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## **Mode of Islamic Bank Financing: Does Effectiveness of Shariah Supervisory Board Matter?**

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### **Abstract**

This paper examines the relationships between the effectiveness of Shariah supervisory board (SSB), their remuneration and mode of financing Islamic bank. The SSB effectiveness is evaluated by an index based on 9 attributes score. This study comprises 18 Islamic banks in which operating in Malaysia from the year 2012 to 2013 as a sample. Our regression analysis shows that the effectiveness of SSB does not concern with the mode of Islamic bank financing. However, we found that SSB remuneration and bank's financial growth shown a positive and significant relationship with mode of financing. The implications of these findings are discussed.

**Key Words:** Shariah Supervisory Board, Mode of Financing, Islamic Bank.

### **1. Introduction**

There is a strong debut on the Islamic mode of financing which do not underlie with the banner of Islamic banking in which constitutes the elimination of injustices of the interest-based system as ordained by Holy Qur'an<sup>1</sup>. According to [1], [2] and [3] the current mode of financing still cannot be expected to completely free from the injustices of the interest-based system or to contribute to the achievement of socioeconomic objectives which Islam seeks to achieve. Although there are many views can be discussed towards the mode of financing adopted by the Islamic banks, this study aims to explain whether Shariah supervisory boards (SSB) and their remuneration have any significant influence towards the choices of Islamic banks mode of financing. Based on the work of [4] who suggested that, SSB plays an important role, particularly in harmonizing the Islamic rules and guidelines in Islamic banks (i.e. Shariah-compliance gatekeeper), this study argues that the choices of style of financing by Islamic banks should be tempted by this board as to avoid any injustices as what has been proposed in Shariah Law. In other words, the SSB should put highly concern with regard to any mode of financing by the Islamic bank in which are not aligned with the profit-sharing principles.

### **2. Literature Review**

#### **2.1 Islamic mode of financing drawbacks**

According to [5] there are five drawbacks of Murabahah mode of financing. First, on the matter of

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<sup>1</sup> The Holy Qur'an versus 2:275 and 3:130.

ownership and ownership whereby bank has been claimed not actually purchase the asset prior to sale. Second, is on the issue of Murabahah's pricing mechanism. Third, is on the extent profit determination with consideration of time value of money with a fixed compensation since the Murabahah deals with instalment sale. Fourth, the issue of customer defaulted toward Murabahah facility. Fifth, refer to the liability of an asset that found defective upon delivery and lastly is on the principle of *al- kharaj bil daman* that being applied in the contract.

## 2.2 Shariah Governance

According to [6], Shariah Supervisory Board (SSB) is one of internal governance mechanisms which involves the monitoring of Islamic banks' activities in accordance to the Sharia (i.e. Islamic law) specifically on its implementation and compliance. It is a part of the big corporate governance framework and what makes it different is only by the existence of Shariah Supervisory Board or Shariah Supervisory Committee or Shariah unit [7]. Since Shariah governance is part of corporate governance, thus, good and effective SSB should reflect the issue of independence, transparent, accountable, responsible, and fair [8]. In this context, studies by [9] and [10], argued that the unique attributes of SSB must be clarified as to incorporating SSB as part of corporate governance mechanisms framework. Although the existence of SSB seemed able to monitor Islamic banking activities, there are still Islamic banks have experienced failure similar to that of conventional in the recent year. Supposedly, by the attaining of Shariah and good corporate governance, Islamic bank basically able to achieve Shariah objectives (i.e., Maqasid Shariah). However, having this kind of committee is sort not like providing reliable Shariah Governance in which utmost important and beneficial to all parties inside and outside the Islamic Banks.

## 3. Hypotheses Development

This study uses agency theory as underpinning theory to develop the hypotheses. The following hypotheses have been developed in this study:

- H<sub>1</sub>** *There is positive relationships between the effectiveness of SSB and mode of financing adopted by the Islamic bank.*
- H<sub>2</sub>** *There is no significant relationship between SSB remuneration and mode of financing adopted by the Islamic bank.*

## 4. Methodology

The sample used in this study comprises 18 Islamic banks in which operating in Malaysia from the year 2012 till 2014. To extract the mode of financing and information about SSB (i.e., effectiveness and remuneration), the annual reports of Islamic bank were scrutinized. The dependent variable of this study denoted as MODE is proxy by *Bai Bhithaman Ajil* to total Finance. This study measured SSB effectiveness based on 9 attributes scored in which aggregately measured. The attributes is captured based on four elements of effectiveness which is proposed in conventional corporate

governance model [11, 12]. These elements are 1) composition, 2) adequate authority, 3) resources and 4) diligence. Since Shariah governance is part of corporate governance model [7], the use of this elements can be assumed valid.

Table 1. Measurement of Explanatory Variables

Variable	Composition of variables
MODE	: <i>Bai Bhithaman Ajil</i> to Total Finance
SSBEFF	: SSB effectiveness Index = Company's actual score on RMC characteristics/ company total possible score of RMC characteristics
SSBREM U	: Log of Total Remuneration
FGROW T	: Log of total finance
H	
PROF	: Number of RMC meetings during the financial year
MSUPP	: M2 plus financial assets
GDP	: Growth rate of real GDP
$\varepsilon$	: Error term

To examine the relationship between SSB effectiveness, remuneration, control variables and the mode of financing, a multiple linear regression is performed. The regression model is built as follows:

$$MODE_i = \alpha_i + \beta_1 SSBEFF_i + \beta_2 SSBREM U_i + \beta_3 FGROW T_i + \beta_4 PROF_i + \beta_5 MSUPP_i + \beta_6 GDP_i + \varepsilon_i$$

### 3. Results and Discussion

The results of descriptive statistics for the variables are shown in Table 2. The average of MODE is 53 percent indicating that more than half of the total finance is dominated by *Bai bhithaman Ajil*. The mean score of 0.7857 for SSBEFF indicates that on average, SSB in Malaysia quite effective. On average, all the SSB members are being paid off RM518, 346 annually, however, there are some bank that did not disclose the SSB remuneration clearly.

Table 2. Descriptive Results

N=42	Mean	Standard Deviation
MODE	.5295	.23113
SSBEFF	.7857	.06639
SSBREM U	12.7312	.78972
FGROW T	16.1884	1.25395
PROF	.0864	.02689
MSUPP	2.300	.5959
GDP	8.300	1.0054

Table 3 presents the outcomes of the regression analysis between the mode of financing, SSB

effectiveness and control variables. The Variance Inflation Factor (VIF) statistics indicate that multicollinearity does not exist in the model as the values are less than 10. The model explains 22.3 percent of the variation towards the mode of financing, which is relatively low. Although the adjusted  $R^2$  is low, the finding is consistent with those of the previous governance studies, which pointed out that the low  $R^2$  is common in corporate governance researches [see 10, 13]. Our analysis shows that SSBEFF do not have a significant relationship with mode of financing, but there are significant relationships between SSBREMU and FGROWTH. Table 3 shows that SSBREMU (t value = -0.029) has a significant and positive relationship with the mode of Islamic bank financing, at  $p < 0.1$  in which indicates that the increase in BBA moves in tandem with the increase in SSB's remuneration. In this respect H2 is rejected. Thus, we support the notion that there is no serious effort was taken to implement the profit and loss sharing mode of financing among Islamic bank [1, 2, 4]. It's not a matter of SSB effectiveness, but it seems that their remuneration may determine the preferences toward BBA and *Murabahah* mode of financing. This might hold a truth since we find that there is an insignificant portion of these asset portfolios is mainly dominated by *murabahah*, BBA and other than profit and loss mode of financing. In addition, judging from the FGROWTH that is positively significant to MODE as reported, we also perceive that the trade-based mode of financing that must be applied temporarily by the Islamic bank as for their transition phase is not much concern after 25 years, it sort like they are maximizing the shareholder wealth. Another possible explanation is that the SSB committee members may have a relationship with the management as to remain their long period as committee members. As a result to this, we perceive that their assessment may have been influenced by the management since their appointment as committee member is merely due to their relationship with the company.

Table 3. Regression Results

Model	Predicted Sign	Coeff.	SE	t	Sig.	VIF
(Constant)		-1.454	1.077	-1.350	.186	-
SSBEFF	+	-.017	0.574	-.029	.977	1.322
SSBREMU	0	.086	.049	1.774	.085*	1.338
<i>Control Variables</i>						
FGROWTH	+	.067	.038	1.775	.085*	2.032
PROF	+	.724	1.614	.448	.657	1.716
MSUPP	+/-	-.058	.089	-.648	.521	2.574
GDP	+/-	-.013	.055	-.245	.808	2.774
<b>R<sup>2</sup></b>	0.228	<b>P value</b>	0.059			
<b>Adjusted R<sup>2</sup></b>	0.203	<b>N</b>	42			
<b>F statistic</b>	2.275					

Note: \*\*\*Significant at 0.01 level, \*\*significant at 0.05 level, \*significant at 0.1 level.

#### 4. Conclusion

The objective of this study is to examine the influence of SSB effectiveness and their remuneration to the choices of Islamic mode of financing by Malaysian Islamic bank. The analysis shows that an effective SSB does not have significant bearing towards the choice of Islamic mode of

financing in Malaysia but their remuneration have. Intrinsically, this finding might give some insight towards the notion of 'cosmetic reason' [14] for regulator, policy maker and another researcher on the effectiveness and the existence of SSB in Malaysia especially when incorporating SSBs as part of the corporate governance mechanism.

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