076)
Inflation _t	0.031 ** (2.095)	-0.001 (-0.448)	-0.000 (-0.041)
Constant _t	-1.751 (-0.871)	-0.553 ** (-2.022)	-0.071 (-0.078)
Year dummy	YES	YES	YES
Observations	70	84	84
AR1	-2.469 **	-1.382	-0.964
AR2	-0.502	-0.748	-2.592 ***
Wald Chi2	38,984.020	217.430	924.500

The table shows the One-step GMM system estimator in Non-Central Shariah Board Countries. The variables are Tobin's Q proxy (*Q*), return on assets (ROA), return on equity (ROE), Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), fraction of non-executive members (BoDIND), logarithm of total assets at book value in US millions (Bank_size), Bank age (Bank_age), the ratio loans to total assets (Loansta), the growth rate of gross domestic product (GDP_growth), the inflation index (Inflation). ***, ** and * denotes statistical significance at 1% , 5% and 10% level, respectively.

5.3.2. GCC vs South Asian countries

Prior literature has extensively used (Hamza, 2013; Grassa and Gazdar, 2014; Abdullah et al., 2015; Mollah and Zaman, 2015; Al-Azizah, 2017), the classification of Islamic banks according to the geographic and economic criteria of being based in one of the Gulf Cooperation Council countries or in the SA region. We have analysed whether this grouping criteria could shed some light over the investigation. To provide additional findings we have run again the model reported above over the new subsamples, GCC countries and SA countries.

Table 5.6 reports the multivariate analysis using one-step system estimator of the Arellano-Bond model (1991). The results related to the banks that belong to GCC countries suggest that, Shariah board size presents the opposite, that is, convex or U-shaped relationship to both Islamic banks measures of profitability, that is, ROA and ROE because the lineal variable (SBS) is negative meanwhile its quadratic form (SBS2) presents a positive coefficient. This is not an isolated finding because it is consistent with previous studies (see e.g., Yermack, 1996; Eisenberg et al., 1998). The reported data also suggest that the remaining SB characteristics, education and activity, do not significantly affect neither the performance nor the profitability of the Islamic banks (according to Grassa and Matoussi, 2014). Therefore, we could reject the first hypothesis (H1) but not H2 and H3 for the GCC countries.

In addition, none of the ownership characteristics but the major shareholder being a bank impact Islamic banks' performance. For the Islamic banks located in

GCC countries, when the main shareholder is a bank presents a positive impact on the Islamic bank's ROA.

Regarding to the control variables, it is worth mention that there is no relationship between board size and bank's performance (Beiner et al.2004; Guest, 2009) but there is a positive relationship between board of directors meetings and market-based measure (Q), which is consistent with previous studies (De Andres and Vallelado, 2008; García-Meca et al., 2015; Liang et al., 2013). However there is no relationship between board meetings and accounting-based measures of performance (ROA and ROE).

We can also assert that there is a negative relationship between the number of non-executive members and bank's performance. This result is consistent with previous studies (Yermack, 1996; Bhagat and Black, 2001; Aebi et al.2012; Mollah and Zaman, 2015) and supports the Stewardship theory.

Table 5. 6: One-step model for GCC countries

VARIABLES	Model (1) Q		Model (2) ROA		Model (3) ROE	
Q _{t-1}	0.170 (1.518)					
Q _{t-2}	-0.831 (-2.964)	***				
ROA _{t-1}			-0.636 (-14.658)	***		
ROA _{t-2}			0.497 (11.611)	***		
ROE _{t-1}					-0.145 (-0.994)	
ROE _{t-2}					-0.052 (-0.303)	
SBS _t	0.069 (0.135)		-0.097 (-2.237)	**	-0.444 (-3.323)	***
SBS _t ²	0.070 (1.122)		0.011 (2.503)	**	0.051 (3.710)	***
SBM _t	0.003 (1.379)		-0.000 (-0.221)		-0.000 (-0.066)	
SBEDu _t	-1.340 (-0.743)		-0.056 (-1.058)		-0.195 (-0.931)	
Control_Rate _t	-0.490 (-0.495)		0.074 (0.428)		0.246 (0.298)	
State _t	0.051 (0.124)		0.013 (0.208)		-0.354 (-1.170)	
Bank _t	0.225 (1.376)		0.088 (1.998)	**	-0.003 (-0.006)	
Control_Rate*State	-0.847 (-0.385)		-0.035 (-0.094)		2.102 (1.130)	
Control_Rate*Bank	-1.144 (-0.970)		-0.630 (-2.000)	**	-0.039 (-0.011)	
BoDS _t	0.005 (0.765)		-0.001 (-0.676)		-0.000 (-0.043)	
BoDM _t	0.013 (2.071)	**	-0.000 (-0.480)		-0.001 (-0.377)	
BoDIND _t	-0.095 (-2.225)	**	-0.04 (-2.846)	***	-0.126 (-2.992)	***
Bank_size _t	-0.010 (-0.128)		-0.008 (-0.976)		0.022 (0.480)	
Bank_age _t	0.031 (0.804)		0.029 (8.310)	***	-0.025 (-1.373)	
Loansta _t	-0.318 (-1.200)		0.044 (1.288)		0.206 (1.377)	
GDP_growth _t	-0.150 (-1.312)		-0.003 (-0.122)		-0.052 (-0.468)	
Inflation _t	0.005 (1.449)		0.001 (2.446)	**	0.003 (1.916)	*
Constant _t	0.000 (0.990)		-0.270 (-0.956)		1.379 (1.384)	
Year dummy	YES		YES		YES	
Observations	63		84		84	
AR1	-1.777	*	-1.941	*	-1.613	
AR2	-0.578		-1.429		-1.946	*
Wald Chi2	1.380·10 ⁹		4.740·10 ⁹		8.200·10 ⁷	

The table shows the One-step GMM system estimator in Gulf Cooperation Council countries (GCC). The variables are Tobin's Q proxy (Q), return on assets (ROA), return on equity (ROE), Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), fraction of non-executive members (BoDIND), logarithm of total assets at book value in US \$ millions (Bank_size), Bank age (Bank_age), the ratio loans to total assets (Loansta), the growth rate of gross domestic product (GDP_growth), the inflation index (Inflation), the percentage held by the major shareholder (Control_rate), the major shareholder is the government (State), the major shareholder is a financial institution (Bank). ***, ** and * denotes statistical significance at 1% , 5% and 10% level, respectively.

Table 5.7 shows the results related to the banks settled in SA countries. The Shariah board characteristics do not affect significantly the performance of banks, except for Shariah board size that presents a convex relationship with bank's ROE (model 3). Shariah board meetings (SBM) present a weak association with Q ratio. Regarding ownership characteristics, the results depicted in Table 5.7 suggest a weak association with Q ratio (10% significance) and, similar to the subsample of GCC banks, only when the major shareholder is another financial institution it seems to impact positively on the Islamic bank's ROE (model 3). None of the interactions between control rate and major shareholder ($\text{Control_Rate} * \text{State}$ and $\text{Control_Rate} * \text{Bank}$) exhibits significant association with the three performance measures (Models 1, 2 and 3).

Table 5. 7: One-step model for South Asian Countries

VARIABLES	Model (1) <i>Q</i>	Model (2) ROA	Model (3) ROE
<i>Q</i> _{t-1}	0.137 (1.167)		
<i>Q</i> _{t-2}	0.226 * (1.857)		
ROA _{t-1}		-0.075 (-0.295)	
ROA _{t-2}		-0.033 (-0.218)	
ROE _{t-1}			-0.019 (-0.083)
ROE _{t-2}			-0.106 * (-1.771)
SBS _t	0.010 (0.117)	0.008 (0.640)	0.112 ** (2.198)
SBS _t ²	-0.003 (-0.796)	-0.001 (-1.333)	-0.010 ** (-2.543)
SBM _t	0.003 * (1.765)	0.001 (0.858)	-0.000 (-0.136)
SBEDu _t	-0.170 (-0.855)	-0.030 (-0.985)	0.107 (0.698)
Control_Rate _t	0.185 * (1.787)	0.146 (1.248)	0.536 * (1.715)
State _t	0.000 (0.990)	0.000 (0.990)	0.000 (0.990)
Bank _t	-0.023 (-0.535)	0.016 (0.720)	0.271 ** (2.472)
Control_Rate*State	0.000 (0.990)	-21.837 (-0.880)	-92.097 (-1.194)
Control_Rate*Bank	0.053 (0.327)	0.023 (0.296)	-0.441 (-1.632)
BoDS _t	0.005 ** (2.157)	0.000 (0.312)	0.004 (0.937)
BoDM _t	0.000 (0.338)	0.000 (0.763)	0.001 (0.844)
BoDIND _t	-0.021 (-1.454)	-0.004 (-0.246)	0.015 (0.325)
Bank_size _t	-0.060 (-1.380)	0.037 (1.073)	0.161 * (1.665)
Bank_age _t	-0.001 *** (-5.434)	-0.000 (-0.824)	-0.004 (-0.948)
Loansta _t	0.404 *** (2.746)	0.158 (1.316)	0.387 ** (2.163)
GDP_growth _t	-0.239 ** (-2.001)	-0.041 (-0.937)	-0.174 * (-1.772)
Inflation _t	0.001 (0.360)	-0.004 (-1.326)	-0.020 (-1.503)
Constant _t	1.693 (1.379)	0.000 (0.990)	0.000 (0.990)
Year dummy	YES	YES	YES
Observations	63	84	84
AR1	-2.260 **	-1.267 *	-1.777 *
AR2	0.995	-1.355	-0.913
Wald Chi2	429.100	359.98	56,147.080

The table shows the One-step GMM system estimator in SA Countries. The variables are Tobin's Q proxy (*Q*), return on assets (ROA), return on equity (ROE), Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), fraction of non-executive members (BoDIND), logarithm of total assets at book value in US \$ millions (Bank_size), Bank age (Bank_age), the ratio loans to total assets (Loansta), the growth rate of gross domestic product (GDP_growth), the inflation index (Inflation), the percentage held by the major shareholder (Control_rate), the major shareholder is the government (State), the major shareholder is a financial institution (Bank). ***, ** and * denotes statistical significance at 1% , 5% and 10% level, respectively.

5.3.3. Alternative measures of bank's performance

Prior investigations have used different measures of firm's performance. As a robustness check, we have rerun the model with different dependent approaches to firm's performance.

Table 5.8 exhibits the results when the dependent variable is ROA and ROE, but the numerator is the Ebitda (Earnings Before Interest, Taxes, Depreciation and Amortization) instead of net income. We have also considered Loans quality, Net interest margin and Sales growth (Beck et al., 2013; Zouari and Taktak, 2014) as dependent variables.

Regarding Shariah board characteristics, only its size (SBS) displays a concave or u-inverted relationship with Sales growth. Therefore, it seems that the increase in the number of members positively affect bank's growth but there is point when the bigger size impacts negatively on the bank's sales growth. This confirms our previous findings reported in the table 5.1.

The ownership characteristics become more relevant when addressing alternate measures of performance than in prior analysis. When the main shareholder is a governmental entity (State) negatively impact bank's ROE-Ebitda (1% of significance). Conversely, the main shareholder being a bank positively impacts bank' performance when it is measured through ROE-Ebitda. Despite this, the interaction between those two variables with the Control rate (Control_rate*State and Control_rate*Bank) presents the opposite sign.

The control variables do not present consistent results. Only Board of Directors meetings offer weak-significant negative relationship with ROE-Ebitda and Net interest margin, which is consistent with previous studies (Vafeas, 1999; Jackling and Johl, 2009).

5.3.4. Alternative statistical methodologies

In addition to the GMM dynamic model, we have also used two different static models, i.e. a random effects and Taylor model, in order to test the robustness of our results.

Table 5. 8: Alternative performance measures

VARIABLES	Alternative performance measures						
	ROA (Ebitda)	ROE (Ebitda)	Loans Quality	Net Interest Margin	Sales Growth		
Dep. Var. $t-1$	0.101 (0.413)	0.150 (0.862)	-0.120 (-0.329)	-0.227 (-1.623)	-0.959 (-21.317)	***	
Dep. Var. $t-2$	0.387 (1.988)	** (0.372)	0.019 (-0.252)	-0.006 (-0.229)	-0.625 (-17.127)	***	
SBS $_t$	0.006 (0.715)	-0.018 (-0.244)	-0.033 (-0.420)	0.009 (0.752)	0.915 (3.150)	***	
SBS $_t^2$	-0.001 (-0.890)	0.001 (0.142)	0.008 (1.149)	-0.001 (-1.333)	-0.088 (-3.258)	***	
SBM $_t$	-0.000 (-0.210)	0.000 (0.294)	0.001 (0.765)	-0.000 (-0.199)	-0.001 (-0.240)		
SBEDu $_t$	-0.010 (-0.323)	-0.169 (-0.785)	-0.192 (-0.631)	0.024 (0.581)	-0.641 (-1.066)		
Control_Rate $_t$	0.0429 (0.274)	-1.252 (-0.855)	0.545 (1.398)	-0.278 (-1.964)	** (0.504)	2.032 (0.504)	
State $_t$	-0.048 (-1.311)	-1.799 (-4.586)	*** (-1.414)	-0.280 (1.378)	0.075 (0.990)	0.000 (0.990)	
Bank $_t$	0.048 (2.053)	** (2.319)	0.797 (2.319)	** (0.348)	0.043 (2.393)	** (0.074)	
Control_Rate*State	0.280 (1.395)	10.526 (4.787)	*** (1.340)	1.277 (-0.890)	-0.250 (-0.890)	-0.238 (-0.123)	
Control_Rate*Bank	-0.174 (-2.282)	** (-2.443)	-2.664 (-0.039)	** (-2.451)	-0.284 (-2.451)	** (-0.229)	
BoDS $_t$	0.000 (0.078)	0.005 (0.725)	0.004 (0.655)	-0.001 (-0.895)	-0.001 (-0.362)	-0.008 (-0.362)	
BoDM $_t$	-0.000 (-0.570)	-0.008 (-1.751)	* (-0.988)	-0.002 (-2.182)	** (-2.182)	-0.001 (-0.419)	
BoDIND $_t$	-0.002 (-0.319)	-0.081 (-1.920)	* (1.005)	0.043 (-1.066)	-0.009 (-1.066)	0.136 (0.534)	
Bank_size $_t$	-0.007 (-1.313)	0.053 (0.899)	0.061 (1.047)	0.004 (0.479)	0.509 (2.020)	** (2.020)	
Bank_age $_t$	0.000 (0.797)	-0.002 (-1.451)	-0.004 (-1.043)	-0.000 (-0.944)	-0.006 (1.836)	* (1.836)	
Loansta $_t$	-0.001 (-0.043)	0.188 (1.348)	0.578 (1.546)	-0.061 (-2.014)	** (-2.014)	-0.561 (-0.759)	
GDP_growth $_t$	0.005 (0.415)	0.167 (1.025)	0.044 (0.396)	0.013 (0.960)	-0.169 (-0.460)	-0.169 (-0.460)	
Inflation $_t$	0.000 (0.685)	0.006 (1.675)	* (0.262)	0.001 (1.042)	-0.021 (-3.241)	*** (-3.241)	
Constant $_t$	0.154 (1.105)	-0.053 (-0.035)	-1.983 (-1.328)	0.250 (1.063)	-11.883 (-1.949)	* (-1.949)	
Year dummy	YES	YES	YES	YES	YES	YES	
Observations	165	165	169	163	106	106	
AR1	-1.680	*	-2.875	***	0.479	0.223	-2.280
AR2	-1.586		-0.338		-0.147	-1.585	-1.742
Wald Chi2	5,955.470		16,467.350		134.000	646.980	44,468.660

The variables are: ROA (EBITDA) is the Return On Assets as EBITDA divided by total assets, ROE (EBITDA) is the Return On Equity as EBITDA divided by total Equity, Loans Quality is the non-performing loans divided by loans, Net Interest Margin is the Net Interest Revenues divided by loans, Sales Growth is the change in turnover between fiscal year t-1 and fiscal year t, Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), fraction of non-executive members (BoDIND), logarithm of total assets at book value in US \$ millions (Bank_size), Bank age (Bank_age), the ratio loans to total assets (Loansta), the growth rate of gross domestic product (GDP_growth), the inflation index (Inflation), the percentage held by the major shareholder (Control_rate), the major shareholder is the government (State), the major shareholder is a financial institution (Bank). ***, ** and * denotes statistical significance at 1%, 5% and 10% level, respectively.

5.3.4.1. Random effects model

The Hausman hypothesis was not rejected and, therefore, we could get better estimations using random effects. Thus, we assume in this model that the individual-specific effect is a random variable that is uncorrelated with the explanatory variables of all past, current and future time periods of the same individual.

Table 5.9 presents the results of using random effects model for all observations. From the data displayed in the table 5.9 we can conclude that Shariah Board characteristics only exhibit a statistically significant relationship with ROE profitability (Model 3). Shariah board size has a concave relationship with ROE, but with weak statistical significance (10%), and Shariah Board education presents a positive association with ROE.

In addition, Islamic banks owned by the government impact in a negative way the market-based measure of profitability, Q ratio, and also the interaction $\text{Control_Rate} * \text{Bank}$ exhibit a significant influence on the Q ratio (the coefficient, 1.582, is positive because it is the outcome of two negative coefficients -0.105 and -0.322).

In general terms, we can conclude that the board of director' characteristics do not impact Islamic bank's performance.

Table 5. 9: Random Effects for the whole sample

VARIABLES	Model (1) <i>Q</i>	Model (2) ROA	Model (3) ROE	
SBS _t	0.011 (0.175)	0.004 (0.953)	0.029 (1.691)	*
SBS _t ²	-0.001 (-0.223)	-0.000 (-1.259)	-0.002 (-1.929)	*
SBM _t	0.003 (1.218)	0.000 (1.193)	-0.000 (-0.039)	
SBEDu _t	0.110 (1.467)	0.016 (1.468)	0.072 (2.189)	**
Control_Rate _t	-0.105 (-1.177)	0.014 (0.948)	0.008 (0.251)	
State _t	-0.322 * (-1.683)	0.007 (0.880)	0.024 (0.921)	
Bank _t	0.028 (0.694)	0.010 (1.257)	0.033 (0.955)	
Control_Rate*State	1.582 ** (1.978)	-0.023 (-1.418)	-0.040 (-0.846)	
Control_Rate*Bank	0.031 (0.286)	-0.016 (-0.957)	-0.013 (-0.256)	
BoDS _t	0.008 * (1.825)	0.001 (0.988)	0.003 (1.184)	
BoDM _t	-0.003 (-1.550)	-0.000 (-0.616)	-0.000 (-0.365)	
BoDIND _t	-0.067 (-1.353)	0.005 (0.371)	0.019 (0.578)	
Bank_size _t	0.046 ** (2.124)	0.006 * (1.894)	0.039 *** (4.757)	
Bank_age _t	-0.001 (-1.044)	0.000 (0.271)	-0.001 (-0.673)	
Loansta _t	-0.063 (-0.697)	0.035 ** (2.013)	0.140 ** (2.477)	
GDP_growth _t	-0.314 *** (-2.738)	0.015 (0.880)	0.134 * (1.914)	
Inflation _t	0.001 (0.341)	0.001 * (1.851)	0.008 *** (3.739)	
Constant _t	-0.034 (-0.066)	-0.192 ** (-2.574)	-1.060 *** (-5.631)	
Year dummy	YES	YES	YES	
Observations	215	377	377	
Wald Chi2	235.430	71.640	275.320	

The table shows the Random Effects model for all observations. The variables are Tobin's Q proxy (*Q*), return on assets (ROA), return on equity (ROE), Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), fraction of non-executive members (BoDIND), logarithm of total assets at book value in US \$ millions (Bank_size), Bank age (Bank_age), the ratio loans to total assets (Loansta), the growth rate of gross domestic product (GDP_growth), the inflation index (Inflation), the percentage held by the major shareholder (Control_rate), the major shareholder is the government (State), the major shareholder is a financial institution (Bank). ***, ** and * denotes statistical significance at 1% , 5% and 10% level, respectively.

5.3.4.2. Taylor model

Finally, we applied the Taylor model. This model is based on the estimators originally proposed by Hausman and Taylor (1981). However, it incorporates instrumental variables, proposed by Amemiya and MaCurdy (1986), and the model is useful to control a specific problem of correlated variables. Specifically, this model assumes that some of the explanatory variables are correlated with the individual-level random effects, but that none of these variables are correlated with the idiosyncratic error. We complement our robustness tests with this method in order to provide further analysis. Data displayed in Table 5.10 indicates that none of the Shariah board characteristics impact significantly on Islamic bank's performance.

Consistently with the prior reported results of this investigation, when the major shareholder is a governmental body it negatively impacts the market-based measure (Q ratio).

None of the board of directors characteristics have significant effect on the performance, except board size that has a positive effect on the performance in model 2 (ROA).

Table 5. 10: Taylor model for the whole sample

VARIABLES	Model (1)		Model (2)		Model (3)
	Q		ROA		ROE
SBS _t	0.070 (0.916)		-0.001 (-0.063)		0.014 (0.228)
SBS _t ²	-0.004 (-0.754)		0.000 (0.175)		-0.001 (-0.248)
SBM _t	0.003 (0.962)		0.000 (0.335)		-0.001 (-0.271)
SBEDu _t	0.070 (0.437)		0.008 (0.391)		0.032 (0.296)
Control_Rate _t	-0.149 (-0.776)		0.015 (0.663)		0.019 (0.172)
State _t	-0.466 (-2.477)	**	0.001 (0.070)		0.038 (0.406)
Bank _t	0.007 (0.064)		0.014 (0.902)		0.136 (1.629)
Control_Rate*State	2.218 (2.828)	***	-0.008 (-0.195)		-0.027 (-0.126)
Control_Rate*Bank	0.071 (0.255)		-0.023 (-0.819)		-0.161 (-1.159)
BoDS _t	0.004 (0.430)		0.003 (2.000)	**	0.002 (0.247)
BoDM _t	-0.001 (-0.366)		0.000 (0.977)		0.001 (0.404)
BoDIND _t	-0.057 (-0.679)		0.017 (1.525)		-0.018 (-0.285)
Bank_size _t	0.036 (1.020)		0.006 (1.536)		0.054 (2.713)
Bank_age _t	-0.001 (-0.645)		-0.000 (-0.443)		-0.003 (-2.084)
Loansta _t	-0.063 (-0.411)		0.039 (2.378)	**	0.151 (1.646)
GDP_growth _t	-0.336 (-2.576)	***	0.008 (0.422)		0.048 (0.415)
Inflation _t	0.001 (0.223)		-0.000 (-0.564)		-0.001 (-0.246)
Constant _t	0.033 (0.045)		-0.152 (-1.647)	*	-0.834 (-1.787)
Year dummy	YES		YES		YES
Country dummy	YES		YES		YES
Observations	215		377		377
Wald Chi2	36.280		42.890		29.370

The table shows the Taylor model in all observations (Central and Non Shariah Board countries). The dependent variables are Tobin's Q proxy (Q), return on assets (ROA), return on equity (ROE), Shariah board size (SBS), Shariah board meeting (SBM), Shariah board average education (SBEDU), Board size (BoDS), Board meeting (BoDM), fraction of non-executive members (BoDIND), logarithm of total assets at book value in US \$ millions (Bank_size), Bank age (Bank_age), the ratio loans to total assets (Loansta), the growth rate of gross domestic product (GDP_growth), the inflation index (Inflation), the percentage held by the major shareholder (Control_rate), the major shareholder is the government (State), the major shareholder is a financial institution (Bank). ***, ** and * denotes statistical significance at 1% , 5% and 10% level, respectively.

CHAPTER 6

CONCLUSIONS, LIMITATIONS AND FUTURE RESEARCH

6.1. Conclusions

The purpose of this research is to identify the associations, if any, between CG mechanisms in Islamic banks and their performance.

Islamic banks are required to meet not only the same goals as their conventional counterparts, in terms of profitability targets, dividend policies, accounting regulation or implementation of prudential measures required by international institutions such as the Basel Committee, but they must also comply with Shariah principles. In this regard, the Shariah board plays a key role in the CG structure of Islamic banks, seeking to ensure fairness to all stakeholders through greater transparency and accountability regarding Islamic principles.

There is scarce research addressing the impact of two governance issues in the Islamic banking industry; namely, the Shariah board characteristics and the ownership structure. This research aims to shed light on both topics through in-depth review of prior literature and an empirical analysis of a sample of Islamic banks based in different countries.

Below, we outline the highlights of this research project.

In **chapter 1**, we explained the concept of Islamic finance and the main similarities with and differences from conventional finance. Some of those differences emerge from the need to comply with the following five Shariah principles:

- a) The prohibition of interest (usury) in all transactions.
- b) The prohibition of excessive uncertainty (*ghara*), according to which the details of the sale contract cannot be unknown or uncertain.
- c) The prohibition on financing illicit industries.
- d) The principle of profit-and-loss sharing.
- e) All transactions have to be backed by a real economic transaction that involves a tangible asset.

We then presented a brief history of the emergence of Islamic banks around the world, followed by an overview of the activities of Islamic banks. In this chapter we illustrated how the Islamic economy has emerged in response to the social commitments and ethical norms established under Shariah law, which originates from the Muslim holy book (*Quran*) and the actions of the prophet Mohammed (*Sunnah*). The main aim of Islamic banks is not only to seek profits for shareholders, but also to perform a wealth redistribution role and adhere to the principle of social justice that contributes to the improvement and well-being of society.

We ended this chapter by describing the current state of Islamic finance and showing how the growth rate of Islamic banks differs not only in Islamic countries but also around the world.

In **chapter 2**, we discussed the concept of CG and reviewed the main characteristics of CG in conventional banking. Then, we explained the specific features of CG in Islamic financial institutions to provide a better understanding of the role of the Shariah supervisory board as an essential body for ensuring good governance in these institutions.

Islamic banks are subject to a multi-level governance system, with religious elements playing a notable role in the governance structure. All Islamic financial institutions must implement a Shariah governance system, and the particular structure of this system is a distinguishing feature of Islamic business organizations (Quttainah, 2013).

In this chapter, we concluded that there is wide variety of Shariah governance models across countries. After a thorough review of the CG regulation in each country analysed in this research, we concluded that the Shariah board can be categorized according to whether or not they have a central Shariah board attached to the national Central Bank (or another regulatory authority). In some countries, i.e. Malaysia, Indonesia, Pakistan, Brunei Darussalam, the United Arab Emirates (UAE) and Sudan, each Islamic Bank has its own Shariah board, but it must comply with the rules set by the Shariah board of the Central Bank.

Additionally, we identify another set of countries that lacks this Central Shariah body at a macro level. Instead, each Islamic bank has its own, individual

Shariah board, since it is compulsory for every Islamic financial institution to establish a Shariah board. The micro-level Shariah board has responsibilities such as participating in product development and structuring activities, reviewing and approving matters related with Shariah, issuing *fatwa* and Shariah auditing pronouncements. Hence, the permissibility of contracts and the Shariah compliance of financial products are decided at the level of these institutions by their own Shariah committees, because every Shariah board is independent of the central bank. This is the typical model implemented in a number of countries of the Gulf Cooperation Council and certain other states (Kuwait, Saudi Arabia, Bahrain, Qatar, Oman, Bangladesh, Singapore, Thailand, Jordan and Indonesia).

In **chapter 3**, we presented an extensive review of the relevant literature related to the subject of study, highlighting the main theories and findings about the composition of the boards of directors, the ownership structure and their impact on the performance of Islamic and conventional banks. We also developed the hypotheses of this research project. Additionally, we showed that most previous empirical studies deal with CG mechanisms in conventional banks and only a few studies are focused on Islamic banks. Therefore, additional empirical investigation seems to be necessary in this field.

In **chapter 4**, we develop the methodology in order to test the research questions. We describe the sample selection process and analyse its composition. Our final sample consists of 50 banks based in 15 countries, providing 300 bank-year observations for the period 2011-16. We review the main descriptive statistics and perform a correlation analysis in order to assess possible problems that may arise in the estimation of the models.

The t-test of means showed that the group of countries with a non-central Shariah board exhibits a significantly higher Q ratio, while the countries with a central Shariah board achieve higher profitability, in terms of ROA. On average, Islamic banks located in countries that follow a centralized model have a bigger and more educated (in the field of accounting and finance) Shariah board than the other group. The former group also display higher ownership concentration with a financial institution as a major shareholder.

Chapter 5 is devoted to displaying the results of the empirical analysis. From this chapter, we draw the following conclusions:

The Shariah board characteristics significantly affect (at the 1 % level) the performance of financial institutions in terms of the Q ratio:

There is a significant association between Shariah board size and bank performance, showing a concave relationship. These results corroborate prior findings about boards of directors (De Andres and Vallelado, 2008; Crove et al., 2011). We estimate that 12 members is the optimal (maximum) size.

There is a positive association between members' average education in accounting and finance, and market performance. That is consistent with the human capital theory and prior studies (Nomran et al., 2018; Farook et al., 2011), which show that aspects relating to educational issues usually translate into better performance.

The data also reveal that the number of meetings positively impacts the Q ratio. These results highlight the relevance of banks having a proactive board (De

Andrés and Vallelado, 2008; Liang et al., 2013; García-Meca et al., 2015). In Islamic banks, the number of meetings of the Shariah board seems to reflect behaviour that is more proactive than reactive, which significantly improves their performance.

Both a larger size and regular activity of the Shariah board seem to generate advantages in Islamic banks (monitoring and advising), increasing the pool of expertise, while mitigating disadvantages (lack of coordination and decision-making deficiencies). This is because the Shariah board must control and review all bank operations.

In sum, our results suggest that a good Shariah board is positively perceived by the investors because they rely on this body to ensure compliance with Islamic principles and because, eventually, it impacts the banks' market capitalization.

Conversely, we failed to find any significant relationship between the Shariah board characteristics and the accounting measures (ROA and ROE); a plausible explanation for this finding is that the range of transactions and operations are limited by the Shariah board (e.g. high volatility investments or high levels of debt that are related to high interest rates). Consequently, the profitability derived from the banking operations performed by the board of directors is not a consequence of the direct intervention of the Shariah board.

Regarding ownership structure, we explored the influence of ownership concentration, which is the percentage of shares held by major shareholders and the identity of the largest owners. None of the variables seem to influence our performance or profitability measures (Thomsen and Pederson, 2000; Zouari and

Taktak, 2014) but investors do not have a positive perception of the State being the majority shareholder. When the majority shareholder in Islamic banks is the government, the bank's performance is negatively influenced. The reason for this might be that the government monitors less intensively than private firms do, which is consistent with the efficient monitoring hypothesis of Demsetz and Villalonga (2001), Iannotta et al. (2007).

Finally, we performed some additional analyses to explore the influence of the geographical region and the Shariah model but we could not provide new insights. We also reckon that the robustness tests offer weak evidence about the relationship between our variable of interests and the Islamic bank's performance.

6.2. Implications of the study

The research findings identify different Shariah board oversight structures among Islamic banks. These differences are not only of a formal nature but also relate to content, since the Shariah board plays different roles according to the governance structure at national and organizational level. In those countries where there is no central Shariah board, the Shariah board at the bank level is a standard-setter or regulatory body because they are entitled to issue *fatwas* that the banks must follow. The harmonization of current divergent governance structures might help in the standardization of banks' practices in adherence with the Islamic religion.

Therefore, the outcome of this research could be useful for:

- a) Regulatory bodies, who could take into account the empirical evidence when developing CG regulation in the future.
- b) Islamic financial institutions, so that they can design a better structure for Islamic banks.
- c) Managers/boards of directors, because they are a crucial part of bank management and seek to improve bank performance.
- d) Other stakeholders, for instance customers or investors, who may be especially interested in the composition of the Shariah board and its reputation.
- e) Future researchers focusing on CG in Islamic banks.

6.3. Limitation of the research

The lack of empirical studies in the field of CG in Islamic banks made it difficult to find good sources on which to ground the hypothesis.

Lack of data also limits the investigation of additional, interesting CG variables (among others, Shariah board members interlock or Shariah board age) that might influence Islamic banks' performance. Furthermore, we were unable to extend our research period because we lacked relevant financial data from 2008 until 2010. This lack of information is likely associated with the financial crisis, which in the case of the Islamic bank industry lasted until 2011. In addition, some

Islamic banks are unlisted due to the national stock market limitations and we could not run the models due to lack of Q ratio values.

Islamic CG is still in a developmental stage and is mainly focused on Islamic financial instruments. Thus, the absence of a single institution that issues governance standards for Islamic institutions has made it difficult to explain and interpret the governance standards of Islamic banks and compare Islamic banks with each other and with their conventional counterparts.

Islamic banks are currently mainly distributed among Gulf and SA countries. Therefore, we could not compare them with Islamic banks based in other parts of the world to examine the influence of environmental and contextual issues.

6.4. Future Research

In our view, future research should address the motivational factors behind CG in Islamic banks that enhance bank performance in terms of efficiency.

In this research, we focused on the Shariah supervisory board in Islamic banks but a comparison of other CG mechanisms in Islamic and conventional banks could help to provide a better understanding of the diversity in the banking industry.

Finally, further insights into the specific country singularities and how they shape the governance framework would also be relevant for the academia and the regulatory bodies.

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Resumen

El objetivo de este proyecto de investigación es arrojar luz sobre las relaciones entre algunas características del Gobierno Corporativo (GC) en la banca Islámica y su desempeño.

Diversas razones motivan este estudio:

En primer lugar, las instituciones financieras Islámicas han experimentado una alta tasa de crecimiento durante las últimas décadas. En particular, los bancos Islámicos se han expandido en varios países europeos, tales como el Reino Unido y Luxemburgo, pero, sobre todo, han experimentado un crecimiento destacable en dos áreas concretas, el Sur de Asia y el Consejo de Cooperación del Golfo (CCG), de acuerdo a la información ofrecida por la International Organization for Securities Commissions (2004) y el Islamic Financial Services Industry (2014). Esta diseminación de la banca Islámica ha generado numerosas cuestiones que deberían ser investigadas, tales como los factores desencadenantes de esa expansión.

En segundo lugar, en las últimas décadas se ha producido un giro de intereses puramente financieros hacia intereses más inclusivos que comprendan valores relativos a la diversidad, a la sostenibilidad y a la responsabilidad social. En esta línea, la banca Islámica representa un área interesante de investigación por sus conexiones sociales y religiosas. El objetivo principal de los bancos Islámicos no es solo buscar beneficios para los accionistas, sino también realizar una función de redistribución de la riqueza y adherirse al principio de justicia social que

contribuya a la mejora y el bienestar de la sociedad. Por lo tanto, se esfuerzan por lograr un equilibrio entre proporcionar suficientes rendimientos a sus accionistas y depositantes, por un lado, y sus compromisos con sus responsabilidades sociales y diversos grupos de interés, por el otro (Haniffa y Hudaib, 2007; Khan, 2010).

En tercer lugar, hay necesidad de explorar las causas de la reciente crisis financiera global, que en muchos países alcanzó proporciones sistémicas. El sector financiero Islámico, aunque experimentó una fuerte caída en su rentabilidad durante los años de la crisis global, no sufrió el mismo impacto grave que la banca convencional, que provocó el colapso de los bancos de inversión y condujo a la pérdida de confianza en el mercado de créditos hipotecarios en los Estados Unidos (Rosman et al.2014). Se han argumentado diversas razones para ello:

- El abanico de servicios y productos financieros que ofrece está limitado por la aplicación de la Ley Shariah
- La autosuficiencia de los bancos Islámicos reduce la diseminación de los problemas entre los agentes del sector financiero

En cuarto lugar, el buen gobierno de las empresas se ha convertido en objeto de atención para académicos, emisores de estándares, legisladores y usuarios financieros. La reciente crisis financiera mundial ha puesto de manifiesto que el gobierno corporativo en instituciones financieras y corporaciones presenta debilidades (Claessens y Yurtoglu, 2013). Por ello, a pesar de que existe un volumen sustancial de literatura sobre el tema, todavía quedan muchas cuestiones por investigar.

Finalmente, la banca Islámica presenta la singularidad de tener un sistema de gobierno con múltiples niveles, donde la religión juega un papel importante. Es interesante analizar sus peculiaridades y cómo influyen los elementos institucionales, religiosos y culturales en el diseño de los mecanismos de buen gobierno.

Este proyecto de investigación pretende contribuir al acervo científico sobre la banca Islámica mediante el estudio del impacto de diversos mecanismos de GC en el desempeño bancario. En concreto, los **objetivos de la tesis** son analizar el impacto de:

- Las características del consejo Shariah.
- Las características de concentración de propiedad

en ambos casos sobre el desempeño del banco Islámico.

Para alcanzar dichos objetivos, la presente tesis se estructura en seis partes diferenciadas:

En el **capítulo 1**, se explica el concepto de finanzas Islámicas y las principales similitudes y diferencias con la banca convencional.

Las principales diferencias entre los bancos Islámicos y convencionales están arraigadas en los cinco principios y prohibiciones del Corán, aunque algunos académicos argumentan que los bancos Islámicos y convencionales son similares

en la sustancia y diferentes en el formato (Beck et al., 2013). Dichos principios son los siguientes:

- El principio de reparto de ganancias y pérdidas, por el cual los contratos típicos de banca Islámica son préstamos de sociedad entre bancos y prestatarios, es decir, contratos de Mudarabah (participación en los beneficios) y contratos de Musharakah (empresa conjunta). La característica común de estos contratos es que el banco comparte el riesgo con el depositante.
- La prohibición de usura, por la cual el banco no puede cargar intereses explícitos en las operaciones financieras.
- La prohibición de incertidumbre se traduce en que los bancos Islámicos no pueden invertir en activos de gran riesgo ni a muy largo plazo.
- La prohibición de financiar actividades ilícitas, como el juego o el consumo de alcohol.
- Las transacciones deben estar respaldadas por activos tangibles.

Así, identificamos los contratos utilizados con mayor frecuencia en la banca Islámica, como son:

- Mudarabah, según el cual el banco proporciona el capital completo necesario para financiar un proyecto, mientras que el cliente ofrece su trabajo y experiencia. Los beneficios del proyecto se comparten entre los

dos (banco y cliente), en una proporción predeterminada; sin embargo, en el caso de pérdida, es exclusiva del banco.

- Bajo los contratos de Musharakah (similar a una joint venture), el banco no es el único proveedor de fondos, sino que más socios contribuirán a financiar el proyecto. Los beneficios y las pérdidas se comparten entre ambas partes (banco y socios) en proporción al capital aportado. Este contrato suele ser el instrumento utilizado para financiar proyectos de inversión a largo plazo (Hasan y Dridi, 2011).
- Mediante el contrato Murabahah, el banco compra un bien único, o un conjunto de productos, en nombre de un cliente, que paga el costo más un recargo. Los reembolsos, incluido el recargo, generalmente se realizan de acuerdo con un calendario preestablecido del banco (Vinnicombe, 2010). Las principales características de este contrato son: (a) tanto el costo como el margen de ganancia deben ser conocidos por el banco y el cliente; (b) el banco debe asumir la propiedad de los bienes antes de revenderlos al cliente (con todos los riesgos de propiedad en el ínterin); (c) la promesa del cliente de comprar los bienes comprados en su pedido por el banco puede o no ser vinculante (en la mayoría de las jurisdicciones es vinculante); (d) no se aplican intereses por pagos atrasados, pero el banco podría requerir una garantía (International Monetary Fund, 2017, p.36).
- Istisna consiste en un contrato que permite a una parte obtener productos industriales con un pago en efectivo inicial y entrega diferida o pago y entrega diferidos. El banco actúa como intermediario (Hussain et al., 2016).

- El contrato de Ijarah es la versión de finanzas Islámicas de los contratos de alquiler y arrendamiento. Si bien en ambos casos el cliente paga una cierta renta fija, solo en este último se transfiere la propiedad al final del período especificado (Zaher y Hassan, 2001).

En el **capítulo 2**, se revisa el concepto de GC y sus principales elementos. Posteriormente, se identifican los elementos singulares del GC en la banca Islámica.

Los bancos Islámicos deben implementar un sistema de gobernanza Shariah, que el Consejo de Servicios Financieros Islámicos (IFSB) en Malasia define en los siguientes términos:

"Sistema de gobierno de la Shariah se refiere al conjunto de arreglos institucionales y organizativos a través de los cuales una Institución que ofrece servicios financieros Islámicos garantiza que exista una supervisión efectiva e independiente del cumplimiento de la Shariah".

Sus principales funciones son:

- Proporcionan solo los productos y servicios aprobados ex-ante conforme a la ley Islámica;
- Ayudan a sus empleados a cumplir con los principios morales en lugar de los intereses personales y la codicia.

- Promueven acciones colectivas de todos los interesados para mejorar la reputación del banco y beneficiar a todas las partes.

Los miembros del consejo Shariah son académicos religiosos de la Shariah con experiencia en el campo de la contabilidad y las finanzas. Pueden emitir fatwas (opiniones legales) de acuerdo con la ley Islámica sobre transacciones comerciales (fiqh al-muamalat) dentro de la religión Islámica. El consejo Shariah se reúne varias veces al año.

La Organización de Contabilidad y Auditoría para Instituciones Financieras Islámicas (AAOIFI), con sede en el Reino de Bahrén, y la Islamic Financial Services Board (IFSB) en Malasia son los dos principales emisores de normas para las instituciones financieras Islámicas. Ambos organismos han recopilado una lista de principios rectores para la gobernanza de la Shariah.

Tras la revisión de normas reguladoras de la gobernanza Shariah en los países de la muestra, hemos identificado dos grupos de países:

- a) Aquellos que siguen un modelo centralizado donde existe un Consejo Shariah a nivel nacional, adjunto al banco central o autoridad reguladora. Los consejos de la Shariah en este nivel juegan un papel importante en términos de armonización y estandarización de fatwas. Además, actúan como la máxima autoridad de la Shariah para las instituciones financieras Islámicas.

Con carácter general, las principales responsabilidades del Consejo Shariah a nivel nacional son las siguientes:

1. Aconsejar al Banco Central sobre cuestiones relacionadas con la Shariah
2. Emitir opiniones religiosas legales (fatwas) sobre asuntos financieros
3. Revise y apruebe los productos financieros que cumplen con la Shariah
4. Asistir a las Juntas de Supervisión de la Shariah en cada banco Islámico
5. En algunos casos (Malasia, Pakistán e Indonesia), el Comité Shariah aprueba o recomienda nombramientos para las juntas Shariah de las instituciones financieras Islámicas.

Cada banco Islámico tiene su propia junta de Shariah, pero debe cumplir con las reglas establecidas por la junta directiva de la Shariah del Banco Central.

Este modelo se utiliza en Malasia, Indonesia, Pakistán, Brunei Darussalam, Emiratos Árabes Unidos y Sudán.

- b) Países que siguen un modelo descentralizado donde no existe un Consejo Shariah a nivel nacional o macro. Sin embargo, como para el resto de bancos Islámicos, es obligatorio que el Consejo Shariah forme parte de los órganos de gobierno.

La permisibilidad de los contratos y el cumplimiento con la Shariah de los productos financieros se deciden a nivel de estas instituciones por sus propios Comités de la Shariah, porque cada junta de la Shariah es independiente.

Este es el modelo típico implementado en algunos países del Consejo de Cooperación del Golfo y algunos otros estados. Tal modelo se puede encontrar en Kuwait, Arabia Saudita, Bahrein, Qatar, Omán, Bangladesh, Singapur, Tailandia, Jordania e Indonesia.

Hay diferentes tamaños de Consejos Shariah en cada banco Islámico. El número más común es tres (en Malasia, Pakistán, Brunei Darussalam, Emiratos Árabes Unidos, Bahrein, Qatar, Kuwait, Omán, Jordania), en Indonesia, el mínimo es dos con un máximo de cinco, pero en los países restantes, el tamaño queda abierto a elección (Bangladesh) o no está especificado.

Las juntas individuales de Shariah en cada banco Islámico tienen diferentes funciones relacionadas con los siguientes roles:

- **Informativo.** En general, se solicita a la junta directiva de la Shariah que presente un informe anual sobre el cumplimiento de la Shariah del banco Islámico a la junta directiva. En el caso de Jordania, también deben informar a la asamblea general de accionistas. Indonesia, Pakistán y Jordania también requieren que la junta de la Shariah informe al Consejo Nacional de la Shariah o al Banco Central.
- **Supervisión.** Por lo general, revisan y aprueban todas las políticas, procedimientos, productos, sistemas, contratos y acuerdos del banco para su cumplimiento con la Shariah.

- Asesoramiento. Brindan consultas sobre cuestiones relacionadas con la Shariah a todas las partes que se ocupan del banco, como auditores, abogados, asesores y clientes.
- Jurisprudencia. En algunos casos, por ejemplo, en Indonesia, dan opiniones legales sobre asuntos financieros.

En el **capítulo 3** se identifican las principales teorías en las que se enmarca la investigación en Gobierno Corporativo, prestando especial atención a la teoría de la agencia, aunque algunos de nuestros resultados corroboran los postulados de la teoría del Stakeholder o Stewardship.

Desde el punto de vista de la teoría de la agencia, en la que se enmarca esta investigación, el cumplimiento de la Shariah en las instituciones Islámicas desencadena una nueva relación principal-agente entre los gerentes y las partes interesadas en los siguientes términos:

- a. Divergencia de intereses principales-agentes: los clientes musulmanes y otras partes interesadas realizan transacciones de inversión y financiación con el banco Islámico sobre la base de que el banco es una institución que cumple con la Shariah. Los gerentes (agentes) pueden perseguir sus propios intereses y liquidar transacciones que sean más rentables pero que no cumplan con los principios de la Shariah, mientras que las partes interesadas actúan en el entendimiento de que están interactuando con una institución Islámica. Como afirma Hasan (2009), el éxito de la industria financiera Islámica se basa en la creencia de todos los interesados de que todos los

componentes del sistema financiero cumplen con los principios y reglas de la Shariah.

- b. Asimetría de información: los gerentes tienen acceso a toda la información interna relacionada con los servicios financieros prestados por el banco, mientras que las partes interesadas carecen de información sobre el cumplimiento de la Shariah de esos productos financieros. Dado que los gerentes son los únicos que tienen derecho a acceder a la información financiera, si los incentivos del agente no están alineados con los de los principales, los gerentes que controlan los activos de las firmas pueden optar por satisfacer sus ambiciones personales en lugar de los accionistas y otras partes interesadas (problema de riesgo moral).

A continuación, se presenta una revisión extensa de las aportaciones teóricas y empíricas que analizan la relación entre los mecanismos de GC y el desempeño del banco. Ello sirve para sustentar las hipótesis de investigación que, de forma resumida, presentamos a continuación:

- Las (buenas) características del consejo Shariah, en concreto el tamaño, su actividad y su educación influirán (positivamente) en el desempeño del banco Islámico.
- La concentración y características de la propiedad influyen en el desempeño del banco Islámico.

En el **capítulo 4** se describe la **metodología** empleada para testar las cuestiones de investigación y la **muestra** de estudio.

La muestra y la información financiera principal se obtuvieron de la base de datos Bankscope. Los datos relacionados con el consejo Shariah fueron recolectados en su mayoría manualmente de los informes anuales individuales de los bancos y, adicionalmente, de otras fuentes como las páginas web de los mercados bursátiles.

Inicialmente, el período de estudio cubre desde 2008 hasta 2016. Sin embargo, carecíamos de datos financieros relevantes desde 2008 hasta 2010, posiblemente debido a la crisis financiera en la industria bancaria Islámica. Por ello, eliminamos 279 observaciones e investigamos el rendimiento de los bancos desde 2011 hasta 2016. Nuestra muestra final está compuesta por 50 bancos establecidos en 15 países que proporcionan 300 observaciones banco-año para el período 2011-2016. La mayoría de estos bancos se encuentran en países del Consejo de Cooperación del Golfo y países del sudeste asiático.

Aplicamos el Método Generalizado de Momentos (GMM) de Arellano y Bond (1991), siguiendo a Arellano y Bover (1995); Blundell y Bond (1998) o De Andres y Vallelado (2008) porque los efectos no observables a nivel de panel derivados de los modelos lineales están controlados y la correlación con las variables dependientes rezagadas no hace estimadores inconsistentes.

La variable dependiente de nuestro modelo es el desempeño del Banco. En primer lugar, hemos empleado la medida más común, es decir, la Q de Tobin, basada en el mercado y que se estima mediante el valor en libros de los activos totales menos el valor en libros del capital ordinario más el valor de mercado del capital dividido por el valor en libros del activo total.

También hemos utilizado enfoques basados en la contabilidad, como la Rentabilidad de los Activos (ROA) y la Rentabilidad de los fondos propios o del Accionista (ROE). Medimos el rendimiento de los activos como el ingreso neto dividido por los activos totales y, de manera similar, estimamos el rendimiento sobre el patrimonio como el ingreso neto dividido por los fondos propios totales (como en Grove et al., 2011; Adams y Mehran, 2012; Aebi et al. al., 2012).

Nuestras variables exploratorias relacionadas con el consejo Shariah son, en primer lugar, el tamaño del consejo, es decir el número total de miembros (Grassa y Matoussi, 2014; Mollah y Zaman, 2015; Matoussi y Nomran et al., 2018). Para observar si existe una relación no cuadrática el modelo también comprende el cuadrado del tamaño del consejo Shariah.

En segundo lugar, medimos la actividad del consejo Shariah a través del número de reuniones que han mantenido durante el año.

En tercer lugar, hemos analizado la educación promedio del consejo Shariah, es decir, el número de miembros que tienen título en contabilidad y finanzas dividido por el número total de miembros del consejo.

El segundo conjunto de variables exploratorias está relacionado con la estructura de propiedad. En primer lugar, medimos la concentración de la propiedad, denominada tasa de control, como el porcentaje de acciones que posee el mayor accionista.

Para estudiar el impacto del tipo de accionista mayoritario en el rendimiento del banco, empleamos la variable *Estado* que equivale a 1 si el mayor accionista es una entidad gubernamental y 0 en caso contrario.

Además, utilizamos una variable denominada Banco que equivale a 1 si el mayor accionista es un banco y 0 en caso contrario.

Controlamos, además, por otros determinantes potenciales de la variable dependiente que, agrupamos en variables de GC y variables macroeconómicas. En relación a las variables de GC, controlamos las características del consejo de administración que afectan el rendimiento de la empresa de acuerdo con los resultados publicados anteriormente. Así, incluimos como variable el tamaño y la actividad del consejo de administración, calculadas de forma similar al consejo Shariah. También consideramos la independencia del consejo medida a través de la fracción de miembros no ejecutivos.

Además de las variables de GC, y limitados por las restricciones de disponibilidad de datos, también hemos considerado otros factores que demostraron estar significativamente asociados a la rentabilidad del banco: tamaño del Banco, calculado como el logaritmo natural de los activos totales; la edad del banco, es decir, el número de años desde su establecimiento hasta la fecha actual. Además, hemos observado el apalancamiento del banco, medido como los

préstamos bancarios en relación a los activos totales. Finalmente, hemos controlado por el país y por el año.

Entre los determinantes macroeconómicos del desempeño del banco hemos incluido el nivel de ingreso por habitante, medida como el producto interior bruto per cápita y la inflación, que también ha demostrado influir en la rentabilidad del banco.

En el **capítulo 5** se presentan los **resultados** del análisis multivariante. Reportamos que las buenas características del Consejo Shariah influyen positivamente en el valor de mercado de los bancos Islámicos pero no en las tasas de rentabilidad contables. Respecto a las variables relativas a la concentración de la propiedad, ninguna de ellas parece tener una influencia significativa sobre el desempeño bancario. Únicamente el hecho de que sea el gobierno el accionista mayoritario, influye negativamente sobre el desempeño, pero consideramos que la evidencia aportada es débil.

En este capítulo también se muestran los resultados de los análisis de sensibilidad a distintas mediciones de las variables y de los tests de robustez.

En el **capítulo 6** se presentan las principales **conclusiones**. Los hallazgos de la investigación identifican:

Hay diferentes modelos de supervisión del Consejo Shariah: En concreto hay un modelo donde existe un Consejo Shariah a nivel nacional y otro modelo donde el Consejo Shariah sólo tiene presencia en los bancos. El grupo de países donde no hay un consejo de Shariah central exhibe un índice de Q

significativamente mayor que el otro grupo con un nivel de significancia estadística del 5%. La rentabilidad medida a través del ROA es estadísticamente más alta en los países con Consejo Central de Shariah, pero cuando se mide a través de ROE no hay diferencias significativas entre los dos grupos. Además, los resultados demuestran que, en promedio, los bancos Islámicos con sede en países que siguen un modelo centralizado tienen un consejo de Shariah que es más pequeño, pero más educado en finanzas y contabilidad que el otro grupo. Finalmente, en lo que respecta a las variables de estructura de propiedad, los bancos con sede en países con una junta central de Shariah muestran un porcentaje significativamente mayor en poder del accionista principal, y una mayor proporción de instituciones financieras es el principal accionista.

En relación a las características del Consejo Shariah, concluimos que el tamaño presenta una relación cóncava con el desempeño del banco, en la misma línea que los hallazgos previos en el consejo de administración (De Andres y Vallelado, 2008, Crove et al., 2011). Estimamos que 12 miembros es el tamaño óptimo (máximo), a partir del cual el incremento de tamaño genera una reducción en el desempeño del banco.

También revelamos una asociación positiva entre la educación promedio en contabilidad y finanzas del consejo Shariah y el desempeño del banco, consistente con la teoría del capital humano y evidencia previa (Nomran et al., 2018 y Farook et al. 2011).

Nuestros resultados avalan que el número de reuniones impacta positivamente en el desempeño del banco Islámico. Es decir, parece que las

reuniones son más proactivas (Andrés y Vallelado, 2008; Liang et al., 2013; García-Meca et al., 2015) que reactivas, lo que mejora significativamente el rendimiento de los mismos.

En resumen, en el caso de los bancos Islámicos un consejo Shariah más grande, más activo y con mayor educación en campos financieros parecen estimular las ventajas (supervisión y asesoramiento), en detrimento de las desventajas (falta de coordinación y deficiencias en la toma de decisiones). Sin embargo, cabe señalar que estas asociaciones positivas son significativas únicamente en el caso del desempeño en términos de mercado, medido a través de la Q de Tobin. Los resultados relativos a las medidas contables, rentabilidad de activos y fondos propios, no resultaron significativos.

Estos resultados sugieren que un buen consejo Shariah es percibido positivamente por los inversores porque confían en este organismo para garantizar el cumplimiento de los principios Islámicos y ello finalmente impacta en el valor de capitalización del mercado.

Por el contrario, el hecho de que no encontramos ninguna relación significativa entre las características del consejo Shariah y las medidas contables (ROA y ROE) podría explicarse por el hecho de que la gama de transacciones y operaciones financieras está limitada por el consejo Shariah siguiendo los principios del Corán. En consecuencia, la rentabilidad derivada de las operaciones bancarias realizadas por el Consejo de Administración no es consecuencia de la intervención directa del Consejo Shariah.

Con respecto a la estructura de propiedad, exploramos la influencia de la concentración, es decir, el porcentaje de acciones que posee el accionista principal y la identidad de los propietarios más grandes. El porcentaje de participación no parece influir en nuestras medidas de rendimiento o rentabilidad (Thomsen y Pederson, 2000; Zouari y Taktak, 2014), pero los resultados sugieren que cuando el principal accionista es el Estado, ello no es bien percibido por los inversores. La razón podría ser que la actividad de monitoreo del gobierno es menos intensiva que la privada, lo que es consistente con la hipótesis de monitoreo eficiente de Demsetz y Villalonga (2001); Iannotta et al. (2007).

Entre las **limitaciones** de esta investigación, necesitamos señalar que la falta de estudios empíricos en el campo de la CG en los bancos Islámicos hizo difícil encontrar buenas fuentes sobre las cuales basar la hipótesis.

La falta de datos también limita la investigación de variables CG adicionales e interesantes (entre otros, la pertenencia a consejos de distintos bancos de miembros del Consejo Shariah o la edad de sus miembros) que podrían influir en el rendimiento de los bancos Islámicos. Además, no pudimos ampliar nuestro período de investigación porque carecíamos de datos financieros relevantes desde 2008 hasta 2010. Esta falta de información probablemente esté asociada con la crisis financiera, que en el caso de la industria bancaria Islámica duró hasta 2011. Además, algunos de los bancos Islámicos no cotizan debido a las limitaciones del mercado de valores nacional y no pudimos ejecutar los modelos debido a la falta de valores de la relación Q.

La CG Islámica aún se encuentra en una etapa de desarrollo y se centra principalmente en los instrumentos financieros Islámicos. Por lo tanto, la ausencia de una institución única que emita estándares de gobernanza para las instituciones Islámicas ha dificultado la explicación e interpretación de los estándares de gobernanza de los bancos Islámicos y la comparación de los bancos Islámicos entre sí y con sus contrapartes convencionales.

Finalmente, es necesario señalar que los bancos Islámicos actualmente se distribuyen principalmente entre los países del Golfo y del sudeste asiático. Por lo tanto, no pudimos compararlos con los bancos Islámicos con sede en otras partes del mundo para examinar la influencia de los problemas ambientales y contextuales.

Respecto a las **futuras líneas de investigación**, consideramos que se deberían abordar los factores de motivación detrás del GC en los bancos Islámicos que mejoran el rendimiento bancario en términos de eficiencia.

En esta investigación, nos enfocamos en el Consejo Shariah en los bancos Islámicos, pero una comparación de otros mecanismos de GC en los bancos Islámicos y convencionales podría ayudar a proporcionar una mejor comprensión de la diversidad en la industria bancaria.

Por último, una mayor comprensión de las singularidades específicas de cada país y la forma en que dan forma al marco de gobernanza también sería relevante para el mundo académico y los organismos reguladores.

Los resultados de este proyecto pueden ser **de interés** para:

- Los organismos emisores de normas, regulatorios y prudenciales podrían considerar la evidencia empírica proporcionada a través de este tipo de investigaciones.
- Bancos Islámicos para mejorar sus mecanismos de gobierno corporativo.
- Los emisores de códigos GC podrían beneficiarse de la evidencia empírica (Grassa, 2013) porque los sistemas de GC en las instituciones financieras Islámicas aún se encuentran en una etapa inicial y son heterogéneos entre países (Hasan, 2011).
- Académicos, porque brindamos información adicional que puede ser considerada en investigaciones futuras.