CORPORATE GOVERNANCE IN ISLAMIC BANKS: A COMPARATIVE STUDY OF CONSERVATIVES, MODERATES, AND LIBERALS

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Abstract

This study seeks to fill the gap in the current literature on corporate governance in Islamic banks. A major limitation of these studies, leading to skewed results when analyzing corporate governance and other issues, is their treatment of all the Islamic banks in one category. This study addresses this issue with results showing that corporate governance is not uniform across various categories of Islamic banks. The study analyzes various aspects of corporate governance in Islamic banks by first classifying them into three categories (i.e., Liberals, Moderates, and Conservatives). A comparison of four important variables of corporate governance (i.e., size of SSB, size of audit committee, size of board of directors, and board composition) within these three categories was expected to yield some new findings. The study uses a sample of 80 fully Islamic banks for the years 2009-2014, from the countries of the GCC, Yemen, Egypt, Sudan, Tunisia, Syria, Turkey, Indonesia, Malaysia, Pakistan, Bangladesh, the UK, and South Africa. The study aims to strengthen and enhance our knowledge of some relevant corporate governance mechanisms in Islamic banks. The results of this study are expected to be useful to practitioners of corporate governance in Islamic banks, customers, and financial regulators including central banks and other relevant stakeholders. In addition, it may allow further research to bring necessary reforms to the corporate governance of Islamic banking and thus generally strengthen its practice.

Keywords: Corporate Governance, Islamic Finance, Shari'ah Supervisory Board, Board of Directors, Audit Committee, Board Composition

1. INTRODUCTION

Corporate governance in Islamic banks has been debated for over two decades and the Islamic Financial Services Board (IFSB)[1] issued a guideline in 2006 on this topic[2]. The main difference, as far as corporate governance is concerned, between conventional and Islamic banks lies in the additional role of the Shari'ah Supervisory Board (SSB) and the moral and ethical dimension of Islamic banking. The key differences are summarized in the table in Appendix A[3]:

Corporate governance in Islamic banks is heavily dependent on the SSB. The role of the SSB is all-pervading and covers almost everything from strategy to day-to-day operations. At the level of strategy, the SSB's vision and functions provide guidelines for various corporate governance components in Islamic banking, including accounting, products, reporting, risk management, compliance, and audit. These are then translated into operational rules and guidelines for all Islamic banks (Khandelwal, 2008). The SSB provides an additional layer of governance sometimes called the *Supra Authority* layer (Choudhury and Hoque, 2006), which is missing in conventional banks. As widely misunderstood, the SSB's role is not limited to transaction approval alone, but it covers all aspects of banking. By virtue of this ever-pervading role, SSB's impact on corporate governance is far more complex and wider than many believe.

The SSB's composition and structure have a direct bearing on the corporate governance in Islamic banks (Khandelwal, 2008). The number of Shari'ah scholars and the independence of the whole group[4] may have an impact on the quality of corporate governance. In addition, the SSB also plays a role in monitoring and controlling the appointment of members of a bank's board, thus affecting their numbers and independence. In a study by Warde (2000) it is found that the number of

[1] In addition to the IFSB, Hawkamah at the Dubai International Financial Centre and Malaysian Central Bank has also issued guidelines on Corporate Governance for Islamic banks. However, these banks have no single universally acceptable Corporate Governance standard.

[2] Principle 3.1 of the IFSB Standards on the corporate governance of Islamic financial institutions reads as follows: "IIFS shall have in place an appropriate mechanism for obtaining rulings from Shari'ah scholars, applying fatwa and monitoring Shari'ah compliance in all aspects of their products, operations and activities (IFSB, 2006, p. 11)."

[3] For a more detailed comparison, see Lewis (2005) p. 19 (IB vs managed corporation/socially responsible corporation), Hasan (2009), p. 288 (IB vs Anglo-Saxon/European), Abu-Tapanjeh (2009), pp. 564-565 (IB vs OECD).

[4] Warde (2000, pp. 227), "A number of issues have been raised in connection with Shari'ah boards. One is about their independence. Insofar as they derive what is frequently their principal income from their membership in a Shari'ah board, some scholars may legitimate the most dubious operations. The debate on 'fatwas for sale' raged in Egypt, especially at the time of the Islamic Money Management Companies (IMMCs). The debate was ideological, political, and of course financial, as much as it was religious."

Shari'ah Board members ranged from one to nine (pp. 227).

The literature has produced a number of research works on corporate governance in Islamic banks compared to that in their conventional counterparts, following Western corporate governance models (Abu-Tapanjeh, 2009; Chapra and Ahmed, 2002; Choudhury and Hoque, 2006; Hasan, 2009; Malekian and Daryaei, 2010; Haniffa and Hudaib, 2002; Lewis, 2005[5]; Nienhaus, 2007; Perry 2011, Grais and Pellegrini, 2006b). However, not much has been written to explore the link between the extent of Shari'ah compliance and corporate governance within Islamic banks (Garas, 2012; Grais and Pellegrini, 2006c; Khandelwal, 2008). What is worse is that putting all Islamic banks into a single category without looking into the level of Shari'ah compliance within them, may distort or bias the research results.

This study is thus an attempt to fill the gap in the current literature on corporate governance in Islamic banks. The study analyses various aspects of corporate governance in Islamic banks by classifying these banks into three categories, (i.e., Liberals, Moderates, and Conservatives). A comparison of four important variables of corporate governance (i.e., size of SSB, size of audit committee, size of board of directors, and board composition) within these three categories presents some new findings. The study aims to strengthen and enhance our knowledge of some of the relevant corporate governance mechanisms in Islamic banks. It is expected that the results of this study will be useful to practitioners of corporate governance in Islamic banks, customers, financial regulators including central banks and other relevant stakeholders. In addition, it could help to enable further research to bring necessary reforms to the corporate governance in Islamic banking and thus generally strengthen its practice.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Two major institutions, AAOIFI[6] and IFSB,[7] have provided the guiding principles for corporate governance. Although not mandatory, the framework for corporate governance in Islamic banks that they provide is authoritative. A number of studies have compared the corporate governance in conventional and Islamic financial institutions (Abu-Tapanjeh, 2009; Chapra and Ahmed, 2002; Choudhury and Hoque, 2006; Hasan, 2009; Malekian and Daryaei, 2010; Haniffa and Hudaib, 2002; Lewis, 2005[8]; Nienhaus, 2007; Perry 2011; Grais and Pellegrini, 2006b). These studies have also addressed some issues related to corporate governance in Islamic banks.

Lewis (2005) points to the wider connotation of corporate governance in the Islamic community, as opposed to the conventional meaning of corporate governance. He summarizes six key issues of corporate governance in Islamic financial institutions: (1) the conventional concept of corporation, (2) the treatment of shareholders as creditors in Islamic finance, (3) specific issues with *Mudãrabah* investors, (4) accounting and reporting, (5) examining parallels rather than differences between conventional and Islamic corporate governance, and (6) the poor record of corruption in many Muslim countries. Hasan, (2009) compares the Anglo-Saxon and European model with the Islamic model of corporate governance; he also points out *maqasid* Shari'ah as the ultimate goal and thus highlights the role of Shari'ah in protecting all the stakeholders. Nienhaus (2007) raises serious concerns about the practice of smoothing returns[9] and its impact on corporate governance in Islamic banks. Abu-Tapanjeh (2009) compares the Islamic corporate governance model with the OECD model and concludes that it is difficult to compartmentalize the roles and responsibilities of SSBs, similar to OECD principles of corporate governance. Chapra and Ahmed (2002) provide an overview of several aspects of corporate governance in Islamic banks covering three key stakeholders, viz., regulators, Islamic financial institutions (IFIs), and depositors. The results show that the regulatory environment for IFIs needs improvements; that there are several variations in the status of corporate governance structures in IFIs; and that depositors are keen to punish IFIs if they produce returns below the market level or carry out their transactions not according to Shari'ah principles. Chapra and Ahmed (2002) also provide the results of a survey of corporate governance issues in Islamic banks, but this is limited in sample size and coverage, as well as concentrating on only three countries (Bahrain, Sudan, and Bangladesh) and fifteen banks.

A few studies focus on a specific country (or group of countries) in considering corporate governance issues in Islamic banks. Garas (2012) presented a study covering the GCC countries which examines the superiority of Shari'ah supervision to external audit and Shari'ah audit to internal audit. According to this study, the reporting of the Shari'ah Control Department, which is responsible for the implementation of SSB's fatwas, is significantly related to SSB control. Governance in Islamic banks has been growing differently, especially as regards the GCC and Malaysia (Hasan, 2011, Gintzburger, 2011). Hameed and Sigit, (2005) and Darmadi (2013) presented studies of disclosures in annual reports related to corporate governance in Indonesian banks and concluded that the banks disclosed most on Board of Commissioners and Board of Directors (BOD) and least on internal control and external audit. Ghayad (2008) examined the effect of corporate governance in Islamic banks on performance and proposed that the scope of Investment Account Holders (IAH) should be

[5] Lewis provides a comparison of alternative approaches to Corporate Governance (pp. 19).

[6] The Accounting and Auditing Organization for Islamic Financial Institutions(AAOIFI) is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari'a standards for Islamic financial institutions and the industry.

[7] For more details on the IFSB guidelines on corporate governance, see Appendix B.

[8] Lewis (2005) provides a comparison of alternative approaches to corporate governance (p. 19)

[9] Several Islamic banks use specific practices to provide Islamic investors (unrestricted and restricted) with a rate of return matching the market rate of return. These practices are termed *smoothing returns* and include: (1) foregoing part of the *Mudarib* share, (2) transferring the profits belonging to shareholders to an Unrestricted Profit Sharing Investment Account (UPSIA) on the basis of *Hibah*, and (3) the creation of two special reserves – the Profit Equalization Reserve (PER) and the Investment Risk Reserve (IRR). The former is used to manage the volatility of the rate of return and the latter is used to compensate for loss of capital in the UPSIA (negative returns).

broadened, and these holders should be represented on the Board. However, this study is based on only one country, Bahrain. Various models of Shari'ah governance, based on six countries – Malaysia, Pakistan, Kuwait, Bahrain, UAE, and Qatar – are discussed briefly by Hasan (2007). The discussion focuses on the differences in these six countries in regard to Shari'ah governance.

A good historical summary of corporate governance in the Islamic financial system is provided by Hasan (2008). A recent study by Ai (2010) draws attention to a creative synthesis of the *Tawhid* episteme and *maqasid al Shari'ah* in corporate governance which provides a Shari'ah-based (not merely Shari'ah compliant) model of corporate governance. Islamic banks have been found not truly honoring their social commitment[10] (Usmani, 2002; Maali *et al.,* 2006; Aggarwal and Youssef, 2000). Aggarwal and Youssef (pg. 119) stresses that economic incentives are currently shaping the structure of Islamic banking more than religious norms. The history of Islamic finance, according to Grais and Pellegrini, (2006a) shows the failure of corporate governance. There are several cases of Islamic banks' failing, sometimes associated with their corporate governance. El-Gamal (2006) presents three cases of failed corporate governance in Islamic banks[11], which have largely lost their focus. This may be attributed to several factors, including rapid unplanned growth in Islamic finance, the absence of a global governing body, lack of consensus on several Shari'ah related issues, limited legislative development, the unpreparedness of regulators and, most critically, to the desire of Islamic banks to emulate the growth models of conventional banks.

None of these studies highlights the corporate governance issues to do with the strictness of Shari'ah compliance, thus leaving a gap in the relevant literature. Moreover, to the best of the authors' knowledge, no study divides Islamic banks into categories. Ioannis and Khandelwal, (2008) mention briefly the four classical schools of thought in Islamic jurisprudence, namely, the Hanafi, Maliki, Shafi'i, and Hanbali schools. There is some evidence that these schools implement Shari'ah laws with varying degrees of strictness, giving rise to the fundamental issue that Islamic banks do not apply Shari'ah laws uniformly, but to varying levels[12]. Different schools of thought on Islamic finance offer different interpretations of permissible financial contracts (El-Hawary *et al.,* 2007). This raises the question whether corporate governance compliance may be influenced by various features of the three categories used in this study. Consequently, this study predicts that there will be differences in using and structuring the corporate governance mechanisms of the three categories discussed in this study. The governance mechanisms selected for the study are the size of the board of directors, the size of the Shari'ah board, the size of the audit committee, and the composition of the board. These four mechanisms are found to be important corporate governance mechanisms. The study focuses on board size as a proper monitoring mechanism (Lipton and Lorsch, 1992; Jensen, 1993). Mixed results have been found in the literature on the effects on firm value of small and large boards of directors (e.g., Kamran *et al.*, 2006; Aljifri and Moustafa, 2007). However, the present study does not test the effect of this mechanism on firm value; instead, it examines the differences, if any, in the size of boards between the three categories, as stated below. For the same reason, this study uses SSB as a good mandatory monitoring mechanism (e.g., Alman, 2012). In fact, SSB is the most effective corporate governance mechanism for helping Islamic banks to comply with Shari'ah laws (Bukhari *et al.* 2013). This study focuses on the differences in the size of the SSB between the three categories. An audit committee is also treated in this study as a useful corporate indicator for monitoring; the first call for such a committee was stated in the Sarbanes-Oxley Act (Hoi and Tessoni, 2007). In the same area of interest, this study tests the differences in committee size, as discussed below, between the three categories. Finally, this study uses the board's composition (i.e., the proportion of outside directors) as a good indicator of corporate governance. The results on the effect of board composition on firm value are mixed (e.g., Yermack, 1996; Weir *et al.* 2002; Jackling and Johl, 2009). The present study investigates the differences in board composition, if any, between the three categories. Building on the above, the following are the hypotheses of this study:

H1: The size of the Shari'ah board differs between liberal, moderate, and conservative banks.

H2: The size of the board of directors differs between liberal, moderate, and conservative banks.

H3: The size of the audit committee differs between liberal, moderate, and conservative banks.

H4: The board composition differs between liberal, moderate, and conservative banks.

H5: The size of the Shari'ah board differs between liberal and moderate banks.

H6: The size of the Shari'ah board differs between liberal and conservative banks.

H7: The size of the Shari'ah board differs between conservative and moderate banks.

H8: The size of the board of directors differs between liberal and moderate banks.

H9: The size of the board of directors differs between liberal and conservative banks.

H10: The size of the board of directors differs between conservative and moderate banks.

H11: The size of the audit committee differs between liberal and moderate banks.

H12: The size of the audit committee board differs between liberal and conservative banks.

H13: The size of the audit committee differs between moderate and conservative banks.

H14: The board composition differs between liberal and moderate banks

[10] Wealth maximization as a corporate objective has always been deeply rooted in the conventional financial system which side-lines the broader goal of social responsibility, due to the excessive focus on maximizing the value for shareholders (Mintzberg *et al.*, 2002). Maximizing the Shareholder's value is a standard of corporate governance followed under the Anglo-American model; a similar model is followed by Franco-German model, although it seeks to maximize the value for all stakeholders, not shareholders alone. While the Corporate Governance model of Islamic banks is closer to the Franco-German model, they have been operating in the same market with similar objectives and hence there is a drag on social commitment.

[11] The three cases are the Ilhas Finance House, the Patni Cooperative Credit Society, and the Bank of Credit and Commerce International (BCCI).

[12] It should be noted that the implementation of the "major Shari'ah laws" between the four classical schools of thought is essentially the same. For more details, please refer to Ioannis and Khandelwal (2008).

H15: The board composition differs between liberal and conservative banks.

H16: The board composition differs between conservative and moderate banks.

3. BACKGROUND OF THE MODIFIED KK ISLAMIC BANKING RATING MODEL

There are, to the best of the authors' knowledge, only two studies that focus directly or indirectly on the classification of Islamic banks on the basis of the ethical, or Shari'ah dimension: the study of Obaidullah (2005) and the study of Muljawan (2002). Obaidullah (2005) proposes a model for an overall rating of Islamic financial institutions, similar to the lines of ratings as used by the rating methodologies of Standard and Poor, Moody and Fitch. Obaidullah's study had two objectives: first to identify or develop a method of rating Islamic financial institutions including financial and ethical performance, and second to provide a score called the Islamic Value Rating (IVR) based on data which are collected from answers to using questionnaires.

The proposed model, in brief, was as follows:

$$V_n = W_1V_1 + W_2V_2 + W_3V_3 + W_4V_4 + W_5V_5 \qquad (1)$$

V*n* represented the IVR; Factor 1 = concern for *riba* (interest) and speculation; Factor 2 = concern for human rights; Factor 3 = concern for social enterprise or support to charities and the broad range of organizations involved in the Social Enterprise sector, including: co-operatives, credit unions, community finance initiatives; Factor 4 = emphasis on partnership-based economy; Factor 5 = concern for under-privileged sector.

The study focused primarily on creating an alternative rating model for Islamic financial institutions which included some element of IVR. However in the calculation of IVR, the study did not take into account the use of various core Islamic contracts. In other words, it failed to incorporate into the model the six major contracts which represent major items in the financial statements of an Islamic bank.

The study by Muljawan focuses on an adaptation of the CAMELS rating to Islamic financial institutions. The proposed model covered: C (Capital), A (Asset quality), M (Management), E (Earnings), L (Liquidity), and S (Sensitivity). Shari'ah compliance was included in the M (Management) category. However, the study did not cover any specific Shari'ah compliance dimension in its rating.

Studies to date have addressed the rating of Islamic financial institutions more from a financial perspective though with some elements of ethical and moral concerns, including the strictness of application of the Shari'ah rules. The initial idea for this classification comes from El-Gamal's criticism of Islamic finance practices (2006)[13]. He analyzed the concept of Shari'ah Arbitrage according to the various shapes and forms that it took in different countries. El-Gamal's idea of Shari'ah Arbitrage raises several questions regarding the interpretation of the sacred texts on which to base Shari'ah approvals and hence brings up the question of how strictly Shari'ah laws are applied. Shari'ah law can be implemented in varying degrees in different circumstances, thus allowing, in simple terms, strict, moderate or liberal interpretation. "Egypt and Malaysia have very liberal interpretations of Shari'ah law, while Saudi Arabia and Kuwait are quite strict. Dubai is somewhere in the middle."[14] (Perry and Rehman, 2011). We aimed at extending this discussion, looking for a more structured and quantified way of classifying banks.

The key objective of the Khaled Khandelwal (KK) model for rating Islamic banks was to provide a scoring methodology for assessing the level of adherence to Islamic financial laws (Aljifri and Khandelwal, 2015). The modified KK model was introduced in this study to classify Islamic banks as liberal, moderate, or conservative, as already noted. To the original model, the modified KK model added more relevant dimensions (i.e., social responsibility, and ethical aspects of disclosure and transparency). The model consisted of set of questions covering the following dimensions:

- Banking Products;
- Shari'ah Board Requirements;
- Accounting Standards;
- Compliance with corporate governance;
- Legality;
- Social Responsibility of IFIs;
- Ethical Aspects of Disclosure and Transparency.

A specific set of questions were then used under each dimension to generate scores based on the level of Shari'ah compliance. These scores were then aggregated and used on a scale of 0.00 to 1.00 to form the classification. Several rounds of discussions were held with senior Islamic bankers in order to establish the cut-off points for each category.

4. DATA AND METHODOLOGY

This study tests the corporate governance efficiency in 80 fully Islamic banks, using a sample that includes most of the countries which have a significant number of Islamic banks. The choice of banks was largely based on the availability of data and level of access to senior individuals for personal interviews. Conventional banks with an Islamic window were not included in the sample. Data were collected for the years 2009 – 2014 through financial statements, other public disclosures, and personal interviews. Some banks' financials were not available and hence they were excluded from the study, while a few banks' financials were in the local language (not English), which could not be translated. Other banks did not report the required variables needed

[13] See Gamal (2006); he speaks of "the irony in reports that "Islam forbids interest" or "the Quran forbids interest," followed by a statement of the interest rate paid by Islamic instruments" (p. 45)". "Thus, instead of seeking to replace the mechanics of conventional financial practices with inefficient analogs synthesized from premodern contract forms, Islamic finance should focus on the substance of Islamic Law with regard to how financial instruments are used, rather than how they are constructed" (pp. 49) … "Even the most conservative contemporary jurists do not consider all forms of what economists and regulators call interest to be forbidden (riba). A simple examination of riba-free Islamic financial methods such as mark-up credit sales (murabaha) and lease (ijara) financing shows that those modes of financing are not "interest-free" (p. 71). "The art of Sharia arbitrage consists of identifying a captive market, with religious injunctions that forbid a given set of financial products and services, and synthesizing those products and services from variations on those premodern nominate contracts (p. 175)."

[14] This statement was stated by Khaled Yousaf, the head of business development in the Islamic finance sector of the Dubai International Finance Center, as Perry and Rehman mentioned in their paper.

in the study and hence were excluded. Therefore, the total sample was 118 banks; however, the study was restricted to 80 banks. The sample was drawn from the following countries: the countries of the GCC, Yemen, Egypt, Sudan, Tunisia, Syria, Turkey, Indonesia, Malaysia, Pakistan, Bangladesh, the UK, and South Africa.

Based on the scorecard analysis, Figure 1 shows that the sample was grouped into twenty-nine conservative banks (36%), twenty-nine moderate banks (36%), and twenty-two liberal banks (28%). This is because Islamic banks are still in a developmental phase, and some would, therefore, adopt a cautious approach avoiding extremes on both sides. Further analysis of results highlights the fact that specific categories tend to concentrate in certain geographical regions (see El-Gamal 2006, pp. 16-20). For example, the Shari'ah Board of a bank in Malaysia may approve a financial product which may not be acceptable or ratified in a country within the GCC (Perry, 2011). More information on the study sample is provided in Table 1.

Figure 1. Sample selection in the three categories

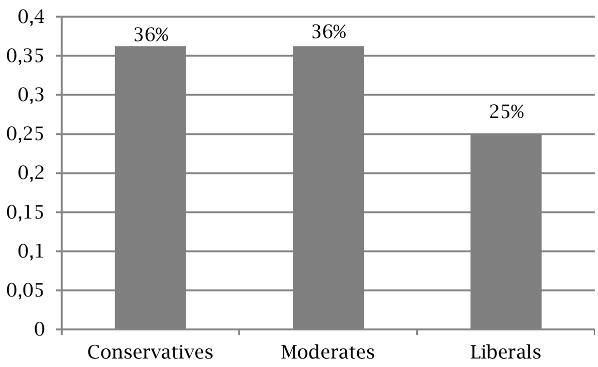


Table 1. Country-wise distribution of the sample

Country	*Frequency*	*Percent*	*Cumulative percent*
Bahrain	26	32.5	32.5
Qatar	3	3.8	36.3
Sudan	1	1.3	37.5
Malaysia	12	15.0	52.5
Pakistan	4	5.0	57.5
Bangladesh	2	2.5	60.0
UAE	6	7.5	67.5
Indonesia	2	2.5	70.0
UK	3	3.8	73.8
Egypt	1	1.3	75.0
South Africa	1	1.3	76.3
Yemen	1	1.3	77.5
KSA	10	12.5	90.0
Kuwait	8	10.0	100.0
Total	80	100.0	

5. RESULTS AND DISCUSSION

Table 2, and Figures 2, 3, and 4 summarize and illustrate the descriptive analysis of the sizes of SSB, audit committee, and board in the three categories. The table shows that the size of the audit committees among the liberals ranges from 2 to 5 members with a mean of 3.14 and standard deviation of 0.86. The mean of audit committee size for the moderates is 3.53 with standard deviation of 0.73, while its range lies between 3 and 5. The table also shows that the audit committee size for conservatives remains constant at 3, with a mean of 3.00 and standard deviation of 0.00. The results of the SSB size for liberals indicate that the mean is 3.67 with standard deviation of 0.84; the range is from 3 to 5. The mean of SSB size for moderates is 4.16 with standard deviation of 1.67, and the range is from 2 to 6. For the conservatives, the range of SSB size is from 3 to 7, and the mean is 3.89 with standard deviation of 1.27. The table also shows that the mean of the board size for liberals is 8.83 with standard deviation of 2.59, and the range is from 5 to 15. The mean of board size for moderates is 8.00 with standard deviation of 1.92 whilst the range is from 5 to 11. However, for conservatives, the mean of the board size is 7.89 with standard deviation of 2.15, and the range is from 3 to 12. Important results are also presented about the board composition: for liberals, the mean is .47 with standard deviation of 0.51, for moderates, the mean is .48 with standard deviation of 0.43, and for conservatives, the mean is .72 with standard deviation of 0.42. Regarding bank size, the table presents that the range of the size for liberals is from 14.09 to 26.02, and the mean is 20.06 with standard deviation of 3.70. A very close result is found regarding the size of moderate banks: the range is from 13.93 to 25.44, and the mean is 20.97 with standard deviation of 3.34. Regarding the size of conservative banks, the mean is 17.82 with standard deviation of 4.63, and the range is from 11.80 to 24.70.

The table reveals that moderate banks are the largest in size, including the size of the audit committee and SSB. In contrast, the liberal banks have the lowest numbers and percentages of SSB members and board composition. The same is true for the conservative banks, which seem to be the smallest category in size and have audit committee with the fewest and most stable members. However, the results show that they have a higher proportion of outside directors (i.e., in their board composition) than either moderate or liberal banks.

Nonparametric tests (i.e., Kruskal-Wallis and Mann-Whitney) were used in this study to examine its hypotheses. Table 2 presents the results of a Kruskal-Wallis (KW) test to examine the differences, if any, between the size of the audit committee, SSB size, board size, and board composition in the three categories. It shows that there is a significant difference between the three categories in the audit committee size, the board composition, and the bank's size (as a control variable) but not for the other two variables (i.e., SSB size and board size). However, when a Mann-Whitney (MW) test was used, the results revealed significant differences only between the moderate and the conservative banks in the size of audit committee, board compositions, and the control variable. The result also showed a significant difference in the control variable between liberal and the conservative banks. This can be explained by the detailed results presented above, which state that conservative banks are smaller in size than moderate and liberal ones are. In short, these results allow us to accept the following alternative hypotheses: H3, H4, H13, and H16 and reject all the others.

One possible reason for these results is that, unlike conservative banks, moderate banks, due to their larger size, appear to tolerate significant differences in the audit committee size and board composition. This is evident from the result of the MW test presented in Table 2. The result of the bank size is consistent with the study of Aljifri and Khandelwal (2015), which documented that the size of moderate banks appears to be greater than either liberal or conservative banks. The literature contains a number of studies that examine board size, SSB size, audit committee size, and board composition and come up with mixed findings (e.g., Lipton and Lorsch, 1992; Jensen, 1993; Kamran *et al.*, 2006; Aljifri and Moustafa, 2007; Alman, 2012; Bukhari *et al.* 2013). In order to successfully justify the results of this study, one would have to depend mainly on the relevant studies of similar issues and understand the effect of the seven dimensions used for classifying banks into the above three categories. Unfortunately, the idea of dividing banks into these categories is new and, to the best of the authors' knowledge, no study has done so before. This greatly limits the benefit of using the current literature to justify and/or support the results because of its irrelevance to the unique aims of the present study.

Table 2. Comparison between the corporate governance variables in the three categories

Variable	*Values*	*Liberals*	*Moderates*	*Conservatives*	*Liberals*	*Moderates*	*Conservatives*
Size of AC	Min	2	3	3	2	3	3
	Max	5	5	3	5	5	3
	Mean	3.14	3.53	3.00	3.14	3.53	3.00
	SD	0.86	0.73	0.00	0.86	0.73	0.00
	MW Test	.060		1.00		.001*	
	KW Test	.002*					
Size of SSB	Min	3	2	3	3	2	3
	Max	5	6	7	5	6	7
	Mean	3.67	4.16	3.89	3.67	4.16	3.89
	SD	0.84	1.67	1.27	0.84	1.67	1.27
	MW Test	.120		.814		.232	
	KW Test	.269					
Size of Board	Min	5	5	3	5	5	3
	Max	15	11	12	15	11	12
	Mean	8.83	8.00	7.89	8.83	8.00	7.89
	SD	2.59	1.92	2.15	2.59	1.92	2.15
	MW Test	.326		.228		.838	
	KW Test	.467					
Board composition	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	Mean	.47	.48	.72	.47	.48	0.72
	SD	0.51	0.43	0.42	0.51	.43	0.42
	MW Test	.413		.067		.004*	
	KW Test	.001*					
Size of Banks***	Min	14.09	13.93	11.80	14.09	13.93	11.80
	Max	26.02	25.44	24.70	26.02	25.44	24.70
	Mean	20.06	20.97	17.82	20.06	20.97	17.82
	SD	3.70	3.34	4.63	3.70	3.34	4.63
	MW Test	.341		.041**		.001*	
	KW Test	.004*					

*Note: *The result is statistically significant at the p < 0.01; ** The result is statistically significant at the p < 0.05; *** Bank's size is measured by the natural logarithm of total assets*

Figure 2. Average SSB size

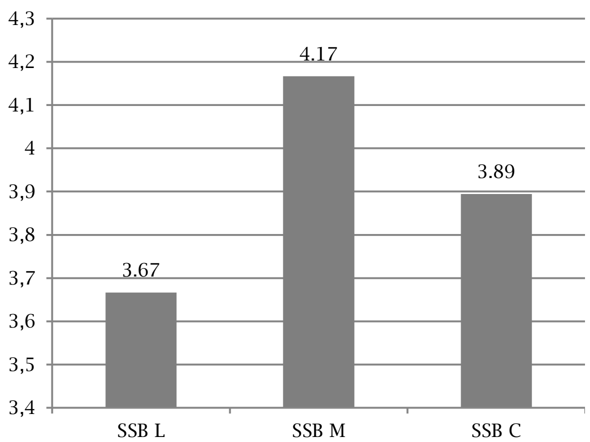


Figure 3. Average audit committee size

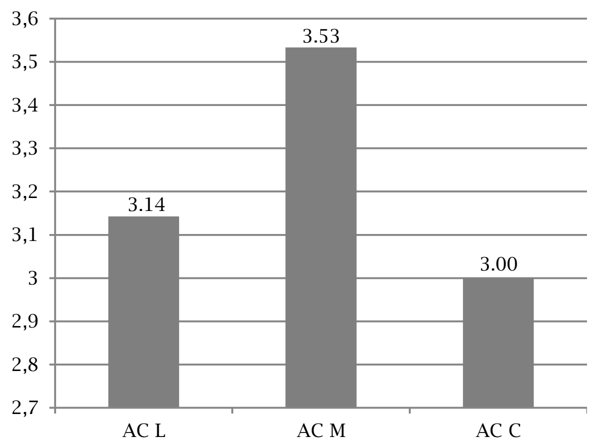
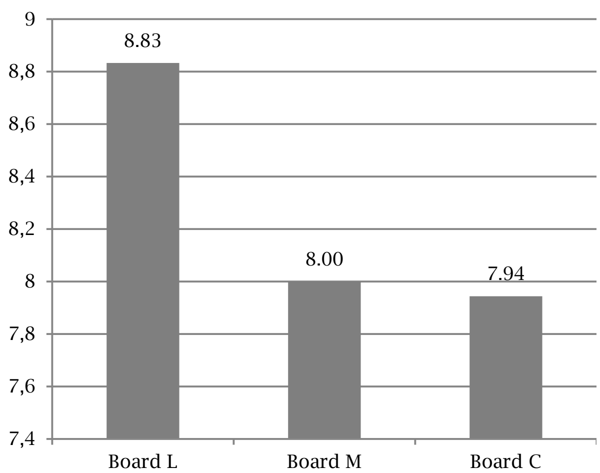


Figure 4. Average board size



Note: L – Liberals; M – Moderates; and C – Conservatives

6. CONCLUSION

Though studies have been written on corporate governance in Islamic banks versus conventional banks, some researchers believe that all Islamic banks have almost the same structure and level of adopting corporate governance. However, this study classifies Islamic banks into three categories: conservative, moderate, and liberal banks. This classification was conducted by introducing a modified KK rating model that brings to the original model some critical dimensions related to social responsibility, and ethical aspects of disclosure and transparency. The study examined four corporate governance mechanisms (i.e., board size, size of SSB, size of audit committee, and board composition) to see if there were any differences between the three categories in the structure of their adopting these indicators. The results reveal that there are significant differences in the audit committee size and the board composition between the three categories. The findings also show that the significant differences lie only between moderate banks and conservative banks.

There are certainly major differences between Islamic banks and conventional banks; however, the studies on the topic of the present paper are limited because Islamic banks have not so far been classified in this way and they have all been treated as a single group, which is surely mistaken. All Islamic banks do not share the same structure, product composition, corporate governance setup, reporting rules, accounting standards, and operational efficiencies. Therefore, a robust classification of Islamic banks on Shari'ah compliance, their most important parameter, is expected to open several new avenues of study and additional work in the field of Islamic accounting and finance by extending and initiating new research. A comparison of several dimensions of Islamic finance within the three groups provides deeper insight into Islamic banks and also allows more segmental studies within and outside Islamic banks.

The limitation of the present study lies in its limited coverage of its variables. The study did not examine other related characteristics to the board of directors, SSB, and audit committee. Examples of these features are the structure of expertise among audit committee members, the number of meetings, and the level of dedication of the SSB. Such information is not always publicly available and in most cases much time and efforts would require to collect them manually. Future research using larger samples and a longer time series should be conducted, taking into consideration the limitations of this study.

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Appendix A

Table A.1. Corporate governance in Conventional and Islamic banks

	Stakeholders	*Presence of SSB*	*Ethical dimension*	*Commercial Model*	*Structure*	*Reporting*
CB	Shareholders, Board of Director, Customers, Employees, Government, Regulators	Not applicable	Limited ethical dimension	Agency theory represents typical commercial model of CG in CB	Shareholder and BOD represent the top-most layer of CG	Reporting is limited to statutory reports including financial reporting. This also includes Statutory Audit.
IB	All of the above and society, investors, UPSIA and RPSIA holders, Partners under various Islamic contracts	Presence of SSB adds specific layer to corporate governance	Complete ethical model, including specifications on type of activities, distribution of profits and social contributions.	Although Agency Theory applies to IB, there are several gaps and there is no specific commercial model to represent CG in IB	SSB represents the top-most layer of CG	In addition to the above, reporting by Shari'ah is mandatory and provides an additional layer of transparency to CG. In addition to statutory audit, there is a concept of religious audit.

Note: UPSIA – Unrestricted Profit Sharing Investment Account, RPSIA – Restricted Profit Sharing Investment Account, SSB – Shari'ah Supervisory Board, CB – Conventional Banking, IB – Islamic Banking

Appendix B

Table B.1. IFSB guidelines on corporate governance for IFS

Part 1: General Governance Approach of IIFS	
Principle 1.1	IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS's accountabilities to various stakeholders
Principle 1.2	IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with *Shari'ah* rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country
Part 2: Rights of Investment Account Holders (IAHs)	
Principle 2.1	IIFS shall acknowledge IAHs' right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised
Principle 2.2	IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns
Part 3: Compliance with Shari'ah Rules and Principles	
Principle 3.1	IIFS shall have in place an appropriate mechanism for obtaining rulings from *Shari'ah* scholars, applying *fatāwā* and monitoring *Shari'ah* compliance in all aspects of their products, operations, and activities
Principle 3.2	IIFS shall comply with the *Shari'ah* rules and principles as expressed in the rulings of the IIFS's *Shari'ah* scholars. The IIFS shall make these rulings available to the public
Part 4: Transparency of Financial Reporting in respect of Investment Accounts	
Principle 4	IIFS shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage

Source: IFSB (2006)