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BOARD DIVERSITY AND FINANCIAL PERFORMANCE OF ISLAMIC BANKS IN MALAYSIA

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Abstract
Corporate governance of Islamic Banks (IBs) presents entirely unique and different complexities compared to conventional counterparts. Despite these complexities and some reported cases of financial scandals involving the IBs, studies of the corporate governance of the IBs are still lacking. This paper examines the board aspect of Islamic banks. The study specifically examined the impact of board diversity and financial performance IBs in Malaysia. The sample of the study comprised of the 16 IBs operating in Malaysia over six (6) years from 2015 to 2020. Data was analysed with regression method of data analysis. The study also utilises t-test and perform robustness test for the predictor variables. The overall finding revealed that, diversity in the board of the IBs induces better financial performance. Additionally, the research also found gender diversity and board directorships attributes of the board's positive and significantly linked with the financial performance of the IBs. Considering the result of the study we argue that more diverse board could not only guarantee proper monitoring and resource provision, but could also improve the independence of the board in its role as the trustee of shareholders, especially in complex institutions like IBs. By having a well inclusive board, IBs will benefit equally from valuable abilities across demographic, ethnic and religious groups in the society. Furthermore, by ensuring very well inclusive boards, IBs can effectively contribute to enhancing social welfare of various segments in the society. This is the first study best known to the authors that provides empirical evidence on the influence of gender diversity, board national, board duality and board skills and expertise among board on the financial performance of IBs. This paper could be referred to by the shareholders and other stakeholders.

Keywords: Board diversity, Financial Performance, Islamic Banks, Malaysia

1. Introduction

Islamic finance has recorded a remarkable increase for about half a century (Chapra & Ahmed, 2002). Globally, the Islamic financial institutions (IFIs) are growing at the rate of 10% to 15% annually. Not only that, IFIs are growing in numbers as they also grow in size. Islamic Financial Services Board (IFSB, 2020) reported that, the total worth of the Islamic Financial Servises Industries (IFSI) globally across its three main segments (banking, capital markets and takāful) is estimated at USD 2.44 trillion in the year 2019, marking noticeable growth of 11.4% in assets in US dollar terms as agaisnt USD 2.19 trillion reported in 2018 The strength of IFIs is commendable and among the few positive is how the IFIs stand the test of global coronavirus pandemic. The broad resilience shown by the global financial system including the IFIs has done much to assure the world that lessons from the 2008 global financial crisis (GFC) have been learnt. And among the various banking sectors that have stood tall through the period of the pandemic, Islamic banks has arguably shone the brightest.

The trend of IFIs' growth and development have not gone unnoticed in Malaysia. Islamic Banks (IBs) who are the key players in Islamic financial services, have seen a growing market share as a result of growing demand for Islamic financial services. It is evident that IBs are increasing in number and at same time growing in size. Yet, governance remains an issue of greater concern. Just like their conventional counterparts as IBs are also victims of poor governance. Corporate failures like *Ihlas* Finance House in Turkey, financial scandal in the case of Dubai Islamic Bank, the closure of the Islamic Bank of South Africa, and Islamic Investment Companies of Egypt were all examples of governance concerns (Hassan, 2006). In Malaysia accordingly, the financial scandal of Bank Islam in 2005 was attributed to mismanagement due to poor governance as well as weak internal control mechanisms (Parker, 2005).

The fact that Islamic banking is established mostly in the countries where the legal and regulatory framework necessary to enforce financial contracts are still growing could arguably be part of the concerns. That is, the financial environment characterized by a high degree of information asymmetry and moral hazard, which is supported by a high level of practical inefficiencies (Haniffa & Hudaib, 2006; Uppal & Mangla, 2014). Hence, the development of proper governance mechanisms to monitor management's action calls for proper investigation.

Apparently, governance raise greater concerns among shareholders, government, regulatory agencies, and other players in the market. The lack of regulatory standards in Islamic finance, however, presents the industry with arguably its biggest immediate challenge. Therefore, we argue that a larger and diversified board could be a better monitor that could ensure goal congruence and hence, better performance (Almutairi & Quttainah, 2017). This study is set to examine diversity in the board of IBs in Malaysia, and examine the impact of board diversity on the financial performance of the IBs. Diversity in the paper represent board gender, board independence, board skills and expertise, and board nationality.

2. Empirical Review and Hypotheses Development

2.1 Agency Theory and Resource Dependency Theory

The inherent nature of banking industry is the diverse interests, ranging from shareholders, saving and investing public, and management. Islamic banks (IBs) which are another aspect of banking industry attracts greater attention in its governance structure (Grassa & Matoussi, 2014;Almutairi & Quttainah, 2017). This is very glaring considering the conflicting goals of *shariah* compliance besides the issues of value creation for the investors. In this sense, investors refer to both Investment Account Holders (IAHs) and shareholders. Due to these complexities, attention is drawn on how IBs strike balance between these conflicting needs, and at same time achieve long-term value for all, while remaining in consonant with *shariah.*

Most corporate governance researches are based on the agency theory approach which is defined as the relationship between shareholders and their agents (Fama &Jensen, 1983). The common assumption of agency theory is about how could the board be independent to serve as a good monitor of management for shareholder (Terjesen et al., 2009). The paper compliment the agency theory with dependency theorist proponents who postulated that a people have different resource, attitude and aptitude (Hillman & Dalziel, 2003; Nomran & Haron, 2020). Hence, larger and well diversified boards are better monitors of management and also minimise agency cost (Almutairi & Quttainah, 2017).

2.2 Board Gender

Ferreira (2014) cited Adams and Ferreira (2009) and revealed some of the interactions between gender and governance. They reported that female directors are more independent than male directors. Specifically, they found women directors to have better attendance at board meetings, more likely to sit on monitoring committees, and are more likely to influence CEO withdrawals after poor performance. They conclude that, female board members are more likely to be tough monitors of managers. Carter et. al. (2003) also found a positive relationship between the percentage of female gender on board and firm value.

Consistent with Buss (2005), Jabari and Muhamad (2020) believed women to be different in personality, communication style, educational background, and career experience and expertise. Hence, this will mean a unique resource to the board consistent with the assumptions of resource dependency theory, which will add to another dimension of diversity to the board. In view this, Jabari and Muhamad (2020) examined gender diversity and performance of IBs of Indonesia and Malaysia where they found IBs with more gender diversity to have better financial performance. Thus, the paper hypotheses that:

H_{O1} - there is a significant positive effect between female gender on the board and the financial performance of IBs.

2.3 Board Skills and Expertise

Moreover, in line with resource dependency theory, board skills and expertise are exceptional and unique qualities that will improve their independence and better monitoring of a firm. It will also help their counselling to the management in the business operational sense (Hillman & Dalziel, 2003; Nomran & Haron, 2020; Richard, 2000; Ujunwa, 2012). Therefore, the study proposes board skills and expertise to be another dimension of board diversity that will improve board's function and resource provision, and thus, firm performance. Hence, the study postulates that;

H_{O2} - there is a significant positive effect between board skills and expertise and financial performance of IBs.

2.4 Board Nationality

Almutairi and Quttainah (2017) examined the corporate governance of 82 IBs from 15 countries including Malaysia from 1993 to 2014. They concluded that larger boards tend to contain different personalities with different resource and hence more diversified. A decade earlier, Ruigrok et al. (2007) revealed that foreign directors with strong networks, and without previous or current directorship experience on a particular board might introduce fresh ideas and initiate new discussions from their diverse knowledge and expertise to the board. They argued that, foreign directors tend to be free from any type of relationship to a firm which guarantees their independence. Additionally, foreign directors can provide another dimension of diversity to the board as a result the board will benefit from their international experience to improve thereby improving the board quality. This is consistent with Ujunwa (2012), who found foreign directors on the board to improve firms performance. Hence, considering these unique features, the study hypotheses foreign directors to improve firm performance.

H_{O3} - there is a significant positive effect between board nationality and the financial performance of IBs.

2.5 Board Directorships

Hakimi et al. (2018) investigate the link between board characteristics and performance of 13 Bahraini banks for seven-year period from 2005 to 2011. Using random effect regression analysis, the study revealed board directorships as measured by multiple director role significant and positively related with the performance of the Bahraini bank. Consistently, Ferris et al. (2003) contended that directors with multiples roles are normally old and corporate outsiders; majority of them are bankers, consultants, and executives. Hence, IBs who are relatively lacking in terms of industry experience, might tend to extract the benefits of incorporating directors with multiple roles in their board structure. Admittedly, the research proposed that;

H_{O4} – there is a significant positive effect between board directorships and the financial performance of IBs.

3. Methodology and Data

The population under study consists of all registered IBs with Bank Negara, Malaysia (BNM). As at December 2020, there were sixteen (16) registered IBs operating in Malaysia. Using panel data, the study examines these banks for six (6) years period ranging from 2015 to 2020. The six years' period have been determined based on the factors specific to the IBs in Malaysia which include existence of the IBs and availability of data for all the years under consideration (Grassa & Matoussi, 2014).

Table 1: Study Variables and Measurements

Variables	Definitions	Sources
Gender	Proportion of female members to overall board members	Proportion of female members to overall board members
Nationality	Dummy with value 1 represents foreign board members, and value of 0 if otherwise.	(Ruigrok et al., 2007; Ujunwa, 2012)
Skills and expertise	Dummy value 1 for board member with professional qualification or PhD qualification, and value of 0 if otherwise.	(Ma et al., 2019; Ujunwa, 2012)
Directorships	Dummy value 1 for directorships and 0 if otherwise.	(Haniffa & Hudaib, 2006; Kathyayini & Carol, 2016)
ROA	Measured as profit before interest and tax over total asset.	(Issa et al., 2021; Kathyayini & Carol, 2016)
ROE	Measured as profit after tax divided by owners' equity	(Grassa et al., 2014

Firm size	Measured as the log of total assets.	(Issa et al., 2021; Ujunwa, 2012)
Leverage	Measured as a total debt divided by total assets.	(Wei & Peng, 2014)

Source: Compiled by the authors, 2021

3.1 T-Test (Independent T-Test)

In this regard, this study compared the mean differences of the board diversity variables (gender, nationality, skills and expertise, and directorship) of the IBs in order to examine the statistical significance of the variables (Grassa et al., 2014). The results of the t-test are used by the researchers to determine the statistical significance of the variable for the study (Appendix A). Results from the t-test revealed board gender and directorships are statistically significant when the mean of board with female and foreign member are compared with those without respectively. Additionally, the analysis also revealed ROE is statistically significant compared to ROA which is found insignificant (Grassa et al., 2014), although this is common given that IBs by their nature tend to have higher rate of ROE and smaller ROA (IFSB, 2020).

3.2 Multiple Regression

The functional relationship and regression models derived from board diversity and performance are stated below:

$$Performance = a + b_1 boardattributes + Control\ variables + e \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ i$$

$$ROE = a + b_1BGen + b_2BSE + b_3BNat + b_4BDir + b_5Bsize + b_6Lev + e \ldots\ldots\ldots..\ ii$$

Where:

BGen = Board Gender
BSE = Board Skills and Expertise
BNat = Board Nationality
BDir = Directorships
ROE = Returns on Equity

Control variables = Bank size and Leverage.

a = overall intercept

$b_1 \ldots b_6$ = beta coefficient of explanatory variables.

Note: the models above contained the modified regression models based on the study variables.

4. Results and Discussions

4.1 Descriptive statistic

Table 2 below provides the descriptive statistics of board diversity attributes namely; gender, nationality, skills and expertise, and directorships. Analysis on the board gender contained that, on the average, the board of the IBs is composed of at least 5% female genders. This depicts that, board of the IBs in Malaysia are dominated by male members. The maximum percentage of female members on the board stood at 33% (0.33, SD = 0.78). Likewise, the result of the descriptive statistic revealed the average percentage of foreign directors (nationality) on the board of IBs is 16% (SD = 0.25). This shows that, the board of IBs are dominated by local directors. However, there exists IBs with 100% foreign directors (maximum = 1.00), as they are foreign banks which have established offices in Malaysia. Moreover, from the board skills and expertise variable, which is represented by board members' PhD or professional qualification, the result revealed that, about 31% (SD = 0.23) of the board possess either PhD or professional qualification. Lastly, the table also revealed about 25% of the board members to have a multiple director role in other entities (SD = 0.21).

Table 2: Descriptive Statistics

Variables	**Min**	**Max**	**Mean**	**SD**
BGen	0.000	0.333	0.05243	0.078489
BNat	0.000	1.000	0.16019	0.246252
BSE	0.000	0.857	0.30724	0.225065
BDir	0.000	0.750	0.24738	0.206670
ROA	-0.074	0.022	0.00823	0.010896
ROE	-0.497	0.350	0.12201	0.108100

Sources: Compiled by the Authors, 2021

4.2 Regression Result

Table 3 contains the summary of the regression result. Using the enter method of regression analysis, the research found board diversity attributes to explain a significant amount of variation in the ROE (F = 3.583, P = .003). It holds that, about 15% of the variation in ROE could be explained by diversity attributes (Adjusted R^2 = .148).

Table 3: Model Summary

Model	R	R^2	Adjusted R^2	Std. Error	Durbin-Watson
1	0.454	0.206	0.148	0.101578	1.527

Sources: Compiled by the Authors, 2021

Table 4: Anova						
Model		Sum of squares	Df	Mean square	F	Sig.
1	Regression	0.222	6	0.037	3.583	0.003
	Residual	0.856	83	0.010		
	Total	1.078	89			

Sources: Compiled by the Authors, 2021

Table 5: Coefficients							
	B	Std. Error	Beta	T	Sig.	Tolerance	VIF
Constant	0.015	0.095		0.160	0.873		
BGen	0.050	0.023	0.222	2.141	0.035	0.887	1.127
BNat	-0.002	0.023	-0.008	-0.077	0.939	0.876	1.114
BSE	-0.033	0.017	-0.201	-1.888	0.062	0.842	1.187
BDir	0.056	0.028	0.215	1.981	0.051	0.813	1.230
BSIE	0.001	0.001	0.196	1.889	0.062	0.890	1.124
LEV	0.075	0.106	0.074	0.705	0.483	0.876	1.141

Sources: Compiled by the Authors,2021

Moreover, additional analysis as contained in table 5 regarding the contribution of each independent variable in the model revealed board gender and directorships to have a significant impact on performance of the IBs as measured by ROE. This is the fact that gender ($t = 2.141$, $p = .035$) and board directorships ($t = 1.981$, $p = .051$) are statistically significant contributors in the model. The significant positive relation between (after holding other independent variables constant) gender and ROE indicates that increase in one female gender in the board, will lead a positive increase in the performance of the IBs by 5% ($B = .050$). Consistent with this finding are the studies of Ujunwa (2012) and Jabari and Muhamad (2020). Furthermore, in agreement with this, is the work of Hakimi et al. (2018) who also found board nationality positive and significantly impacts IBs' performance. This finding implies that, an introduction of one board member with directorships role will improve performance of the IBs by 6% ($B = .056$). On the contrary, the regression result revealed both board nationality and board skills and expertise to be negatively (statistically insignificant) related to ROE. The also confirms the fitness and validity of the regression model.

5. Conclusion and Recommendation

From analysis of the result, the study could establish that female board member has the most significant impact on the board of the IBs. Thus, this shows support to resource dependency theory view and also support diversity argument about the unique qualities of female gender. Also, this supports the present policy recommendations by various countries including Malaysia that recommend for incorporating more female members in the decision making position and boardroom decisions (Ahmad-Zaluki, 2012; Francoeur et al., 2008).

Therefore, the study concludes that, a higher percentage of female members in the board could improve the monitoring and advisory roles of the board. Hence, the effort towards incorporating more female members in the top management decisions in Malaysia is timely and relevant for better performance. Although, considering the result of the study incorporating more diverse member on the board could not only guarantee proper monitoring and resource provision, but could also improve the independence of the board in its role as the trustee of shareholders who monitor management, especially in complex institutions like IBs. This might go a long way to help address the complex agency issues among stakeholders in the IBs.

The research recommended that, “one rule might not fit all” or “there might not be an optimal solution for all”. This is the fact that, bigger and smaller companies are not the same in terms of profitability, asset base and complexities. Hence, board composition should not be at random. The fact that larger and diverse boards might be beneficial for bigger companies, such instance could end up in exacerbating the agency problems of the smaller companies. This is because smaller companies might not have more complex issues to address. Hence, larger and diversified board might tend to take more of their smaller profitability in form of salary which could ordinarily be used for further expansion and development projects. Lastly, future studies might look into the impact of regulatory requirement on the performance of the IBs. One area could the practices of Islamic banks before and after the issuance of *shariah* governance policy (2019).

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