Board Governance Characteristics, Ownership Structure and Capital Structure Decisions among Islamic Banks in Malaysia: A Conceptual Model

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Abstract

Islamic banks should continue to have less risky capital structure in order to maintain their sustainability and profitability. High risk capital structure tend to exposes Islamic banks to bankruptcy. Previous studies have focused on leverage in public listed companies and conventional banking but scanty studies focus on Islamic banks in Malaysia. Islamic banks are growing rapidly nowadays. The objective of this study is to develop a conceptual model on the influence of board governance characteristics and managerial ownership on leverage among Islamic banks in Malaysia. Thus, the study fills an important gap in board governance studies as many areas have not been explored, particularly, female directors and director's meeting attendance and their association with leverage in Islamic banks. It is appropriate to look at the application of the agency theory in the perspective of capital structure decisions.

Keywords**:** Directors' education background, board size, female directors, directors' meeting attendance, managerial ownership, leverage

1.0 Introduction

The growth of any economy is largely reflected on the stability of the financial sector including Islamic banking. The banking sector is important for a country's economic growth as it allocates funds to various sectors of the economy. The traditional banking business is highly leveraged. In order to have comparative advantage, Islamic banks should move away from debt-based financing, and move towards more equity-based products and services (Khaliq Ahmadi, 2016). Banks with excessive leverage is exposed to bankruptcy. The main cause of bank failure could be attributed to poor corporate governance (Dibra, 2016). A case worth mentioning is the closure of Ihlas Finance in Turkey in 2007. Ihlas Finance made a lot of long term financings which affected its performance. In September 2008, The Bear Stern is also one of the examples of investment banks in New York City that collapsed due to poor board monitoring.

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The decision determining the company leverage is discussed and approved by the board. Therefore, companies should consider appointing effective boards of directors who will steer the companies to success. Effective board governance may reduce the leverage of the institutions, whereas the responsibility is taken by the directors (Bajagai, Keshari, Bhetwal, Sah & Jha, 2019). Thus, it is interesting to study board governance characteristics particularly board effectiveness and its influence on capital structure decision among Islam banks. Besides, it also appropriate to investigate ownership structure's influence on the relationship between board effectiveness and capital structure decisions among Islamic banks in Malaysia.

Previous studies have focused on board governance characteristics, capital structure decisions and company performance among public listed companies in Malaysia (Aza Azlina, Zuaini & Nor Aziah, 2013). There are still scanty studies that focus on the influence of board governance characteristics and managerial ownership on leverage among Islamic banks. Therefore, the current study will fill the gap by focusing on the Islamic banks. In this paper, a conceptual model is developed. The literature on capital structure, board governance characteristics and ownership structure is presented in the next section. The third section discusses the hypotheses development. The contributions and conclusion are presented in the final section.

2.0 Literature Review

2.1 Capital Structure

Capital structure decision is among the significant and crucial financial policies in a company. It reflects how the company finances its assets and operations (Li & Islam, 2019). In the context of Islamic banks, the capital structure consists of debts and shareholders' equity (Bukair, 2019). The biggest portion of Islamic banks funding is the debt since equity is very costly (Bukair, 2019). The main financial sources of the debt are the current and saving accounts in the form of Wadiah and Qard as well as fixed deposits in the form of Murabahah or Tawarruq (Noor Mahinar, Norhashimah & Ng, 2019). The banks are under obligation to refund part or the entire amount of the deposits. It seems that those deposits are banks' borrowings. Too much debt means high financial risk to the stakeholders (Bae, El Ghoul, Guedhami, Kwok & Zheng, 2019). Besides, high debt reduces company performance particularly its profitability. This is because, the institutions need to maximize their income to pay the interests and the loan itself (Syed Syah Fasih, 2013).

However, banks that adopt more equity as their financing have low bankruptcy risk and high sustainability (Choudhury, Hossain & Mohammad, 2019). The losses from the investment will be absorbed by the investors. Therefore, having a right capital structure insulates the institutions from the risk of failure. In this study, debt/leverage represents the capital structure decisions.

2.2 Board Governance

According to Finance Committee on Corporate Governance (1999), corporate governance is the process and structure used to direct and manage the business of the company towards promoting business prosperity and accountability. The ultimate objective is to maximize the shareholders' value and the interest of other stakeholders. Meanwhile, corporate governance affects the institutional process as a whole (Turnbull, 1997). It emphasizes the company's responsibilities to its entire stakeholder and the society (Yasser, 2011). According to OECD (1999), board governance refers to the relationship among board of directors, owners, investors and shareholders. It provides objectives that needs to be achieved in order to determine the overall performance.

Furthermore, Jensen and Meckling (1976) emphasize that a company or an organization exists as a legal person that can be sued and sue in court based on the legal requirement and required to act on behalf of the company. Commonly, the legal person will be appointed by the top management of the company or organization.

2.3 Board Governance in Islamic Banking

Currently, Islamic finance is one of the fastest growing industries since 1970s. Islamic finance institutions are established to serve Muslims who are prohibited from involving in any transactions that contains riba (Nor Farizal, Fadzlina & Asyaari Elmiza, 2019). With regards to Islamic banking, the objective of its operation is to comply with Shariah in which fairness to all stakeholders is attained through greater transparency and accountability. Islamic banking is subject to some form of rules and regulations similar to the conventional banks.

Nevertheless, Islamic banks need to embed the Islamic banking characteristics and review their compliance with Islamic principles and rules that are stipulated by the Shariah board, which constitutes an important roles of governance in Islamic bank. The Shariah board is part of board governance whereby the board will review existing and proposed new products and the transactions (inflow and outflow) that the bank enters to make sure that they adhere to Shariah principles. Any new product proposed will not be launched until they are accepted by the Shariah board. In theory, the Islamic bank should not seek for profit at any price.

Board with strong governance may lower the cost of capital by reducing the risk of borrowing, improve operational performance and resource allocation as well as increase the ability to face any external financial distress (Hassan & Ammara, 2019).

2.4 Board Governance Characteristics

Every factor that influence the success of a company has its own unique characteristics, and board governance is no exception. In this section, five characteristics of governance that will be considered in this study are discussed; 1) board composition, 2) board characteristic, 3) board structure, 4) board process and 5) managerial ownership. These five characteristics are the possible factors that lead to performance not only for a company but also for financial institutions.

2.4.1 Board Composition

According to Zahra and Pearce (1989), board composition refers to board size and directors type. Therefore, the present study focuses on two variables related to the board; 1) board size and 2) female directors.

2.4.1.1 Board Size

Board size refers to the number of the board of directors who have the authority to make decisions in the company. According to Malaysian Code and Corporate Governance (MCCG), there is no specific number of the directors in a company but the important factor is the effectiveness of the board. Besides that, MCCG encourages active participation of every member of the board in order to make effective decisions. According to Finkelsein and Mooney (2003), the ability and quality of the directors play an important role in ensuring the effectiveness of boards. Previous researchers suggest that the limit of the board size is around eight directors as any greater number is more likely to interfere with group dynamics and affects the board's performance (Jensen, 1993). A study conducted by Isik and Ince (2016) found that larger board size is able to monitor management decisions closely including capital structure decisions.

2.4.1.2 Female Directors

According to MCCG (2012), the United States Catalyst report shows that companies with 3 or 4 female directors on their boards outperformed companies with minimal female board representatives. Although the correlation between more women directors and better financial performance does not prove the causation, it may support the notion that having more female directors on the board can be valuable. Besides, Corporate Governance Blueprint 2011 predicted that the participation of female directors will reach 30% in 2016. Kajola, Olabisi, and Fapetu (2019) and Lukerath-Rovers (2013) agreed that female directors are needed to improve board performance. Greater representation of female directors could bring in heterogeneity in values, beliefs and attitudes which would broaden the range of perspective in the decision making process (OECD, 2012). Thus, the rise of female directors will increase the representations and enhance gender diversity among managers and subordinates which would enhance the productivity level (Guiliano, 2006).

A research conducted by Hernandez-Nicolas, Martin-Ugedo & Minguez-Vera (2015) found that companies run by women tend to have less borrowing and incur lower costs of debts. Besides, Ahmad-Zaluki (2012) found that companies with a higher number of foreign ethnic female directors' experience less underperformance and adopt non-risky decisions. It shows that the number of female directors on the board do influence decision making. As they are more risk averse, they tend to adopt less leverage in the institutions' capital structure. Nevertheless, Carter, D'Souza, Simkins and Simpson (2010) did not find any correlation between female directors and company leverage.

2.4.2 Board Characteristics

Two variables under board characteristics are included in this study namely; 1) directors' educational background and 2) directors' tenure.

2.4.2.1 Directors' Educational Background

Educational level of directors plays a big role in the performance of a company. The educational level of the board will lead to maturity in making low risk decisions. Directors' educational background is defined as the education level of the director that holds the position in the company. The educational background will reflect on the decision making abilities (Johnson, Schnatterly & Hill (2013). For example, the finance directors should have the knowledge of finance and be able to resolve financial issues in the company wisely. Director's knowledge and experience can help improve the strategic roles of boards. Scholtz and Kieviet (2018) found that number of directors with proper business qualifications may influence the board's deliberation including decisions on capital structure.

2.4.2.2 Director Tenure

The directors' tenure affects both the level of their knowledge as well as independence. Moreover, the company specific knowledge can be accumulated with long period of tenure (Celikyut, Sevilir and Shivdasani, 2012). According the California Public Employees' Retirement System (CaIPERS), directors with more than 12 years in the same company are at risk of compromising their decision making. Directors with long tenure are more likely to choose low level of leverage in order to avoid high risk of default loan (Wen, Rwegasira & Bilderbeek, 2002).

2.4.3 Board Structure

Board structure refers to the leadership of a company. There are two types of board leadership structure; board duality and unitary (Zahra & Pearce, 1989). Unitary refers to companies where the CEO and chairman positions are held by different persons. Meanwhile, board duality refers to both positions being held by a same person. Wan and Ong (2005) agreed that the CEO and chairman position should be separated. It is supported by agency theory which mentions that when the CEO holds the chairmanship position, it will reduce the effectiveness of board monitoring function (Finkelstein & D'Aveni, 1994). Besides, Fama and Jensen (1983) and Wan and Ong (2005) suggested that the separation can act as a check and balance mechanism over management's performance.

2.4.4 Board Process

Board process is one of the elements that measure the effectiveness of the board (Aza Azlina, 2017; Nicholson & Kiel, 2007; Wan & Ong 2005; Finkelstein & Mooney, 2003). It refers to the actions and decisions of the directors in discharging their duties and steering the board (Leblanc, 2004; Macus, 2008). Board process also includes the clarification of board and management responsibilities, composition and company planning and managing board meetings and the effectiveness of the board. While, according to Jiraporn, Jang-Chul, Young and Kitsabunnarat (2012), companies with poor corporate governance tend to have high leverage, effective corporate governance prevents the company from taking excessive leverage (Mande et al., 2012). Previous researchers, Zuaini, Nor Aziah and Aza Azlina (2011) have conducted studies on board process which include risk oversight, accessibility of information, performance of independent directors and CEO's evaluation performance towards company leverage. The result shows that an effective board may influence the management to adopt low level of leverage in order to avoid unfortunate losses and risk of bankruptcy.

Existing empirical studies of board process concentrates on board meeting attendance (Khan & Wasim, 2016; Adams & Ferreira, 2009). The attendances of the directors are disclosed in the annual report to ensure that the directors are committed to the company (Noriza, 2010). The frequency of the directors' attendance in the meeting will lead to effective decisions during the board meeting including in deciding the capital structure decisions (Chou, Chung & Yin, 2013; Noriza, 2010). In this dimension, the study will include directors' meeting attendance in representing the board process.

2.4.5 Managerial Ownership

Ownership structure helps to identify the equity, roles and categories of the owners such as sole proprietorship, partnership, corporation, enterprises which is a crucial component for a strong banking system. Changes in ownership structure without any supporting regulatory and supervisory body may expose the banks to crisis (Boubakri, Cosset, Guedhami & Fisher, 2005). These structures have major significance in corporate governance because they help to determine the economic efficiency of the company (Jensen & Meckling, 1976). Managerial ownership refers to the amount of shares held by the management team. The ownership may affect the incentive of managers and affect company efficiency (Jensen and Meckeling 1976).

Leverage is one of the external mechanisms which decision makers believe to be a useful tool in reducing agency costs. Banks with high managerial ownership tend to have lower default risk on debt and higher cash holdings (Calomiris & Carlson, 2016). Banks may choose two options of risk management in reducing the risk of default on debts. The options are a higher cash-to-asset ratio (on the asset side) or a higher equity-to-asset ratio (on the liability side).

3.0 The Conceptual Framework and Hypothesis Development

Figure 1 below presents the conceptual framework of the present study. The framework is formulated to explain the influence of directors' educational background, directors' tenure, board size, female directors, leadership structure, directors' meeting attendance and managerial ownership on capital structure decisions among Islamic banks in Malaysia.

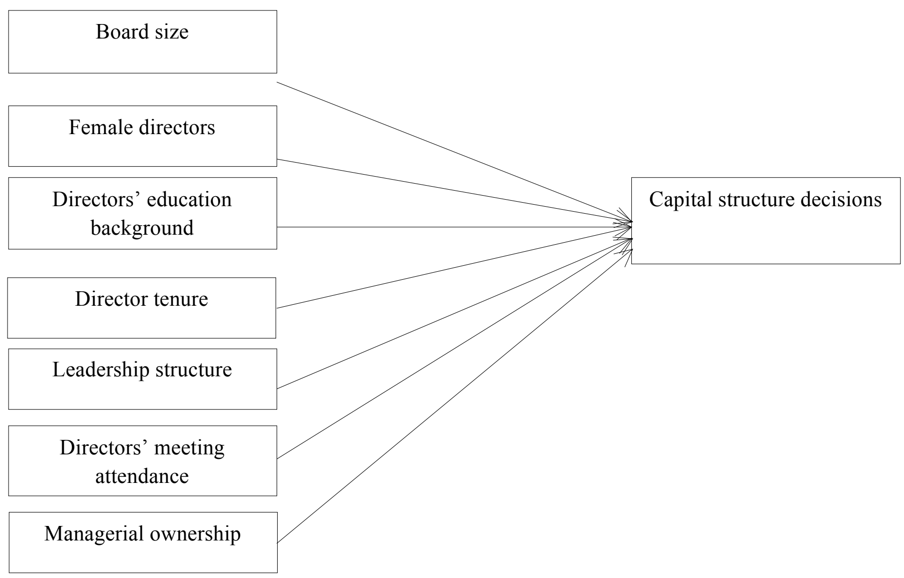

Figure 1. Conceptual framework on the influence of directors' educational background, directors' tenure, board size, female directors, leadership structure, directors' meeting attendance and managerial ownership on capital structure decisions among Islamic banks

Several hypotheses are developed which are: board composition (board size, female directors), board characteristics (directors' educational background, directors' tenure), board structure (leadership structure), board process (directors' meeting attendance) and managerial ownership.

3.1 Board Composition

In this study, board composition is represented by board size and female directors. Board size is the number of directors in the company or institution. It has been identified as an important determinant of corporate governance effectiveness in theoretical articles (Pfeffer and Salancik, 1978; Jensen, 1993). Jensen (1986) and Abor (2007) claimed that firms with higher leverage tend to have a larger board size. The study suggested that larger boards are less effective than smaller boards. Besides, more problems can arise with larger board size, such as slow decision making and ineffective decisions.

Based on the study by Isik and Ince (2016), their result shows that there is a significant and positive relationship between board size and institutional performance. The empirical result confirms that bank may improve their performance and decision making by increasing their board size. Besides, Orozco, Vargas and Galindo-Dorado (2018) found that large board size supports the synergies among financial performance as supported by the theory agency.

As the board size of the banks increase, the directors' monitoring towards management will also increase (Jadah, Murugiah & Abdul Adzis, 2016). Looking at the theoretical perspective, agency theory suggests that management must be monitored to ensure that manager will make prudent and less risky decisions particularly in deciding the bank capital structure. The above argument supports that board size does influence capital structure decisions.

Hypothesis 1: Board size influences the bank's leverage

In a study by Solimene, Coluccia and Fontana (2017), results showed that gender diversity could improve company performance. The Italian law requires the composition of gender diversity to be implemented in companies by at least 20% in year 2012 and 33% in year 2015. Throughout the study, the researchers confirm that the presence of female director on boards affects board decisions. Meanwhile, MCCG (2017) advise that companies need to incorporate at least 30% female directors not only in board level but also in the senior management level.

It is perceived that women directors are highly qualified and able to add expertise to the boardroom. Besides, they are more objective during boardroom discussions (Joecks, Pull & Scharfenkamp, 2018). Women directors are risk averse and will opt for less risky decisions which affect the institutions debt level (Apesteguia, Azmat & Iriberri, 2012). In a study by Hernandez-Nicolas, Martin-Ugedo & Minguez-Vera (2015), they found that institutions with female Chief Executive Officers (CEOs) have lower leverage.

The above arguments lead to the following hypotheses.

Hypothesis 2: Female directors influence banks' leverage

3.2 Board Characteristics

Two elements under board characteristics are discussed; board educational background and board tenure. The educational background of the board of directors is one of the important elements that contribute to the sustainability of a company. According to Chih-Yang and Jia-Ying (2016), successful companies are linked to higher directors' educational background since they are able to contribute brilliant ideas based on their formal knowledge. Besides, those with sound educational background tend to be more creative with high self-determination. They also have effective skills in analyzing decisions and planning (Blossfelf & Von Maurice, 2019). Thus, they are more credible to serve as an independent directors or committee members (Nekhili & Gatfaoui, 2013). In the banking sector, those with accountancy, financial and banking backgrounds are highly demanded as they better understand the operations of such sectors. They may bring various ideas during discussions and it will lead to lower risks of capital structure decision making (Njuguna & Obwogi, 2015). Thus, this study proposes that:

Hypothesis 3: Directors' education background influences bank's leverage

Directors tenure measures the employment period of the board members. As board tenure lengthens, their passion and self-belonging in the board that they serve also increases (Huang & Hilary (2018). Besides, they may increase their knowledge and reduce uncertainty in making decisions (Grassa, Chakroun & Hussainey, 2018) including in deciding a less risk capital structure.

Li and Aida (2017) found that boards that have a long average tenure would increase tenure diversity. Such diversity may improve the quality of governance. While, based on the MCCG (2017), large companies or institutions are not encouraged to keep a board director for more than 12 years. The suitable cumulative term limit is only for 9 years. This will result in the company acquiring fresh ideas and less risky decision making. Hence, this study proposes that:

Hypothesis 4: Director tenure influences the bank's leverage

3.3 Board Structure

As suggested by Best Practice AAIII of the Malaysian Code of Corporate governance (MCCG), organizations are highly encouraged to separate the two major roles which are CEO and chairman positions to ensure a proper checking on the top leadership. Organizations that have the same persons holding the two roles will have lesser monitoring of their companies as stated by previous researchers; "the same person will mark his own examination papers" (Wan & Ong, 2005). Based on the agency theory, having the same person holding similar position will reduce the function of board monitoring (Finkelstein & D' Aveni, 1994). However, Sheikh and Wang (2012) found an insignificant relationship between board leadership and level of leverage. This contradicts the study of Mokarami, Ahmadi and Hosseinzadeh (2012), whereby they found a positive relationship between board leadership structure and capital structure decisions. A good leadership skill helps to get things done effectively and influence overall performance. Thus, this study proposes the following hypothesis.

Hypothesis 5: Leadership structure influences the bank's leverage

3.4 Board Process

Generally, board process refers to the decision-making process of the boards (Zahra and Pearce, 1989). An effective board process pertains to the healthy and rigorous discussion of corporate issues and problems so that decision making can be reached and supported. Cornforth (2001) defines board process as *"the extended to board and management in order to share a common vision, clarity of the boards' role, ability to handle conflict meeting practices and board review procedures"*

Besides that, MCCG (2017) introduced additional requirement to improve the participation of boards' directors in meetings. One of such requirements is that notice of the annual meeting needs to be given at least 28 days before, all directors need to attend the meeting to have a positive engagement with the client, companies that are in remote locations need to leverage on technology to facilitate electronic voting and remote the shareholder's participation. As such, adherence by companies in MCCG will catapult Malaysian companies to be at par with the International standard of governance.

Previous research found that directors' attendance is related to capital structure decisions. High directors' attendance indicates active monitoring of managers' decisions causing those managers to adopt lower leverage in order to avoid the pressures associated with higher leverage (Khan & Wasim, 2016; Noriza, 2010). However, the empirical evidence on the impact of directors' attendance on capital structure decision is still limited. This will lead to the next hypothesis:

Hypothesis 6: Directors' meeting attendance influence the bank's leverage

3.5 Managerial Ownership

Managerial ownership acts as an indicator in explaining whether the board can effectively control the managers' decisions or the ownership will reduce the functions of the board. Boeker and Goodstein (1993) indicated that owner-managers are more likely to face difficulty in influencing the decisions when the managerial ownership is more dispersed. A disperse managerial ownership indicates less power to influence the decision making. Normally, the large shareholders control board meetings and influence other directors.

Friend and Lang (1988) found that debt level decreases as the level of management shareholdings increases. They suggested that debt has a greater non-diversifiable risk and it leads to lower levels of leverage. However, Khawaja, Bhatti, Ashraf and Henry (2018) found that institutions with more managerial ownership tend to adopt more debts in order to avoid ownership dilution. Thus, this study proposes that:

Hypothesis 7: Ownership structure influences the bank's leverage

4.0 Contributions and Conclusion

Corporate governance is one of the issues that have been widely raised in the corporate world. The issue of corporate governance can have an impact on company's management including the capital structure. The management of capital structure which reflect the company's leverage and the way capital of the company is applied by the managers may affect the institutions (El-Habashy, 2018). Thus, having a right capital structure insulates the institutions from risk of failure or bankruptcy. There are a number of studies regarding corporate governance characteristics and company leverage (Aza Azlina, Zuaini & Nor Aziah, 2013; Sheikh & Wang, 2012; Friend & Lang, 1988). However, studies on board governance and its influence on the leverage of Islamic banks are still limited. Thus, the current study fills this important gap in board governance studies as many issues in such studies have not been investigated, particularly, the effect of female directors and directors' meeting attendance and their impact on Islamic banks' leverage.

The implication for corporate governance from the agency theory perspective is that the monitoring mechanism needs to be used to protect and reduce conflict of interest between shareholders and management. In previous research, the application of agency theory has focused on board structures, board compositions and board characteristics among public listed companies (Polleti-Hughes & Carmen Briano Turrent, 2019). Thus, it is appropriate to look at the applicability of the agency theory in board governance characteristic on capital structure decisions among Islamic banks in Malaysia.

The findings on board process can practically assist board members in maximizing their contributions and improving their roles during board deliberations. It is expected that an effective board may lead to better decision making particularly on capital structure decisions. The banks may reduce their default risk on debts by having less borrowing and increasing investment funding.

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