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Mode of Islamic Bank Financing: Does Effectiveness of Shari'ah Supervisory Board Matter?

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ABSTRACT

This paper examines the relationships between the effectiveness of Shari'ah supervisory board (SSB), their remuneration and mode of financing of Islamicbank. The SSB effectiveness is evaluated by an index based on 9 attributes score. This study comprises 18 Islamic banks in which operating in Malaysia from the year 2012 to 2014 as a sample. Our regression analysis shows that the effectiveness of SSB does not concern with the mode of Islamic bank financing. However, we found that SSB remuneration and bank's financial growth shown a positive and significant relationship with mode of financing. The implications of these findings are discussed.

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INTRODUCTION

There is a strong debut on the Islamic mode of financing which do not underlie with the banner of Islamic banking in which constitutes the elimination of injustices of the interest-based system as ordained by Holy Qur'an. According to Rosly, *et al*., (2011), Anwar, *et al*., (2003) and Usmani, (2004) the current mode of financing still cannot be expected to completely free from the injustices of the interest-based system or to contribute to the achievement of socioeconomic objectives which Islam seeks to achieve. Although there are many views can be discussed towards the mode of financing adopted by the Islamic banks, this study aims to explain whether Shari'ahsupervisory boards (SSB) and their remuneration have any significant influence towards the choices of Islamic banks mode of financing. Based on the work of Ahmad, (2014) who suggested that, SSB plays an important role, particularly in harmonizing the Islamic rules and guidelines in Islamic banks (i.e.,Shari'ah-compliance gatekeeper), this study argued that the choices of style of financing by Islamic banks should be tempted by this board as to avoid any injustices as what has been proposed in Shari'ah Law. In other words, the SSB should put highly concern with regard to any mode of financing by the Islamic bank in which are not aligned with the profit- sharing principles.

Literature Review:

Islamic mode of financing drawbacks:

According to Rosly, (2010) there are five drawbacks of *Murabahah* or mark-up based mode of financing. First, on the matter of ownership and ownership whereby bank has been claimed not actually purchase the asset prior to sale. Second, is on the issue of *Murabahah's* pricing mechanism. Third, is on the extent profit determination with consideration of time value of money with a fixed compensation since the *Murabahah* deals with installment sale. Fourth, the issue of customer defaulted toward *Murabahah* facility. Fifth, refer to the liability of an asset that found defective upon delivery and lastly is on the principle of *al- kharaj bil daman* where entitlement for gain subjects to liability for loss that being applied in the contract.

Shari'ah Governance:

According to Alman, (2012), Shari'ah Supervisory Board (SSB) is one of internal governance mechanisms which involves the monitoring of Islamic banks' activities in accordance to the Sharia (i.e. Islamic law) specifically on its implementation and compliance. It is a part of the big corporate governance framework and what makes it different is only by the existence of Shari'ah Supervisory Board or Shari'ah Supervisory Committee or Shari'ah unit (Rahajeng, 2012). Since Shari'ah governance is part of corporate governance, thus, good and effective SSB should reflect the issue of independence, transparent, accountable, responsible, and fair Bhatti and Bhatti (2010). In this context, studies by Grais and Pellegrini (2006) and

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Farook, and Lanis (2011), argued that the unique attributes of SSB must be clarified as to incorporating SSB as part of corporate governance mechanisms framework. Although the existence of SSB seemed to be able to monitor Islamic banking activities, there are still Islamic banks have experienced failure similar to that of conventional in the recent year. Supposedly, by the attaining of Shari'ah and good corporate governance, Islamic bank basically able to achieve Shari'ah objectives (i.e., Maqasid Shari'ah). However, having this kind of committee is sort not like providing reliable Shari'ah Governance in which utmost important and beneficial to all parties inside and outside the Islamic Banks.

Issues on Shari'ah Supervisory Board:

It is prevalent that the roles of shari'ah supervisory council, shari'ah committee or shari'ah supervisory board emphasized on matter pertaining to shari'ah compliance see (Besar, *et al*., 2009). These committees do not participate directly in the risk management process as evidenced from the Islamic banks annual reports shows that SSB does not appear in the risk management committee. The opinion of the SSB of shari'ah related matters are reported to the board of directors as they are the one who make the final decision.

Hence, the shari'ah committee basically exists merely to fulfill the central bank of Malaysia or BNM's requirement for Islamic banks establishment. The interest of board of directors may depart from interest of their stakeholders in the context of *Ummah* or Muslim nation and community. Thus, it is very important to understand that to whom these SSB are accountable and how far it existence is really relevant at the banks level.

A study by Hasan, (2011) shows that SSB is accountable to the board of directors in many respects as their remuneration, appointment and dismissal are subjected to the approval of the board of directors at bank level. The existences of superior board at central banks level also known as shari'ah advisory council should be sufficient to guide Islamic bank to comply with shari'ah requirements.

The rationale of having two-tier board system was aimed to provide better supervisory at a higher agency cost from shareholders or depositors return. The existence of SSB should have contributed greatly for the betterment of the *ummah* through promoting profit and loss sharing based financing. On contrary, the SSB committee at bank level was established to minimize reputational risk originated from *shari'ah* noncompliance matters see (Akhtar, 2006). However, the Islamic banks' reputational risk may arises from other sources such as risk taking appetite of Islamic banks' financing portfolio which is predominately of debt based such as *Murabahah* and *Baibhithaman Ajil*. From the preliminary analysis of the annual report shows that more than 50% of Islamic bank portfolio is concentrated in non-profit and loss sharing mode.

Profitability:

Net profit after taxes to total assets was used as proxy for determining banks profitability. Ahmad and Mohammad (2011) shows that ROA is negatively significant to credit risk, which implies that increase in credit risk reduce Islamic banks profitability in Middle East and Southeast Asia countries. Cebenoyan and Strahan (2004) show banks that engage in buying and selling loans to manage credit risk increase their profitability.

Ahmad and Mohammad (2010) show that technical and scale efficiency is positively significant to credit risk. The increases of return on assets and profitability reduce credit risks for conventional banks, according to Miller and Noulas (1997) and Said and Tumin (2011) show that as banks were exposed to high-risks loans, their higher accumulation of unpaid loans result in lower profitability.

Boudriga, *et al.*(2009) explain that association between performance and risk does not hold at aggregate level rather it may hold at bank level. The possible explanations for this phenomenon could be due to both are operating side by side in the same economic environment, which possibly exposed them to similar risk. Another possible reason is that interest rate was used as benchmark by Islamic banks to determine profit rate as a result they are rivaling against each other to generate profit from the same market Nienhaus (1983).

The past research of Bader *et al.* (2008), Mohamad *et al*. (2008) who found that there are no difference in term of profit between Islamic banks and conventional banks in GCC, MENA, ASIA and South East Asia. Hence, the sources of credit risk is created with excessive concentration of financing in risky sectors which is prominent for *Murabahah* and *Bai Bhithaman ajil* financing that is mainly in construction, property and real estate sectors which is prone to higher risk.

Macroeconomic factor:

Money Supply:

Broad money (M3) indicates that increase in money supply lower the credit risk as the borrowers able to service their loan obligations as suggested in Ahmad and Ariff (2007) suggest that increase in money supply reduce the interest rate as borrower were able to obtain cheaper fun consequently reduce credit risk whereas lower money supply increase credit risks. According to Haron and Wan Azmi (2008) Kok *et al*. (2012) indicates that positive significant to banks profit which implies that Islamic banks were able to generate more profit when central bank's eases up the money supply policy conversely this would have negative significant to credit risk as reported in previous studies (Bourke, 1989), (Molyneux and Thornton, 1992), (Haron and Azmi, 2004) and (Haron, 1996).

GDP:

GDP was used as indicators for overall economic activities. Haq and Heaney (2012) suggest that improve in economic performance as indicate by GDP growth reduce credit risk. Marcucci and Quagliariello (2009) the study shows that during economic downturn risky portfolio bank exposed to credit risks compared less risky ones. Jakubík (2007) higher GDP growth leads to lower credit risk which is consistent to intuition of economic theory as also found in Jakubík (2007) and Castro (2013) suggest that deterioration of economic growth leading to unemployment consequently increases in credit risk. According toBoudriga*et al*.(2009) suggest that economic health contribute to explain problem loan, economic recovery improve borrower credit quality in facilitatingof repayment especially in developing economies

Hypotheses Development:

This study employs agency theory as underpinning theory to develop the hypotheses. The following hypotheses have been developed in this study:

H_1 *There is positive relationships between the effectiveness of SSB and mode offinancing adopted by the Islamic bank.*

H_2 *There is no significant relationship between SSB remuneration and mode of financing adopted by the Islamic bank.*

Methodology:

Sample of this study comprises 18 Islamic banks in which operating in Malaysia from the year 2012 till 2014. To extract the mode of financing and information about SSB (i.e., effectiveness and remuneration), the annual reports of Islamic bank were scrutinized.

The dependent variable of this study denoted as MODE is proxy by *Bai Bhithaman Ajil* (deferred payment sales)to total Finance. This study measured SSB effectiveness based on 9 attributes scored in which aggregately measured. The attributes is captured based on four elements of effectiveness which is proposed in conventional corporate governance model (Ika and Ghazali, 2012; DeZoort, *et al*., 2002). These elements are 1) composition, 2) adequate authority, 3) resources and 4) diligence. Since Shari'ah governance is part of corporate governance model (Farook *et al*., 2011), the use of this elements can be assumed valid.

The study employs ordinary least square OLS on the dependent variables denoted as MODE and six independent variables namely SSBREMU, FGROWTH, PROF, MSUPP, GDP and SSBEFF or the efficiency index of shari'ah supervisory board which is measured based on thier nationality, qualification, gender diversity, shari'ah compliance oriented, risk management partcipation, size of SSB board, number of meeting and experience.

The score is given based on the disclosed items. Each disclosed score is assigned with 1 for disclose where 0 undiscosed. Hence, the accumulated score is total up to determine the index score. Those banks with highest disclosure produce higher index score. FGROWTH is proxy for financing growth based on total financing of Islamic banks.

Table 1: Measurement of Explanatory Variables

Variable		Composition of variables
MODE	:	*Bai Bhithaman Ajil* to Total Finance
SSBEFF	:	SSB effectiveness Index = Company's actual score on SSB characteristics/ company total possible score of SSB characteristics
SSBREMU	:	Log of Total Remuneration
FGROWTH	:	Log of Total Finance
PROF	:	Net profit to Total assets
MSUPP	:	M2 plus financial assets
GDP	:	Growth rate of real GDP
ε	:	Error term

To examine the relationship between SSB effectiveness, remuneration, control variables and the mode of financing, a multiple linear regression is performed. The regression model is built as follows:

$$\boldsymbol{MODE_i} = \alpha_i + \boldsymbol{\beta 1}SSBEFF_i + \boldsymbol{\beta 2}SSBREMU_i + \boldsymbol{\beta 3}FGROWTH_i + \boldsymbol{\beta 4}PROF_i + \boldsymbol{\beta 5}MSUPP_i + \boldsymbol{\beta 6}GDP_i + \varepsilon_i$$

RESULTS AND DISCUSSION

Descriptive statistics for the variables is shown in Table 2. The average of MODE is 53 percent indicating that more than half of the total finance is dominated by *Bai bhithaman Ajil*. The mean score of 0.7857 for SSBEFF indicates that on average, SSB in Malaysia quite effective. On average, all the SSB members are being paid of RM518, 346 annually, however, there are some bank that did not disclose the SSB remuneration clearly.

The study shows that the assets size of Islamic banks are consist of small, medium and large banks where high standard deviation of .78972 indicates that banks are differences in size with average size of

RM27,942,718.

The financing growth on the other hand shows that on average the banks growth at 3.8% during the study period with high standard deviation 1.25395. This could be the result of different financing strategy adopted by each bank their financing portfolio are different in its compositions subject to their risk preferences. The PROF ratio exhibits that on average the Islamic banks earn 8.6% profit during the period of study with standard deviation of 0.02689this implies that Islamic banks profit are at the same level regardless of their differences in size.

Table 2: Descriptive Results

N=42		
	Mean	Standard Deviation
MODE	.5295	.23113
SSBEFF	.7857	.06639
SSBREMU	12.7312	.78972
FGROWTH	16.1884	1.25395
PROF	.0864	.02689
MSUPP	2.300	.5959
GDP	8.300	1.0054

Table 3 presents the outcomes of the regression analysis between the Mode of financing, SSB effectiveness and control variables. The Variance Inflation Factor (VIF) statistics indicate that multicollinearity does not exist in the model as the values are less than 10. The model explains 22.3 percent of the variation towards the mode of financing, which is relatively low. Although the adjusted R^2 is low, the finding is consistent with those of the previous governance studies, which pointed out that the low R^2 iscommon in corporate governance researches see (Farook, *et al.*, 2011)and(Abdul Rahman, *et al.*, 2013). Our analysis show that SSBEFF does not have significant relationship with mode of financing but there are significant relationship between SSBREMU and FGROWTH. Table 3 shows that SSBREMU (t value = 1.77) has a significant and positive relationship with the mode of Islamic bank financing, at $p < 0.1$ in which indicates that the increase in BBA moves in tandem with the increase in SSB's remuneration.

It's not a matter of SSB effectiveness, but it seems that their remuneration may determine the preferences toward BBA and *Murabahah* mode of financing. This might hold a truth since we found that there is an insignificant portion of these asset portfolios is mainly dominated by *murabahah*, BBA and other than profit and loss mode of financing. In addition, judging from the FGROWTH that is positively significant to MODE as reported, we also perceived that the trade-based mode of financing that must be applied temporarily by Islamic bank as for their transitional phase is not much concern after 25 years, it sort like they are maximizing the shareholders wealth.

Table 3: Regression Results

Model	Pred. Sign	Coeff.	SE	t	Sig.	VIF
(Constant)		-1.454	1.077	-1.35	.186	-
SSBEFF	+	-.017	0.574	-.029	.977	1.322
SSBREMU	0	.086	.049	1.77	.085*	1.338
<u>*Control Variables*</u>						
FGROWTH	+	.067	.038	1.77	.085*	2.032
PROF	+	.724	1.614	.448	.657	1.716
MSUPP	+/-	-.058	.089	-.648	.521	2.574
GDP	+/-	-.013	.055	-.245	.808	2.774
R^2	0.228	P value	0.059			
Adjusted R^2	0.203	N	42			
F statistic	2.275					

Note: ***Significant at 0.01 level, **significant at 0.05 level, *significant at 0.1 level.

In another view, the ineffectiveness of SSB committee can be excused due to a relationship with the management making way for their long period of trust (see Ika and Ghazali, 2012; Rahman et al. 2012). SSB assessment may have been influenced by the management decisions since their appointment to the board is merely due to their relationship with the company. The study includes gross domestic product GDP and money supply MSUPP as external determinants.However, the finding shows negative but insignificant of both macroeconomic factors on the financing preference of Islamic banks with p-value = 0.521 and 0.808 respectively. This is consistant with the notion that Islamic banks are crisis proof given the unique assets and liabilities that allow Islamic banks to share their risk with its investment account holders. This internal liquidity advantage allows Islamic banks to absorb the shocks in the event of financial turmoil.

Conclusion:

The objective of this study is to examine the influence of SSB effectiveness and their remuneration to the choices of Islamic mode of financing by Malaysian Islamic bank. The analysis shows that an effective SSB does not have significant bearing towards the choice of Islamic mode of financing in Malaysia but their remuneration have. Intrinsically, this finding might give some insight towards the notion of 'cosmetic reason' (Zaman, *et al*., 2001) for regulator, policy maker and another researcher on the effectiveness and the existence of SSB in Malaysia especially when incorporating SSBs as part of the corporate governance mechanism. However, it should be noted that the finding in this study is considered small due to the some limitation and should becarefully generalized by other researcher. It is suggested that further studyto be conducted by extending more observation

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