

Effects Of The Board Of Director's Characteristics On Islamic Banks' Financial Soundness

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Abstract: *The aims of this study is to diagnose the Board of Director's characteristics and its impact on the financial soundness of Islamic banks. Regression analysis are applied to test the effect of the Board of Director's characteristics on the financial soundness of Islamic banking, employing a panel data composed of 67 Islamic banks during the period 2005-2014. The level of Islamic bank soundness is individually using the Z-score indicator. To verify the robustness of results, we use other dependent variables (CAMEL) than the Z-score for the year 2018. Results show that the independent non-executive director, the foreign director and the institutional director, have a negative and significant impact on the financial soundness of Islamic banks. While, the Board of Director's size does not have any significant effect on the financial soundness of Islamic banks. This research contributes to fill the gaps in the literature that discussed the Board of Directors' role in the corporate governance of Islamic banking. In other words, it shows the role played by the Board of Director and improves our knowledge of the financial soundness-corporate governance relationship. With this paper, we hope to clarify the relationship between the Board of Director and the financial soundness of Islamic banks and provide new insights to the literature review. This study offers practical and valuable implications for banking associations, researchers and regulators. In other words, in addition to its theoretical and scientific value, this paper is practical and useful for professionals.*

Keywords: *Board of Director, Corporate Governance, Financial soundness, Islamic Bank*

Introduction

In the last few decades, Islamic banks has rapidly grown in both size and number in the world due to the increasing demand from customers who are motivated to engage with banks that comply with shariah laws (Lassoued, 2018; Nomran et al., 2018). Ulussever (2018) says that the financial assets of the Islamic financial sector grew 50% faster than the other banking sector and achieved US\$1.7 trillion in 2013. The financial assets of Islamic institutions are expected to reach US\$6.5 trillion in 2020.

The corporate governance structure is mainly guided by the Shariah Board and the Board of Directors (Nomran et al., 2018; Khalil and Taktak, 2020; Khalil and Ben Slimene, 2021). Grassa and Matoussi (2014) add that the Board of Director and the

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Shariah Board are the two most important organs that have a crucial role in the corporate governance of Islamic banking.

The Board of Director is an internal organ linked to the management and the direction of the bank and it is composed of various directors (Amine, 2018). This board has the same role as a conventional bank's board. However, the principles of Islamic laws add responsibilities on the Islamic bank's board (Hakimi et al., 2018). Directors must assure compliance with shariah principles (Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), 2010; Ullah et al., 2014; Hakimi et al., 2018). Thus, the Board of Director is responsible for the effective role of the shariah corporate governance and verifies that this framework is compatible with the size of the Islamic financial institution (IFI) (Islamic Financial Services Board (IFSB), 2006; AAOIFI, 2010; Bank Negara Malaysia (BNM), 2010; Ullah et al., 2014).

The effectiveness of the Board of Director depends on its composition (Klai and Omri, 2013; Hakimi et al., 2018). In other words, the structure of the Board of Directors can affect the corporate governance of the bank and has a significant impact on its futures. Thus, it is important to study the Board of Director's characteristics. We note that, unlike conventional banks, the number of studies is limited. The Islamic banks are still characterized by a lack of publications about the corporate governance mechanism and its impact on the financial soundness.

In this study, we aim at diagnosing the effect of the Board of Director on the financial soundness of Islamic banks during the period 2005-2014. This paper goes as follows. Section 2 discusses a literature review on the relationship between the Board of Director's characteristics and the financial soundness. We present in the third section the sample and the variables used. The discussion of the empirical results is in the fourth section. Section 5 summarizes the main conclusion.

Literature review

Independent non-executive director

Proponents of agency theory suggest that having a high number of independent non-executive directors in the board allows a better activities control and reduces the

manager opportunism (Jensen and Meckling, 1976; Fama and Jensen 1983). Moreover, the independent non-executive director support the Shariah Board in order to check the compliance of financial products with shariah principles (Quttainah et al., 2013; Khalil 2021). While, the presence of independent non-executive directors guarantees the independence of the Board of Directors (Amine, 2018; Ramly et al., 2018). According to the resource dependency theory, a large number of independent directors provides better knowledge and financial skills (Pfeffer, 1972 in Aduda et al., 2013). The independent non-executive director is responsible for identifying the main risks and improving the performance and the stability of the IFI (BNM, 2015; Hakimi et al., 2018; Buallay, 2019). However, other researchers ignore the positive effect of the independent non-executive directors on the financial soundness. Indeed, Independent non-executive director has difficulty to understand his role on the bank due to his limited participation in the financial institution's activities and the refusal of internal directors to disclose information (Lassoued, 2018; Khalil and Chihi, 2020a,b,c). The Code of Best Practices for IFI corporate governance proposes that 2/9 of the directors should be independent non-executives (Code of Best Practices for CGIFI in Ibrahim et al., 2012). In addition, Hawkamah (2011) suggests that a majority of the board members must be non-executive and at least 1/3 of them must be independent. The BNM Guide (2013) says that the number of independent directors must be less than 1/3 of the Director. We suggest the following hypothesis:

H1. The presence of an independent non-executive director has a positive and significant effect on the financial soundness of Islamic banks.

Foreign director

Proponents of agency theory argue that the presence of foreign directors can effect the management of the bank and decrease agency costs (Ujunwa, 2012; Klai and Omri, 2013). Moreover, the recruitment of directors of various nationalities improves the performance of banks by attracting new investors and contributes to high quality decisions (Daly and Frikha, 2015; Ramly et al., 2018). The corporate governance standards of BNM Guide (2013) suggest foreign directors to ensure that the Board of Director has various skills and experience to perform its functions. Boussaada (2012), in contrast, states that the foreigners have difficult to manage the risk effectively.

Masulis et al. (2012) and Rafindaa et al. (2018) add that foreign directors are less familiar with management practices and accounting rules. This hinders the ability of directors to control and have the necessary information (Masulis et al., 2012). We hypothesize that:

H2. The percentage of foreign directors has a positive and significant effect on the financial soundness of Islamic banks.

Institutional director

According to passivity thesis, institutional investors penalize long-term investment projects and more particularly research and development investments. Brickley et al. (1988) add that institutional directors are dependent and vote for the interest of managers. Porter (1992) says that institutional shareholders have difficulties to analyze the financial institution and don't have any specific information about the firm. However, proponents of activism thesis predict that institutional directors encourage management to invest in long-term projects to increase productivity and improve the firm's performance (Jensen and Meckling, 1976; Hakimi et al., 2018). Institutional directors have the expertise and a better knowledge of the of the sector issues compared to other directors (Hakimi et al., 2018; Khalil, 2020). Institutional investors are also more independent to control managers (Jensen, 1993). This reduces financial costs and risks and improves financial performance (Jensen 1993; Hakimi et al., 2018). We suggest to test our third hypothesis:

H3. The percentage of institutional directors has a negative and significant impact on the financial soundness of Islamic banks.

Size

According to the agency theory, the larger Board of Director increases the problem communication and presents difficulties to coordinate efforts between directors. In addition, a high number of directors creates agency problems and encourages board members to pursue their own interests (Lipton and Lorsch, 1992; Jensen, 1993). Moreover, the higher number of directors increases the problem of information asymmetry which leads to conflicts of interest and increases agency costs (Prowses 1997). Bukair and Abdul Rahman (2015) and Buallay (2019) say that the size

of the Board of Directors has a negative effect on the financial performance of banks. Proponents of resource dependency theory, in contrast, show that a large board has a variety of knowledge and experience (Goodstein et al., 1994; Tazilah and Abdul Rahman, 2014; Amine, 2018). In addition, a board with a large number of directors increases supervisory capacity, makes effective decisions and meets the needs of stakeholders (Pfeffer, 1972; Fama and Jensen 1983). Many researchers show that a large board is associated with better financial performance and is able to better manage risk in order to avoid bankruptcy (Hakimi et al., 2018; Ulussever, 2018; Buallay, 2019).

The BNM (2013) Guide indicates that the number of directors is an important factor determining the board's efficiency and the appropriate size of the Board of Director is determined by the size and complexity of the IFI's activities. The sign of this variable is expected to be negative:

H4. The size of the Board of Director has a negative and significant effect on the financial soundness of Islamic banks.

Methodology

Sample and data

Our sample is composed of 67 Islamic banks observed over the period 2005-2014. Data is manually collected from international site of Islamic banks 'IBISONLINE'¹ and the site of each Islamic bank to download the annual reports. The rate of gross domestic product and the rate of inflation are extracted from the site of World Bank².

Variables measurement

Measurement of financial soundness (dependent variable). We define the bank's financial soundness according to Khalil and Chihi (2020d) and Khalil and Taktak (2020), we calculate the Z-score as follows:

$$Z\text{-score} = (ROA+K) / \sigma (ROA).$$

Where : ROA = Return on asset; k = Total equity/Total assets; σ (ROA) = Standard deviation of ROA.

¹ Available on: www.ibisonline.com

² Available on: www.worldbank.org

Measurement of the independent variables

Seven characteristics of the board are tested. The presence of independent non-executive directors (INE) is a binary variable that is equal to 1 if an independent non-executive director exists and 0 otherwise³, institutional directors (AdmI) measured by the percentage of institutional directors, foreign directors (AdmE) measured by the percentage of foreign directors and the Board of Directors' size (TCA) measured by the number of director.

In order to improve our empirical results, we introduce 7 control variables. TB is the logarithm of the bank's total assets, AB is the logarithm of the bank's age, Modèle is a binary variable that is equal to 1 if the bank has a central Shariah Board and 0 otherwise, Shariah is a binary variable that is equal to 1 if the bank apply the shariah law and 0 otherwise, NAAOIFI is a binary variable which is equal to 1 if the bank applies the AAOIFI's standards and 0 otherwise, PIB is the gross domestic product, TXI is the inflation rate.

We suggest the below model to study the effect of Board of Director's characteristics on the financial soundness of Islamic bank:

$$Z\text{-score}_{it} = C + \beta_1 \text{INE}_{it} + \beta_2 \text{AdmE}_{it} + \beta_3 \text{AdmI}_{it} + \beta_4 \text{TCA}_{it} + \beta_5 \text{TB}_{it} + \beta_6 \text{AB}_{it} + \beta_7 \text{Modèle}_{it} + \beta_8 \text{Shariah}_{it} + \beta_9 \text{NAAOIFI}_{it} + \beta_{10} \text{PIB}_{it} + \beta_{11} \text{TXI}_{it} + \varepsilon_{it}$$

Where C: a constant, $\beta_1 \dots \beta_{11}$: the coefficients to be estimated, ε_{it} : the error term, i: the bank (the individual), t: the period.

The model of our study is estimated by using the Panel Corrected Standard Errors method (PCSE) proposed by Beck and Katz (1995). We use method eliminates autocorrelation and heteroscedasticity errors by having results that are more robust.

Results and discussion

Descriptive statistics

The descriptive statistics in Table 1 shows that the average of (AdmE) variable is 20.660%. The mean for (AdmI) variable is 7.530%, which ranges from 0% to 100%. The Board of Director consists approximately of 8 directors, with minimum of 3 and maximum of 9.

Table1. Descriptive statistics of corporate governance variables

Variables	Mean	SD	Skweness	Kurtosis	Median	Min	Max
AdmE %	20.660	25.860	1.302	3.879	11.111	0	100
AdmI %	7.530	21.572	3.343	13.564	0	0	100
TCA	8.217	2.398	0.475	3.395	8	3	19

Table 2 shows that banks of our sample are composed of 41.044% of independent non-executive directors.

Table 2. Frequency of binary variables

Variables	INE	
Frequency %	1	0
	41.044	58.955

The descriptive statistics in Table 3 shows that 53.731% of banks belong to countries whose legal framework employed shariah laws and 65.671% of Islamic banking are governed by a central Shariah Board. 35.820% of Islamic banks belong to countries which apply the AAOIFI standards.

Table 3. Frequency of binary control variables

Variables	Modèle		Shariah		NAAOIFI	
	1	0	1	0	1	0
Frequency %	65.671	34.328	53.731	46.268	35.820	64.179

For other control variables, the mean for bank size (TB) is 9.055, which ranges from 1.269 to 12.013. The average of (AB) variable is 1.080. The mean for (PIB) variable is estimated at 4.558 while its minimum and maximum values are -10.500 and 18.600 respectively. (TXI) variable is ranged from -4.900 to 39.300 with an average of 7.793. The average of (Z-score) variable is 12.217.

Table 4. Descriptive statistics of the dependent variable and control variables

Variables	Mean	SD	Median	Min	Max
TB	9.055	1.940	9.464	1.269	12.013
AB	1.080	0.402	1.146	0	1.792
PIB	4.558	3.511	4.700	-10.500	18.600
TXI	7.793	8.280	4.862	-4.900	39.300
Z-score	12.217	10.272	9.876	-1.359	70.954

Cross-Correlation Matrix and Test Variance Inflation Factor

The analysis of the Cross-Correlation matrix indicates the absence of the problem of multi-collinearity. All the coefficients of correlations are less than 0.7 - which corresponds to the limit set by Kennedy (2008). All our independent variables have a variance inflation factor (VIF) value that is less than the limit (10) suggested by Kennedy (1998).

Table 5. Cross-Correlation Matrix and VIF coefficients

	INE	AdmE	AdmI	TCA	TB	AB	Modèle	Shariah	NAAOIFI	PIB	TXI	VIF
INE	1.000											1.36
AdmE	0.109	1.000										1.14
AdmI	-0.046	0.073	1.000									1.09
TCA	0.021	0.057	0.061	1.000								1.26
TB	-0.117	-0.112	-0.016	0.084	1.000							1.13
AB	-0.225	-0.192	0.002	0.230	0.059	1.000						1.38
Modèle	0.136	0.111	0.124	-0.137	0.003	-0.078	1.000					1.70
Shariah	-0.138	0.082	0.011	0.053	0.076	0.027	0.463	1.000				2.38
NAAOIFI	-0.110	0.079	-0.066	0.091	-0.058	-0.027	0.474	0.693	1.000			2.58
PIB	0.025	0.023	-0.016	0.043	0.104	-0.096	-0.012	-0.052	0.015	1.000		1.27
TXI	-0.365	-0.067	0.055	0.045	0.124	0.264	0.141	0.320	0.136	-0.310	1.000	1.56

Discussion

Independent non-executive director and financial soundness

Table 6 shows that the coefficient on INE is negative and significant (p -value < 0.1). H1, thus, is not supported. We conclude that the independent non-executive directors has a negative and significant effect on the financial soundness of Islamic banking. This result contradicts the findings of Lassoued (2018) and Buallay (2019) and confirms rooting theory implying that managers employ strategies making the role of directors passive. Managers design unqualified independent directors and to weaken the role of the Board of Directors. Plus, this result supports the agency theory, the resource dependency theory and the results of several researches (Quttainah et al., 2013; Amine, 2018; Hakimi et al., 2018; Mansoor et al., 2019), and shows that the independent non-executive director is unable to manage the Islamic banks.

Foreign director and financial soundness

Table 6 indicates that the coefficient associated with (AdmE) variable has a significant and negative effect on the financial soundness of Islamic banks. H2, therefore, is not supported. This result contradicts agency theory and predictions of previous studies (Al-Musalli and Ismail, 2012; Daly and Frikha, 2015; Ramly et al., 2018; Mansoor et al., 2019). It appears that the benefits provided by the foreigners do not cover its costs (e.g. technologies, international expertise, skills, etc.)

Institutional director and financial soundness

The coefficient on AdmI does not have any significant impact on the financial soundness of Islamic banks (p -value > 0.1). H3, thus is not supported. This finding contradicts the prediction of activism thesis and passivity thesis, and does not confirm the study of Hakimi et al. (2018).

Size and financial soundness

Table 6 shows that (TCA) variable does not have any significant impact on the financial soundness of Islamic banks. H4, thus is not supported. This finding does not confirm, on one hand, proponents of agency theory and suggestions of resource dependency theory. On the other hand, it contradicts the results of many studies (Tazilah and Abdul Rahman, 2014; Amine, 2018; Ulussever, 2018; Buallay, 2019).

Control variables and financial soundness

Table 6 indicates that the coefficient associated with (TB) variable is negative and significant, suggesting that the large bank adopts a bad strategy that does not permit the development of financial products. (AB) variable is negative and significant implying that the old bank cannot reach new technology. Furthermore, the significantly negative association between (Modèle) variable and financial soundness concludes that the central Shariah Board does not respond to the bank's need and is very rigid in its fatwas and does not support the study of Grassa (2013). (Shariah) variable has a significant and positive effect on the financial soundness of Islamic banks. This finding indicates that Shariah laws is used in a flexible way by the legal framework of the country and is updated to the financial environment. Plus, (NAAOIFI) variable has a negative and significant impact on the financial soundness of banks. This results reveals that the Islamic bank does not correctly use the AAOIFI's standards (Oud and Amedjar, 2016). Table 6 indicate that (TXI) variable and (PIB) variable do not have any significant effect on the financial soundness of Islamic banking.

Table 6. Results

Independent Variables	Coef.	Z	P> z
TB	-0.630	-3.14	0.002***
AB	-7.019	-3.98	0.000***
Modèle	-4.178	-2.10	0.036**
Shariah	8.155	2.67	0.007***
NAAOIFI	-8.399	-2.82	0.005***
PIB	0.011	0.19	0.853
TXI	0.052	1.14	0.254
TCA	-0.174	-1.13	0.259
INE	-1.724	-1.80	0.072*
AdmE	-0.046	-2.18	0.029**
AdmI	-0.009	-0.88	0.380
Cons	29.712	10.31	0.000***
R ²		39.61%	
N		670	

Notes : *significant at 10 per cent; ** significant at 5 per cent and *** significant at 1 per cent

Robustness Test

According to the International Monetary Fund (IMF) guide, financial soundness can be measured by two ways. The first approach employs the Z-score as an indicator of the financial soundness. The second proposes a set of indicators known as 'CAMEL' (IMF, 2006). To check the robustness of our finding, we employ other dependent variables (CAMEL) than the Z-score for the year 2018. We use only two measures due to the unavailability of required data. The first indicator is the Capital Adequacy Ratio (CAR). It is measured by two ratios: $CAR1 = \text{Equity} / \text{Total Assets}$; $CAR2 = \text{Equity} / \text{Total Liabilities}$. The second indicator is the Equity ratio (E). It is calculated by two ratios: $ROA = \text{Return on asset} = \text{Net income} / \text{Total asset}$; $ROE = \text{Return on equity} = \text{Net income} / \text{Shareholder's equity}$. Table 7 shows that the result is not robust and depends on the dependent variable.

Table 7. Robustness test

Independent Variables	Capital Adequacy Ratio (C)						Equity (E)					
	CAR1			CAR2			ROA			ROE		
	Coef.	z	P> z	Coef.	z	P> z	Coef.	z	P> z	Coef.	z	P> z
TB	-1.358	-0.63	0.531	11.017	1.37	0.172	-0.530	-1.35	0.176	-2.846	-1.53	0.127
AB	-27.629	-1.73	0.084*	-92.199	-1.45	0.147	0.738	0.19	0.847	28.410	1.24	0.214
Modèle	-4.655	-0.63	0.527	-8.840	-0.28	0.782	-0.197	-0.08	0.938	16.606	1.31	0.189
Shariah	-6.588	-0.90	0.370	-7.200	-0.29	0.775	-5.176	-2.65	0.008***	-11.032	-1.25	0.212
NAAOIFI	35.154	4.00	0.000***	189.257	2.64	0.008***	0.235	0.16	0.871	-13.594	-2.37	0.018**
PIB	0.154	0.30	0.764	2.305	0.99	0.323	0.018	0.11	0.914	0.477	1.06	0.287
TXI	-0.669	-2.39	0.017**	-3.047	-2.26	0.024**	0.037	0.63	0.526	-0.416	-1.20	0.230
TCA	-1.657	-1.47	0.143	-9.555	-1.38	0.140	-0.005	-0.02	0.983	2.876	1.71	0.088*
INE	-0.929	-0.11	0.916	62.612	1.70	0.068*	-2.561	-0.97	0.334	-21.195	-1.58	0.115
AdmE	-0.023	-0.22	0.829	-0.598	-0.79	0.089*	-0.038	-1.39	0.164	-0.096	-1.41	0.158
AdmI	0.301	2.45	0.014**	0.664	1.48	0.432	-0.035	-1.37	0.171	-0.279	-1.47	0.142
Cons	87.883	3.09	0.002***	169.387	1.83	0.169	10.670	1.53	0.125	-15.103	-0.57	0.568
R ²		28.25%			31.19%			19.21%			26.87%	
N		67			67			67			67	

Notes : *significant at 10 per cent; ** significant at 5 per cent and *** significant at 1 per cent

Conclusion

This research paper aims to empirically analyze the effect of the Board of Director's characteristics on the financial soundness of Islamic banking. To answer this question, we employ a sample composed of 67 Islamic banks over the period 2005-2014. We used the PCSE method to avoid heteroscedasticity and autocorrelation problems.

The findings show that the presence of independent non-executive director and the foreign director and have a negative and significant effect on the financial soundness of Islamic banking. However, the institutional director and the Board of Directors' size do not have any significant impact on the financial soundness of banks. To verify the robustness of our results, we use other dependent variables (CAMEL) than the Z-score. We conclude that the findings are not robust and belongs to the dependent variable.

Results emphasize the role of the Board of Directors and permit us to increase our knowledge regarding the corporate governance-financial soundness relationship. This paper offers a practical and useful evidence for academics, regulators, banking associations, etc. and makes a good contribution to the literature on the study of the corporate governance and their impact on the financial soundness of Islamic banking.

However, this research has limitations. The study is delimited to 2018 because of the missing of all required data. Plus, it is recommended to use in the future research other corporate governance mechanisms to better assess the relationship between the corporate governance structures and the financial soundness of Islamic banking.

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