



The Impact of Governance on the Performance of Islamic Banks: A Case Study of Selected Banks in Iraq

By:

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Abstract

The study aimed to determine the relationship between governance principles and financial performance of Islamic banks in Iraq. It delved into the specificity of governance in Islamic banks, discussing its importance in the banking sector generally. The research measured the impact of governance rules on financial performance using a sample of Islamic banks in Iraq from 2018 to 2022. The researcher utilized the correlation function between the dependent variable, represented by the return on total assets (indicating financial performance), and corporate governance variables as independent factors. The findings revealed a strong relationship between the application of governance principles and the financial performance of the studied Islamic banks. Results showed a positive correlation between return on assets and factors such as board composition, board size, committee count in the board, and the number of members in the Shariah supervisory board. As the independent variable (governance principles) increased, the return on assets (dependent variable) also increased. Additionally, there was a negative correlation between return on assets and ownership concentration.

Keywords:

Corporate Governance, Islamic Banking, Financial Performance, Board Composition, Shariah Supervision.

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I. Introduction

Background: The events that the global economy has experienced have placed the concept of governance at the top of the attention of the business community and international financial companies. Since the year 1997, the date of the occurrence of the Asian financial crisis, through the Enron scandal in 2003, to the global financial crisis in 2007, and then the 2010 crisis, all of them are events that highlighted the importance of governance as an optimal approach to addressing and preventing crises (Aslam, 2020, 1073).

Many researchers and interested parties agree on the importance of corporate governance and what it represents in terms of driving development, raising the level of performance, and reducing the degree of risk related to administrative and financial corruption at the level of companies and countries alike... Also, governance applications are considered more important in the banking sector than in other sectors. Banks contain a set of interrelated elements and relationships that do not exist in other sectors, which greatly affects the nature of the governance system (Aslam, 2020, 1090).

Hence, this concept has become more important and complex in Islamic banks because of the latter's banking operations that differ in form and content from traditional banking operations, in addition to the presence of two boards, namely the Board of Directors and the Sharia Board (the Sharia Supervisory Board), whose goals and functions overlap in some cases... and many findings have been reached. Studies indicate that following sound principles of governance leads to providing the necessary precautions against administrative corruption and contributes to encouraging and consolidating transparency in economic life (Raouf, 2022, 52).

In the study by Rameez Rahman, 2020 [Corporate governance and performance of financial companies in Pakistan: A comparative study between conventional banks and Islamic banks], the study compared corporate governance in Islamic banks and conventional banks, and the impact of governance variables on the performance of banks in the Gulf Cooperation Council countries and Southeast Asian countries. During the period 2000-2009, the study reached several results, the most important of which are: that there are fundamental differences between governance in traditional banks and Islamic banks, and there are also differences between governance in the Gulf countries and Southeast Asia. The study also concluded that the expenses of the board of directors negatively affect the banks' returns. Islamic banking, and that the characteristics of the Sharia Supervisory Board do not affect the financial performance of Islamic banks (Almutairi, 2020, 765).

Research Problem: The research problem can be expressed in the following questions: (1) What is the nature of the relationship between corporate governance variables and the financial performance of Islamic banks? (2) Is there a difference in governance between conventional banks and Islamic banks? (3) How can governance applications contribute to raising the efficiency of Islamic banks?

Research Importance: The scientific importance of the research is that shedding light on the impact of governance on the performance of Islamic banks in Iraq contributes to enriching

scientific knowledge in the field of economics and Islamic banking. This research opens new horizons for a deeper understanding of the relationship of governance and financial performance, and contributes to developing theories and concepts related to improving the performance of financial institutions (Elamer, 2020, 914). As for the practical importance of the research, by shedding light on governance in Islamic banks in Iraq, this research can contribute to directing banking policies and making relevant decisions at the national level. By practical analysis of the study results, officials and decision-makers in the Iraqi banking sector can benefit from the guidance to strengthen governance and thus improve the performance of Islamic banks and the financial system in general.

Research Objectives: The main objective of the research is to find the answer to the following question: Does adherence to governance elements affect the financial performance of Islamic banks? Sub-objectives emerge from this: (1) presenting and discussing the elements of governance in general, (2) identifying the specificity of governance in Islamic banks.

Research Hypotheses: For the purpose of achieving the research objective, the researcher assumes the following: (1) There is a statistically significant relationship between corporate governance variables and the financial performance of Islamic banks. (2) There is a positive relationship between the composition of the Board of Directors and Board Committees, and the return on assets. (3) There is a negative relationship between ownership concentration and return on assets. (4) There is no relationship between the number of members of the Sharia Supervisory Board and the financial performance of Islamic banks.

Research Contribution: There are many studies that touched on governance in Islamic banking, but most were dominated by conceptual analysis, and only a few provided performance-based empirical evaluation. This research combines the theoretical dimension highlighting the specificity of governance in Islamic banks versus conventional ones with an applied dimension through empirical analysis of variables impacting Islamic bank performance, using a representative sample from the Gulf region, considered one of the largest Islamic financial hubs. The study period (2018–2022) also contributes to the recency and relevance of the findings.

II. Literature Review

II. A. Corporate Governance: General Issues

The Cadbury Society (1992) defined corporate governance as “the method that achieves a balance between economic and social objectives on the one hand, and between individual and joint objectives on the other hand...” (Sehen Issa, 2023,292).

The Organization for Economic Co-operation and Development (OECD) defined governance as “a set of relationships between a company’s management, its board of directors, its shareholders, and other parties...” (Mukhibad, 2022,270).

Governance is also defined as a set of rules and procedures aimed at ensuring the good functioning of the facility... (Meskovic, 2023,567).

Reasons for the increasing interest in corporate governance include financial globalization, executive power abuse, corruption, and major company collapses (Jallali, 2022, 464).

Governance theory is rooted in multiple management theories, especially agency theory, and emphasizes rights protection, transparency, and oversight (Elgattani, 2021, 454).

The OECD (1999) proposed principles that ensure shareholder protection, equal treatment, stakeholder respect, and disclosure transparency (Ajili, 2018, 475; Athari, 2023, 2124).

II. B. Governance in the Banking Sector

Governance in banks refers to managing the bank's affairs through defined roles for management and the board of directors, ensuring depositor rights and operational integrity (Tashkandi, 2023, 250).

The bankruptcy of banks can affect the entire economy due to interconnectedness in the inter-bank market, making governance more critical in this sector (Tashkandi, 2023, 260).

Governance complexity in banks stems from elements like deposit insurance, systemic risk, and funding structures. Strong governance enhances efficiency and market value (Elgattani, 2021, 450).

Determinants of good banking governance include: (1) Internal decision-making structures; and (2) External regulatory environment, competitiveness, and financial infrastructure (Tashkandi, 2023, 255).

II. C. Governance from an Islamic Perspective

Islamic governance is rooted in faith-based principles regulating administrative conduct, linking it with worship, ethics, and community relations (Meskovic, 2023,323).

Two key implications: (1) managing conflict of interest among stakeholders; (2) reliance on Shariah principles: justice, accountability, responsibility, and transparency (Sehen Issa, 2023, 292).

Justice in Islam requires fairness in contracts and responsibility before God and society, with supporting verses from the Quran and sayings of the Prophet (Elamer, 2020, 920).

Accountability includes internal systems of reward/punishment, legal and divine accountability as embedded in Sharia law (Elgattani, 2021, 434).

Transparency is defined as providing accurate and honest information to all stakeholders to ensure trust in management.

Shariah contains all core governance principles known internationally. This raises the question: Are Islamic banks inherently aligned with governance due to Shariah adherence? (Raouf, 2022, 52).

Governance in Islamic banks features: (1) High-risk investment deposit management; (2) Dual governance via both administrative and Sharia supervisory boards (Ajili, 2018, 480).

III. Methodology

III. A. Research population and sample: The total population for the research consists of 28 Islamic banks in Iraq, 17 banks were randomly selected, so the sample percentage of the population is 60%. Appendix No. 1 shows the names of the banks for the study population and sample.

III. B. Study variables: The standard model includes a dependent variable, which is the return on assets, which expresses the financial performance of the Islamic banks under study during a certain period, and six independent variables, five of which express the basic variables of corporate governance, which are: the variable of the composition of the board of directors, which can be measured by the number of independent members in The Council, the variable number of board committees, the variable ownership concentration which is measured by the percentage of shares owned by major shareholders, and a variable related to the size of the Sharia Supervisory Board which is measured by the number of members. As for the sixth independent variable, it is called a controlling variable, which is the size of the bank, measured by the logarithm of total assets. The details of these variables can be explained as follows:

Figure (1): Details of the study variables

Variable type	Variable name	code	Measurement
Dependent variable	the performance	ROA	Return on total assets = net profit / total assets
Independent variables	Composition of the Board of Directors	BCM	Number of independent members of the Council
	Council committees	CBD	Number of committees in the Board of Directors
	Ownership concentration	OCN	Percentage of shares owned by major shareholders
	Size of the Sharia Supervisory Board	SSB	Number of members of the Sharia Supervisory Board
	Drain size (control variable)	SZE	Logarithm of total assets

III. C. Data collection: The data needed for the research was collected from the annual reports of the banks under study and from the official bulletins of the Central Bank of Iraq.

The researcher summarized the development of the average variables of the Islamic banks under study during the period 2015 to 2022, as shown in the following table:

Table 2: Average development of study variables during the period 2015-2022

	ROA	BCM	CBD	OCN	SSB	SZE
2015	0.4	2	2	0.17	2.5	4.53
2016	0.5	3	2	0.19	3.5	5.04
2017	0.6	3	3	0.21	3.5	6.02
2018	0.4	3	3	0.25	4	6.24
2019	0.8	4	4	0.28	4.5	5.12
2020	0.6	6	4	0.31	5	6.64
2021	0.7	8	5	0.36	5.5	7.28
2022	0.6	8	5	0.35	5.5	8.59

Prepared by the researcher based on the annual reports of the banks under study

III.D. Measurement model and statistical analyses

To measure the impact of governance variables on the performance of Islamic banks; The correlation analysis method will be used according to the following equation

$$ROA_{it} = \alpha_0 + \beta_1 BCM_{it} + \beta_2 BSZ_{it} + \beta_3 CBD_{it} + \beta_4 OCN_{it} + \beta_5 SSB_{it} + \beta_5 SZE_{it} + \varepsilon_{it}$$

Whereas

ROA_{it} : The dependent variable that explains the financial performance of Islamic banks

$(\beta_1 - \beta_5)$:- Coefficients of the independent variables

BCM_{it} : Number of independent members of the Council

CBD_{it} : Number of committees in the Board of Directors

OCN_{it} : Percentage of shares owned by major shareholders

SSB_{it} : SSBIt size.

SZE_{it} : Size of the Islamic bank = logarithm of total assets.

ε_{it} : random error.

The following table shows the most important statistical data for the variables used in the study. It is clear that the dependent variable: the average return on total assets is estimated at approximately (57%), and the average variable of board composition (BCM) is estimated at approximately (4.62); that is, on average there are approximately 5 independent members on the board of directors, which indicates that there are A number of independent members, which increases the acceptability of the independence and transparency of the Board and thus the effectiveness of corporate governance

As for the variable of board committees (CBD), the average number of committees present in the board of directors across the Islamic banks under study was estimated at about 7 committees, which is close to the average number of committees recommended by corporate governance rules.

As for the ownership concentration (OCN) variable, it is clear that the average percentage of shares owned by major shareholders is estimated at approximately (26%) of the total shares. That is, it does not exceed 50%, which is a percentage that shows the inability of the major shareholders to control the bank's decisions and direct them to their own interests. This helps in applying governance principles and thus in the performance of the banks under study.

As for the variable size of the Sharia Supervisory Board (SSB), it is clear that the average number of members is estimated at about 4 members, which facilitates the work of the Sharia Supervisory Board. It is not a small number that makes it difficult for them to audit all of the bank's activities from a Sharia perspective. It is not a large number, which may lead to difficulty in understanding and coordinating the members of the Sharia Supervisory Board.

Table 3: of statistical data for study variables

Variable	lowest value	Greatest value	Average	standard deviation
ROA	0.4	0.8	0.57	1.069
BCM	2	8	4.62	2.386
CBD	4	10	7.12	2.295
OCN	0.17	0.36	0.26	0.072
SSB	2.5	5.5	4.25	0.123
SZE	4.53	8.59	6.18	1.331

Preparing the researcher using the program (Eviews)

Table No. (3) shows the results of estimating the correlation function between the return on total assets, which expresses the financial performance of the Islamic banks under study, and corporate governance variables, where the least squares method was used, through cross-sectional data (data panel), and the number of observations is 96, i.e. (8 years x 12 banks = 96 views)

Table 4: Estimating function coefficients

Dependent Variable: ROA ; Method: Least Squares ; Sample: 2015– 2022 ; observations: 96				
Variable	Coefficient	Std. Error	t-Statistic	Prob
C	0.763537	0.066693	11.44848	0.0075
BCM	0.025301	0.010760	2.351519	0.0430
CBD	0.348128	0.029398	11.84187	0.0071
OCN	- 7.614178	0.853048	- 8.925854	0.0123
SSB	0.279575	0.036588	7.641151	0.0167
SZE	- 0.112323	0.011096	- 10.12278	0.0096
R-squared	0.994828	Mean dependent var		0.575000
Adjusted R-squared	0.981897	S.D. dependent var		0.138873
S.E. of regression	0.018685	Akaike info criterion		- 5.008501
Sum squared resid	0.000698	Schwarz criterion		- 4.948920
Log likelihood	26.03400	F-statistic		76.93642
Durbin-Watson stat	2.238717	Prob(F-statistic)		0.012880

Preparing the researcher using the program (Eviews)

III.E. Discuss the results

The previous table shows the estimated coefficients of the model, the t-statistic value, the standard deviation, and the probability of error. The results show that the value of the coefficient of determination (R²) is estimated at (0.99). And that the independent variables have a statistically significant effect at a significance level of (5%), meaning that these variables have a strong relationship with the dependent variable (return on assets (ROA) at a rate of (99.48%), that there is a very strong relationship Between return on assets (ROA) and corporate governance variables.

The results also show that the Watson Durbin coefficient reached a statistical value of (2.49), which indicates the absence of an autocorrelation problem between the independent variables.

Also, the probability value (Prob (F-statistic) = 0.012880 < 0.05), that is, it is statistically significant, which means that the model used has statistical significance and is appropriate for the data used and the results obtained can be relied upon.

It is clear from the coefficients of the independent variables that there is a positive relationship between the return on assets and both the composition of the board of directors and the variable of the number of committees in the board, as well as the variable of the number of members of the Sharia Supervisory Board. Where the higher the size of the

variable; The return on assets increased, while it is clear that there is a negative relationship between the return on assets and the ownership concentration variable. That is, the higher the proportion of shares owned by major shareholders, the lower the return on total assets.

V. Conclusion and Findings

From the above results and analysis, it became clear that the importance of governance lies in its core objectives: achieving transparency and justice, ensuring accountability of company management, protecting shareholders, safeguarding employee interests, and limiting misuse of authority. These elements contribute to investment development, savings growth, and profit maximization.

The existence of an effective governance system capable of building trust and combating corruption in Islamic financial companies can enhance their success and operational expansion. This, however, depends on the internal support of governance-related departments, such as Compliance, Internal and Legal Audit, and Sharia Oversight both internally and externally.

The application of corporate governance principles in Islamic banks is critical, particularly in the accurate detailing of contracts, ensuring clarity from both legal and regulatory perspectives, and preventing fraud, ignorance, or deceit. Islamic banks will operate efficiently when their managers achieve two key goals simultaneously: meeting shareholder and investor demands, and ensuring compliance with Islamic law.

- The applied study reached the following findings:
- There is a positive relationship between the financial performance of Islamic banks (return on assets) and the governance variable represented by the composition of the board of directors and the number of independent members.
- There is a positive relationship between the financial performance of Islamic banks (return on assets) and the number of committees in the board of directors.
- There is a positive relationship between the financial performance of Islamic banks (return on assets) and the number of members of the Sharia Supervisory Board.
- There is a negative relationship between the financial performance of Islamic banks (return on assets) and the ownership concentration variable (percentage of shares held by major shareholders).

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