Four Essays on the Impact of Shari'ah (Islamic Law) as an Institutional Governance Mechanism on Organizational Performance and Managerial Behavior

By

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ABSTRACT

This dissertation consists of four distinct chapters that examine Islamic business organizations, specifically as they relate to Islamic banks that integrate the Shari'ah (Islamic Law) Supervisory Boards and their impact on managerial behavior and organizational financial performance.

The first chapter examines Islamic financial institutions' emergence, functions, socioeconomic development, principles, strengths, and weaknesses in the global arena. This chapter also discusses the underlying concepts of Shari'ah-compliant institutions and the values reflected in the economic principles that underpin Islamic finance. Unlike commercial banking systems, Islamic modes of finance are interest-free; however, such modes of finance add entrepreneurial payment obligations and revenue accrual. In addition, Islamic finance introduces a sharing basis of financing by linking financial intermediaries' returns to fund revenues that redirect capital to higher-return projects. Accordingly, Islamic Banks are able to replace conventional interest-based finance, which many argue is a cause of free-market instability.

The second chapter investigates the impact of institutional corporate governance on the financial performance of Islamic banks, with a specific focus on Shari'ah Supervisory Boards and corporate boards. The findings of this study indicate that Islamic banks with Shari'ah Supervisory Boards outperform Islamic banks without such boards, as measured by return on assets (ROA), return on equity (ROE), asset growth (AG), and interest margins (IM). Further findings of this study indicate that the financial performances of Islamic banks with Shari'ah Supervisory Boards and corporate boards are influenced by several board characteristics, including the size of the board and the education of the board members. Moreover, Shari'ah Supervisory Boards provide tighter monitoring and control, as well as more advising and counseling, as compared with Islamic banks without Shari'ah Supervisory Boards. Later findings indicate that Shari'ah Supervisory Boards' affiliations with international Islamic financial institutions motivate the positive relationship between the Shari'ah Supervisory Boards and Islamic bank performance. Overall, this study provides strong evidence that Shari'ah Supervisory Boards benefit shareholders by complementing corporate boards and thus mitigating agency problems and agency costs.

Next, the third chapter examines the organizational forms of Islamic banks and the effects these forms maintain on organizational behavior, specifically as it relates to managerial expense

preferences. This study performs an empirical and comparative analysis of Islamic banks and commercial banks over the period 1993–2010. The findings of this study indicate that organizational forms of Islamic banks influence managerial expense preferences. In addition, analysis using a stochastic frontier approach as a robustness test supports the initial findings. This analysis reveals that the average noninterest cost inefficiency of Islamic banks without Shari'ah Boards is 23% more compared to commercial banks. However, when controlling for Shari'ah Supervisory Boards, Islamic banks are, on average, 28% less noninterest cost inefficient compared to Islamic banks without Shari'ah Boards. In addition, Islamic banks with Shari'ah Boards are, on average, 16% less noninterest cost inefficient compared to commercial banks.

Finally, chapter four empirically examines whether Islamic banks are less likely to manage their earnings (in the context of financial reporting), as well as how their unique corporate governance systems, organizational forms, and accounting standards affect earnings-management behavior. Using a matched-pair sample of Islamic banks and commercial banks in 15 countries, the findings of this study indicate that Islamic banks are less likely to manage earnings as measured by discretionary accruals and abnormal loan-loss provisions. The findings also indicate a significant difference in earnings-management behavior between Islamic banks with and without Shari'ah Supervisory Boards. Several Shari'ah Supervisory Board characteristics, such as board size and the presence of board members from the Accounting and Auditing Organization for Islamic Financial Institutions, are important determinants of the earnings-management behavior of Islamic banks with Shari'ah Supervisory Boards.