Board Characteristics and Risk-Taking Decisions among Islamic Financial Institutions in Bangladesh

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Abstract

The uneven performance of Western financial market has increased the demand by Muslim population for Islamic finance product and services. Recently, the non-Muslim investors particularly in Western countries have put attention and confidence on Islamic finance industry as they believe such industry is operated with high moral and religious value. Besides, good governance in Islamic financial institutions (IFIs) provides better ability for the organizations to protect its stakeholders, reduce risk taking, and enhance its value. Nevertheless, the history of Islamic finance indicates that most of corporate governance failures have similar features with conventional bank scandals, namely ineffective board failure and excessive risk taking by management. Moreover, poor corporate governance leads to inefficient monitoring in the board, caused for higher risk in capital structure, lead to the collapse of the bank. Therefore, this study aims to examine the influence of board characteristics on Islamic Financial Institutions (IFIs) in Bangladesh. The study explored to evaluate the extant literature in order to establish linkage between the Corporate Board Characteristics and higher risk-taking decision. However, the study develops a conceptual framework to test the relationship between Corporate Board Characteristics and higher risk-taking decision in the Islamic Financial Institutions (IFIs) in Bangladesh. This research contributes to the comparative IFIs literature on company governance and provides as source of information for policymakers and regulators, especially in the financial services region for devising strategies to deal with future economic crises.

Keywords: Board characteristics, Corporate Governance, Islamic Financial Institution, Risk management.

1.0 Introduction

The Islamic Financial Institutions (IFIs) are Islamic insurance, mutual funds, banks, hedge funds etc. that maintain interest free transaction and Islamic bonds (*Sukuk*). Generally these institutions officially and virtually follow the Islamic standards, principles and *Shariah* law, which ascertain accountability about fairness and justice in a society (Abu-Tapanjeh, 2009). In addition, from the Islamic finance perspective, Islamic Financial Institutions (IFIs) not only nationally but also globally exhibit the evolution and growth of the Islamic platform of financing in the last few decades (Hassan & Mollah, 2017).The total amount of Islamic finance is rapidly growing consisting of 1% of total global finance as in 2005, while about 600 IFIs over the 75 countries contribute to extend the Islamic finance. In 2012, its value had doubled to USD1.6 trillion and total Islamic financial assets are expected to have a value of USD 6.5 trillion at an estimated compounded annual growth rate (CAGR) of 24.62% during 2012–2020 (IFSB, 2014).

At present the IFIs in Bangladesh are considering as remarkable economics holders of countries' total property with eight full-fledged Islamic bank holding 966 branches, fifteen conventional bank having 21 Islamic branches and windows, fifteen *Takaful* (Islamic insurance), eight Islamic life insurance (total life insurance 32), eleven Islamic not life insurance (46 total general insurance), two Islamic non-banking institutions such as Islamic Finance and Investment Limited (IFIL), Hajj Finance Company Limited (33 total non-Banking finance), and three Islamic mutual fund (34 total mutual fund) (Siddiqur Rahman, 2016).

Although the IFIs have to maintain two boards, they lead to diversification (Garas, 2012b) which enhances board size and its quality that have an impact on the firm's progress. The independent board considers as optimum hidden beneficial for an organization. On the one hand, leadership structure headed by a CEO is considered as the most important element in a firm and hence a different person from the chairmanship is needed within the same time period. On the other hand, the same CEO who is also the chairman of a leadership structure creates a nepotism and exercise bad practice on board decision. Previous empirical literatures found that in a leadership structure, a CEO and chairman significantly post positive impact on risk (Hassan & Mollah, 2017; Mathew, Ibrahim, & Archbold, 2018; Saeed & Buthiena, 2017). A handful of prior studies have examined board education and attendance in meetings. Education makes a complete with multi qualified man and this qualification leads to steady first decision (Kakabadse, Yang, & Sanders, 2010). Board attendance means board assemble and it makes a combined communication that has an impact on risk (Nomran & Haron, 2016).

The concept of IFIs started with noble intention of interest free transaction to maintain classic governance, in that the level of supreme standards will lead to reduce higher interest and risk taking in the future (Abu-Tapanjeh, 2009). With regards to economic scenario, multifaceted incidents in international and neighbourhood economy prevailed in 2016. A modest and uneven recovery in superior economies persevered in the course of the preceding years while events like Brexit, China's slow growth, India's demonetization, a slow rise of oil price and increase in Fed price reshaped the global economy to some extent. Global growth used to be estimated to decline to 3.1 percent from 3.2 percent in 2016 (Annual Report, 2016). Corporate governance failures have similar features with conventional bank scandals, namely ineffective board failure and excessive risk taking (Garas, 2012a).

Practically, the most important issue of IFIs is with regards to risk, which occurs due to improper governance, and poor monitoring by the board towards the management. In this case high risk in capital structure, and may lead to the collapse of banks (Bauer & Frijns, 2008; Bauer, Frijns, Otten, & Tourani, 2008; and Ratu, 2015). According to Yasin Ali (2016) governance is now not properly applied, especially the *Shariah* governance of IFI's operation such as earnings, sharing, lending and bonds issues of most IFIs in Bangladesh. In addition, corporate governance mechanisms in Islamic banks are not strong due to possible market and management inefficiencies (Ullah, Harwood, & Jamali, 2016). As a result, the IFIs face special challenges, due to uneven application of governance mechanisms that have higher risk impact (Ratu, 2015).

Now the prime question arises in risk appetite of IFIs, as it has been argued that the effectiveness of board characteristics deemed as a very serious matter. As a result the IFIs face significant challenges, that of high risk (Ratu (2015). The risk leads to excess expenditure, financial failure, liquidity complexity, bank ruins, corrupted financial institution, industry fall and distribution of financial inequality, and ultimately the IFIs are tied to face acute financial crises. Moreover, due to financial crisis, possible incidences that pose risk elements may occur such as fund management risk, operating risk, liquidity credit risk and market risk (Das, 2010

; Johl, Kaur, & Cooper, 2015). To solve these problems, board characteristics comprising board size, board independent, leadership structure, board education and board attendance in meeting should be properly applied that lead to strong governance. in the multi-functional approaches there are different supporting relevant stakeholder considered to composite of board including of audit committee, risk management committee, and sharia board committee in the IFIs, where are at least three members and one independent director participate from board to audit committee (Risk Guideline, 2012). Board education with accounting expertise and experience with tenure is the most importance on risk that conducted (Chou & Buchdadi, 2017; Hassan & Mollah, 2017; Mohamad & Ishak, 2017; Tazilah & Rahman, 2014).

Therefore, the study is to evaluate the extant literature in order to establish linkage between the Corporate Board Characteristics and higher risk-taking decision. However, the study develops a conceptual framework to test the relationship between the Corporate Board Characteristics and higher risk-taking decision in the Islamic Financial Institutions (IFIs) in Bangladesh. This research contributes to the comparative IFIs literature on company governance and provides as source of information for policymakers and regulators, especially in the financial services region for devising strategies to deal with future economic crises.

2.0 Background of the study

2.1 Risk Taking Decisions

The study incorporates five components of risks namely, fund management risk, operational risk, liquidity risk, credit risk and market risk as the representative of risk taking decisions.

2.1.1 Insolvency risk

Insolvency risk can be considered as credit and liquidity risk, it has a distinct difference that shows the distance of default due to transactions transfer. In fact, the insolvency risk is raised by selling and buying of the senior tranche and holds a properly large first-loss position. However, the risk exchange assets against other assets, and as a result an organization lost its solvency to pay debt. Therefore, the present study shows that, under certain conditions, such opportunities may impair economic stability, and thus calls for further reaction on the patterns of securitization transactions and portfolio claim (Pathan, 2009c).

Empirical studies tend to focus on the default risk as insolvency risk. Several studies discuss the empirical relationship between risk of institutions and credit risk transfer. However, it is worth noting that those studies generally do not disentangle the direct impact of credit risk transfer on insolvency risk and the aforementioned indirect impact as a consequence of changes to risk management practices and investment decisions (Akbar, Kharabsheh, Poletti-Hughes, & Shah, 2017). The Islamic financial institutions have sketched a framework for improving the risk but such types of process are not absolute solution for reducing the risk. To reduce this risk governance particularly board characteristics may be the solution. In addition, in order to meet the risk, an Islamic economic institutions can choose one of the following methods; i) continue plan, ii) insurance plan (*takaful*), iii) consulting, iv) adequate discipline, v) schooling (Risk Guideline, 2012).

2.1.2 Liquidity risk

The liquidity risk revealed considerable relationship of asset and residences or dimension of the IFIs and inside the estimated mannequin (Ramzan & Zafar, 2014). Idiosyncratic factors point out IFI's profitability, capital adequacy ratio and funding ratio. Return on Assets (ROA) whilst the profitability indicator positively affects to liquidity deficit and the capital adequacy ratio (CAR) of IFIs's investment ratio that has appreciably poor relationships with the liquidity risk measure. Nevertheless, the liquidity risk manipulate the company policy (Jedidia & Hamza, 2015). Liquidity risk is time-lagged relationship however, dangers separately have an effect on IFIs sustainability and their interaction of IFIs instability (Ghenimi, Chaibi, & Omri, 2017).

Furthermore, the hazard of liquidity scarcity is sizable significance because, liquidity is a furnish of protracted health problem for the IFIs by using way of way of lowering their income potential, a shortage of liquidity is an acute syndrome that can motive surprising death of IFIs (Khan & Ahmed, 2001). But liquidity risk has not been thoroughly introduced (Ali, 2004). The size of the IFIs with liquidity hazard in the governance shape insignificant relationship with liquidity chance therefore, it can be assumed that sturdy asset base of IFIs contributes towards extra decorate liquidity manipulate(Ramzan & Zafar, 2014).

Moreover, central Bank can be necessary in managing a liquidity financial hardship, however it is now not a panacea. It can act as an right now on the other hand brief endure to liquidity shocks, thereby allocating time for supervision and rules to guard the causes of liquidity risk (Akomeah, Kong, Hu, & Afriyie, 2017; Nathan Garas, 2012). The find out about also decided out, board of administrators and senior administration team, mixed with the approval of the public, may additionally end result in greater efficaciously and greater normal administration of risk (Pearl-Kumah, 2014).

Liquidity administration is the access of financial handy that is measured by the minimum reserve requirement (RR) and financing to deposit ratio (FDR). The study showed that board structure may effect on liquidity risk. As a result the IFIs should advance loan change via composition their mortgage portfolio, risk committee size and sound governance to decorate advantageous threat taking in IFIs (Sambasiva Rao & Dula, 2017).

2.1.3 Credit risk

Credit risk is late payment or pay with delay of the gross amount and applied credit interest and other kind of debts by way of the customers (Hemmati & Vakilalroaia, 2015). However, credit risk means no longer instantaneous charge and default in payments with the aid of counterparties (Abdullah, Khan, & Nazir, 2012). The credit score risk depends on managing efficiency, whilst operational risk is located to be bad to efficiency. The liquidity hazard is managed by means of efficiency in IFIs (Said, 2013). In addition, savings risk as properly as GDP and trade price increments result in lowering in IFIs' credit score risk (Valipour & Vahed, 2017) the savings risk strategy focuses on profitability level , especially, NPL quantity seems to be including the most weight to that than CAR. However, the truth that the IFIs sizes are not on statistically first-class with NPLR and CAR and ROE (Akomeah et al., 2017).

On the other hand, strong capital coverage enhances IFIs' governance stability when it set-off with credit risk. Particularly, the key functions are as follows, the higher association of minority active shareholding, the less entity concentration exhibits their superiority through usual performance (Zheng, Moudud-Ul-Huq, Rahman, & Ashraf, 2017). The finding suggests that legislation and moral insurance policies may additionally alter the parameters of governance in IFIs. In addition, the feature of audit committees in the IFIs area is highlighted, past the position of the board of administrators in common (Pathan, 2009a). The present study summarized the empirical literature on Corporate Governance in the Islamic Banking Institutes, these are as follows.

Table1. Summary of literature review

Year	Author name	Majors findings
2009	(Pathan, 2009b)	Strong bank boards (boards reflecting more of bank shareholders interest) particularly small and less restrictive boards positively affect bank risk-taking.
2016	(Moumen, Othman, & Hussainey, 2016)	The board and its size enhance the in formativeness of risk disclosure as it allows investors to better predict future earnings growth.
2004	CG. code	Independent director expresses his/her opinion with freedom and fairness that impact on risk.
2004	(Code, 2004)	Leadership structure (CEO) is the team leader of board that is appointed by board of director. Leadership structure of a board (CEO) is to be separated from chairman so that chair and CEO can protect risk at different way.
2012	(Alman, 2012b)	Board member with a sound degree of education qualification has the ability to deal with any neologism and innovative in a good manner.
2017	(Akbar et al., 2017)	Board members meeting and qualified display an important role in developing the competitiveness of the companies.

2.2 Underpinning relevant theories:

The study incorporates two theories namely, agency theory and stakeholder theory. Agency is the relationship between principal and agent. CG has been studied underneath the lens of the proprietor (principal) and supervisor (agent) relationship of the organization and create interconnecting network like principal and agent that have an impact on firm risk taking (Al Dareer, 2001; Bukair & Rahman, 2015; Eisenhardt, 1989; Ntim, Lindop, & Thomas, 2013).

Meanwhile, stake holder theory is potential any parties or neighborhood who have affected on organization (Freeman, Harrision, & Wicks, 2010). Stakeholder theory interaction between parties on each other (Nathan, 2010). The stakeholder doctrine affords five steps such as shareholder, customer, employees, suppliers and neighborhood communities who influence on risk taking (Andre, Laplume, Sunpar, & Reginald, 2008)

2.3 Development of the Conceptual Frame Work

The study developed conceptual framework based literature gap and underpinning of most relevant existing theories: such as there are at least two and maximum number of twenty members of board should be appointed of board members in Bangladesh (Code, 2004). The governance style gives impact on risk taking strategies, policies and processes (Subramaniam, McManus, & Zhang, 2009). Although small board size is low agency cost and high, co-ordination that impact on risk taking of IFIs (Quttainah, Song, & Wu, 2013). On the others hand small board size contribution better communication and more effectiveness (Yermack, 1996). Previous empirical literature have argument that BOD size should be at least seven or eight members (Jensen, 1993). Whereas, board size, frequency and operational effectively of management had no vast impact on the liquidity risk (Sambasiva Rao & Dula, 2017).

In the same way, as the governance is a basic driving force in business and entrepreneurship, the weakness of risk taking, board have to maintain one-fifth independent directors. Independent director expresses his/her opinion on board decision with fully freedom.

Due to free movement of independent director in board that lead to risk control (BSEC, 2012). In constraint, independent director gets much freedom. In fact, the Board deal with the identifying, recording, inspecting monitoring, controlling the danger and high-quality implied hazard administration strategies and practices, that the connector between monetary administration and company governance consists of the corporate risk taking (Ionescu & Vilag, 2015). Moreover, as the strong boards depend on shareholders' activity particularly small and much less restrictive boards positively affect risk-taking. In contrast, CEO power (CEO's leadership to control board decision) does no longer positively affect risk-taking. These effects are consistent with the organization contracting surroundings and risk-takings and distinctive estimation strategies (Pathan, 2009b). However, CEO duality that occupies equal post of board that affects to corporate governance characteristics such as function duality, board measurement and mix with governance and non-executives (El-Masry, Abdelfattah, & Elbahar, 2016; Hassan & Mollah, 2017; Sambasiva Rao & Dula, 2017). Thus, it can be decided that CEO leadership may additionally negatively have an effect on IFI's risk-taking (Ratu, 2015).

In the globalization era, there are huge number of challenges in business premises, these challenges is the big issues of risk and to cover this risk a good education background key person such as financial as well as accounting knowledge expertise needed, therefore, previous some empirical literature review have explained that financial expert, scholars and good education background employee impact on risk. In addition, someone has argued that higher degree or Ph.D. degree in board instillation a clean image that impacts on risk (Alman, 2012a; Chan, Liu, & Sun, 2012; Nomran & Haron, 2016). However, The presence of board and head of different sub-committee of the Board, they try to filter the financial statement through scrutinizing the data to be disclosed, and to ensure accuracy, adequacy, transparency and completeness of the disclosed information that reduce any kind of internal shock of an organization (BSEC, 2012).

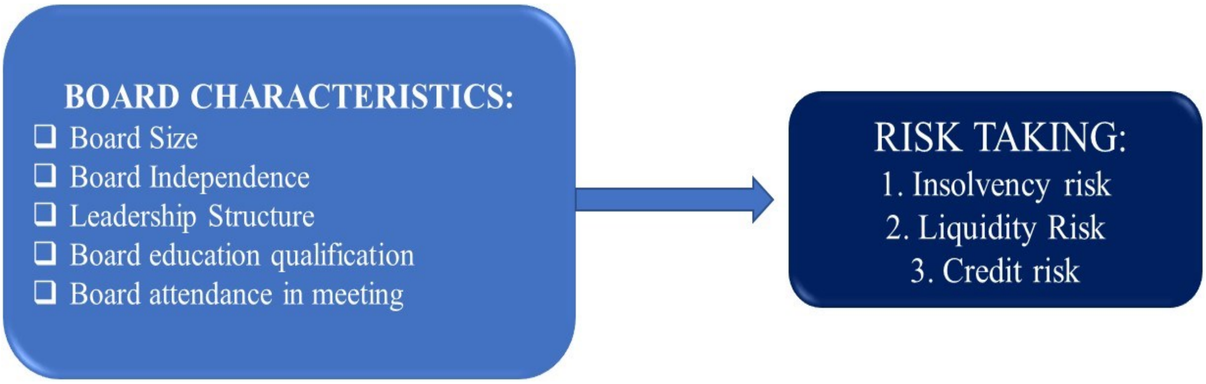

Figure 1: Board characteristic and risk taking

3.0 Hypothesis development

3.1 Board Characteristics and Risk taking of IFIs in Bangladesh

According to Code (2004), at least two and maximum number of twenty members of board should be appointed of board members in Bangladesh. The governance style gives impact on risk taking strategies, policies and processes (Subramaniam et al., 2009). Although small board size is low agency cost and high, co-ordination that impact on risk taking of IFIs (Quttainah et al., 2013). On the other hand, small board size contribution has better communication and more effectiveness (Yermack, 1996). Previous empirical literature have argument that BOD size should be at least seven or eight members (Jensen, 1993). Whereas, board size, frequency and operational effectively of management had no vast impact on the liquidity risk (Sambasiva Rao & Dula, 2017).Therefore, from the above discussion, it can be hypothesized that;

Hypothesis 1 (H1): Board size influences on risk taking of IFIs.

Governance is a basic driving force in business and entrepreneurship, the weakness of risk taking, board have to maintain one-fifth independent directors. Independent director expresses his/her opinion on board decision with fully freedom. Due to free movement of independent director in board that lead to risk control (BSEC, 2012). In constraint, independent director gets much freedom. In fact, the Board deals with the identifying, recording, inspecting monitoring, controlling the danger and high-quality implied hazard administration strategies and practices, that the connector between monetary administration and company governance consists of the corporate risk taking (Ionescu & Vilag, 2015). Therefore, from the above discussion, it can be hypothesized that;

Hypothesis 2 (H2): Board independent influences on risk taking of IFIs.

The strong boards depend on shareholders' activity particularly small and much less restrictive boards positively affect risk-taking. In contrast, CEO power (CEO's leadership to control board decision) does no longer positively affect risk-taking. These effects are consistent with the organization contracting surroundings and risk-takings and distinctive estimation strategies (Pathan, 2009b). However, CEO duality that occupies equal post of board that affects to corporate governance characteristics such as function duality, board measurement and mix with governance and non-executives (El-Masry et al., 2016; Hassan & Mollah, 2017; Sambasiva Rao & Dula, 2017). Thus, it can be decided that 'CEO leadership may additionally negatively have an effect on IFI's risk-taking (Ratu, 2015). Thus, this study proposes that;

Hypothesis 3 (H3): Leadership Structure influences on the risk taking of IFIs.

In the globalization era, there are huge number of challenges in business premises, this challenges is the big issues of risk and to cover this risk a good education background key person such as financial as well as accounting knowledge expertise needed, therefore, previous some empirical literature review have explained that financial expert, scholars and good education background employee impact on risk .In addition, someone has argued that higher degree or Ph.D. degree in board instillation a clean image that impact on risk (Alman, 2012a; Chan et al., 2012; Nomran & Haron, 2016). From the above discussion, it can be hypothesized that:

Hypothesis 4 (H4): Board Qualification influences on risk taking of IFIs.

The presence of board and head of different sub-committee of the Board ,they try to filter the financial statement through scrutinizing the data to be disclosed, and to ensure accuracy, adequacy, transparency and completeness of the disclosed information that reduce any kind of internal shock of an organization (BSEC, 2012). Thus, the study proposes that:

Hypothesis 5 (H5): Board attendance in meeting influences on risk taking of IFIs.

4.0 Conclusion and Recommendations

As this study aims to examine the influence of board characteristics on Islamic Financial Institutions (IFIs) in Bangladesh. Thus, the study explored to evaluate the existing literature review in order to linkage between the Corporate Board Characteristics and higher risk-taking decision. Based on the summary of findings, this study develops a conceptual framework to test the relationship between the Corporate Board Characteristics and higher risk-taking decision in the Islamic Financial Institutions (IFIs) in Bangladesh. The study contributes to the literature on board characteristics effectiveness and gives useful information to policy makers, academics and different stakeholders that inclined more too significant due to the fact board feel this practice can convey greater independence, self-determination, certainly which is sizeable and positively related to risk. It enhances new dimensions for managerial capability with risk management potential as properly as external governance mechanisms. The findings of this research will be treasured source of information for policymakers and regulators, especially in the financial services region for devising strategies to deal with future economic crises. This research contributes to the comparative IFIs literature on company governance. Additionally, future research should further prolong the data analysis.

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