Chapter 11
Impact of Islamic and Conventional Corporate Governance Mechanisms on Financial Performance of Islamic Banks: Evidence from Malaysia

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ABSTRACT
This study aims to analyze the effects of Islamic and conventional corporate governance mechanisms on financial performance. Six hypotheses have been developed and tested on 17 Malaysian Islamic banks observed over 7 years from 2005 to 2011. The measures used for financial performance were ROA; ROE and Operating Ratio (COSR). Using an econometric panel data, the results show that two among three conventional corporate governance mechanisms have significant effects on financial performance: the size of the board of director (SBD) and the degree of independence of the Board (INDEP); Whereas concerning the impact of the three other Islamic corporate governance mechanisms; our results show that only the visibility of supervisors is negatively as well as significantly related to financial performance. Regarding the relevance of control variables, two among three are relevant and positively related to financial performance (the age and the debt of the bank ratio).

1. INTRODUCTION
Most studies (Ahmed and Chapra, 2002; Claessens, 2006; Ghayad, 2008; Nathan and Ribiere, 2008) have neglected the governance problems in Islamic Banks mainly in emerging countries. Indeed, many
think that Islamic bank transactions are not different from conventional banks and that they have the same products that go through the same investment channels. However, this topic is important for several reasons. Today, Islamic banks occupy an important role in the economies. They play a crucial role in any economy as they are in close contact with several partners. Then, the change in the international environment following the recent financial crisis affects deeply the functioning of banks.

The recent financial crisis and its dramatically consequences on the real economy raise the fundamental question of ethics. Newspapers, academic and professional press reported numerous scandals related to executive compensation and other misbehavior of managers, which arouse a feeling and a need for more regulation. Some went until blaming the capitalistic system because it is built on opportunism and selfish behavior.

Meanwhile, more and more people are interested in Islamic finance and started to focus on Islamic Banks, which are supposed to pursue the ethics of Islam in their transactions. Indeed, Islamic banks seem to resist better the financial crisis and reported better performance (Moody’s, 2008; Karyotis et al., 2009).

Malaysia is one of the countries where the Islamic banking sector is the core of the financial system. In 1979, the first Islamic bank was established in Malaysia. From this date, other Islamic banks and Islamic financial institutions settled down in the realm, making of this island the country for most large concentration of the Islamic banks operating side by side with the conventional banks. In recent years, Malaysia has quickly become a global leader in Islamic finance, playing host to the largest concentration of Islamic financial institutions in the south East Asia. In 2014, there are 25 Islamic banks operating in the country.

It is therefore important to scrutinize the governance of Malaysian Islamic banks, particularly their Board of Directors (BD) and the Supervisory Board of the Sharia (SBS) and their effects on performance. Many researchers declare that the Sharia Supervisory Board, as an intellectual capital, adds values to the Board of Director and influence and impacts the Islamic banks performance (Siagh et al., 2004; Nathan and Ribiere, 2008).

Our work is based on a research relating to corporate governance and proposing several control mechanisms to mitigate agency conflicts within financial institutions and improve their performance (Levine, 2004). More specifically, our goal is to determine the impact of internal governance mechanisms on the financial performance of Malaysian Islamic banks.

Since performance is a complex concept and embraces several dimensions, we have to make a choice to measure this variable. Shall we use the same measures as in conventional finance? Muslims scholars define an ethical performance as the one which permit the compliance with sharia. In fact, the evaluation of Islamic financial institutions performance and the conventional ones should not be measured in the same way because of the divergence of their objectives (Ghayad, 2008). Indeed, the roles and responsibilities of Islamic financial institutions are not only limited to the financial wishes of different stakeholders, but more important are how they conduct their business and what are the measures they use to ensure that all the activities of the Islamic bank are in accordance with Islamic law (Shahul et al., 2006). Hence, we can say that the performance of Islamic financial institution is a compound performance that admits two aspects: the financial aspect and the ethical aspect.

Although, the SBS is advanced as the corner stone of Islamic banking governance system and the driver of its performance, little research has focused on the effect of the corporate governance structure on Islamic banks performance.
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