Chapter 15
Corporate Governance in Islamic Banks:
The Efficiency of the Shariah Supervisory Board

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ABSTRACT

This study investigates the efficiency of the Shariah supervisory board as a corporate governance mechanism in Islamic banks. The authors mainly seek to examine the effect of the Shariah board's composition (size and academic background of its members) on the performance of Islamic banks. They also try to highlight the transmission channels explaining this effect, and compare the efficiency of the Shariah board with that of traditional corporate governance mechanisms, namely the board of directors. The empirical investigation is based on a sample of 72 Islamic banks from 19 countries. Estimation results suggest that the Shariah board positively affects the Islamic banks performance through the number of Islamic Shariah scholars. This effect is mainly due to the size and cost transmission channels. These results are robust to different performance measures. On the other hand, results show that the board of directors' size produces a positive effect on a bank's performance, offering evidence for complementarity between traditional and Islamic governance mechanisms.

1. INTRODUCTION

Islamic banking assets have been growing faster than conventional banking assets in many Muslim countries during the past decades. There has also been a surge of interest in Islamic finance in non-Muslim countries. Islamic financial industry growth rate ranged regularly between 15 to 20% (The World Bank, 2015). Despite its rapid growth, Islamic finance is still in its early stages of development and needs to

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address several challenges. To survive and persist, Islamic banks should mainly establish good and effective corporate governance mechanisms.

The Sharia supervisory board is one of the main corporate governance mechanisms in Islamic banks. It ensures that banking business operations adhere to the Islamic Sharia principles. According to the Accounting and Auditing Organization for Islamic Financial Institutions[1] (AAOIFI) standards, the Sharia Board is entrusted with the duty of directing, revising and monitoring the transactions of Islamic banks one by one to ensure that they are compliant with the rules and principles of Sharia. This board is not only independent of the Board of Directors, but it is also allowed to be present at the Board of Directors meetings to argue the religious aspects of their decisions (AAOIFI, 2005).

It is essential for Islamic banks to ensure the compatibility of their products and financial operations with the requirements of Sharia. There is an impending need for the Islamic banks to provide sufficient and reasonable assurance that they are strictly following the Sharia in their products, rules, procedures and contracts as most of their customers and investors are concerned about the respect of the Islamic laws. To ensure Sharia compliance of the banking operations and to inspire confidence to shareholders and stakeholders, each Islamic bank is required to establish a Sharia supervisory board.

During the review process, any revenue of the bank identified as resulting from activities considered as Sharia non-compliant have to be quoted in the Sharia report. The Sharia Board is then required to instruct the disposal of the profit, judged unlawful, for charity causes and to disclose this fact in the bank's Sharia report. Such oversights will generate, in addition to important financial losses, the loss of customers, stockholders and other stakeholders confidence and trust, which would ultimately lead to a loss of the bank's credibility. Such losses are specific to the Islamic banking industry and result from a specific category of risk known as the Sharia risk (Archer and Karim, 2007).

Efficient governance ensured by the Sharia Board may spur the Islamic banks performance through three different channels. First, it will limit the banks' exposure to the Sharia risk and hence reduce the potential financial losses. Second, it will preserve the banks' equity by dissipating the customers and stockholders doubts about the Sharia compliance of the banks activities. Finally, the Sharia Board members may contribute to the banks strategic decisions during their presence at the Board of Directors meetings.

This study investigates the efficiency of the Sharia supervisory board as a corporate governance mechanism in Islamic banks. We mainly seek to examine the effect of the Sharia Board's composition (size and academic background of its members) on the performance of Islamic banks. We also try to highlight the transmission channels explaining this effect, and compare the efficiency of the Sharia Board with that of traditional corporate governance mechanisms; namely the Board of Directors.

This paper is organized as follows. A literature review relative to the impact of the Sharia Board on Islamic banks performance is provided in Section 2. Section 3 describes the model and the sample, while Section 4 discusses the main results. Section 5 concludes.

2. THROUGH WHICH CHANNELS CAN THE SHARIA BOARD PROMOTE THE PERFORMANCE OF ISLAMIC BANKS?

Banks are exposed to specific risks inherent to their financial activities. Moral hazard and adverse selection risks, arising from the financial intermediation process, may significantly affect a bank's performance. In the case of Islamic banks such risks are exacerbated by the profit and loss sharing instruments. Islamic banks are also exposed to specific risks such as the risk of non-compliance with the Sharia (Archer