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CORPORATE GOVERNANCE AND CREDIT RATING: EVIDENCE OF SHARIAH GOVERNANCE FROM PAKISTAN ISLAMIC BANKS

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ABSTRACT

Shariah Governance in Islamic banks is the most essential characteristics which differentiates Islamic banking from conventional banking. The study objective is to confirm that not only corporate governance attributes but Shariah board attributes also affect credit rating in Islamic banks. The study collects the data for the period 2013-2017 of Pakistan Islamic banks and develops the three different models. This study used Long term credit rating scale used by Ashbaugh-Skaife, Collins, and LaFond (2006). The study used ordered logit Model which results shows long term credit rating is associated with governance attributes and Shariah board attributes. The study concluded that Credit rating agencies in Pakistan i.e. PACRA and JC-VIS and other International Credit rating must give weightage to Shariah governance attributes in the evaluation of credit rating procedure.

Disciplinary: Multidisciplinary (Business Administration, Statistics, Financial Sciences).

1. INTRODUCTION

The idea of profit and loss sharing in Islamic financial institution discriminates it from conventional financial institutions on the basis of activities and funding structure. Islamic bank operations are affected by a variety of operational risks (Abdullah et al.2011; Radzi & Lonik, 2016). Two credit rating agencies PACRA and JC-VIS are evaluating the creditability of Pakistani Islamic banks. JC-VIS has the same credit rating methodology for all commercial banks without any discrimination of Islamic and conventional Banks (Jcr-vis's, 2018b). Three factors, operating environment, standalone profile, and external support are considered in the credit rating evaluation.

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The 50% of weight of credit rating consists of quantitative factors including Capitalization, Liquidity of the assets, Stability of earning and Quality of the assets. The 30% of weight is given to evaluation and bank's access to the market. It is determined by the profile of depositors, depositor's concentration, and availability of funds from different sources that are diverse and the market share of the firm. Remaining 20% weight is given to qualitative factors including the profile of management, the ability of risk management, delivery channels and technologies available to the bank (Jcr-vis's, 2018a). PACRA has no changed rating methodology for Islamic and conventional commercial banks (Pacra, 2018). Islamic banking can be discriminated on the basis of Shariah. Islamic banks' commitment towards Shariah Compliance varies despite all are shariah based (Radzi & Lonik 2016). The purpose of a Shariah board is to confirm that all activities conducted in Islamic banks are according to Shariah compliance (Howladar, 2015). So ideally, the credit rating companies must consider the Shariah governance attributes for credit rating (Grassa, 2016).

This study purpose to investigate the Board structure and credit rating relationship of Islamic banks in Pakistan. This is the first study that investigates the complete board structure i.e. board attributes and effects of Shariah board attributes on corporate credit rating. The study will suggest how credit evaluation agencies might change or improve their processes or methodologies with aspect of Shariah board characteristics. It might be convenient for investors to measure the level of shariah compliance of Islamic banks if Shariah governance attributes become component of credit rating. So, high Shariah compliance will give confidence to investors and these results the bank can access low cost sources of funds.

This study contribution includes the enhancement of literature on credit rating and Shariah board characteristics. .Firstly, the other studies do not find literature evidence conducted on Shariah Board characteristics and credit rating in Islamic banks of Pakistan. Hence, the uniqueness of this study is that this is the first study investigating the relationship between Shariah board attributes and credit rating in Pakistan. Secondly, the study extends the literature on Board structure and credit rating. In literature the studies on governance of Islamic institutions focus on shareholder's perspective (Grassa and Matoussi, 2014). Thirdly, this study contributes effectively as it suggests to credit rating agencies how they might improve the credit rating methodologies for Islamic banks.

2. LITURATURE REVIEW

Ashbaugh-Skaife et al. (2006) compared the performance of the firms having strong and weak governance systems. The data gathered from 894 firms of the USA for the period of 2002-2003 was included in the study. This study explored that presence of high percentage of block holders, Board independence and Powerful CEOs are obstacles in the attainment of high credit rating. Alali, Anandarajan, and Jiang (2012) examined how corporate governance attributes and credit rating are associated. 2628 firm's data was collected for two years, 2002 and 2003. The study applied Logistic regression and results showed that the firms which have strong corporate governance enjoyed the high credit ratings and this relationship is emphasized for smaller firms as compared to larger firms. The study concluded that the higher level of bond ratings were related to higher corporate governance attributes.

Tarigan and Fitriany (2017) analyzed the 168 Indonesian firms' 2009-2013 data. The study determined the corporate structure through independent commissioners Board size and number of commissioners. The study used number of block holders and institutional ownership proxy of ownership structure. It is found that board size is key governance attributes enhances the credit rating. Further concluded that performance can be enhanced by increasing board size at a specific level. If the board size exceeds the optimum level then it adversely affects firm performance. Hamdan (2018) examined the linkage between interlock, foreign ownership, and firm performance. The data was collected from 131 firms of 20 different sectors of Saudi Arabia for the year 2016. The study applied the regression analysis and supported the business hypothesis which states that the increase in interlock of the director reduces the effectiveness. The study concluded that high interlock negatively affect the performance but when foreign ownership is used as moderator, then interlock of board positively affect the performance at a certain level.

Dzingai and Fakoya (2017) investigated the South African companies' board attributes characteristics including Board size, Board independence, and performance (ROE). The data was accessed from the annual reports for the period of 2010 to 2015. The regression results showed that association of ROE with level of independence in the board was weakly positive and negative with board size. The study found sale growth is weakly positively associated with ROE but Firm size has weakly negatively associated with firm Size. The study summarized that South African firms can maximize stockholder wealth by increasing independence and shrinking the board size. Kılıç and Kuzey (2016) studied 149 Non-financial companies from 2008 to 2012 to explore the firm performance and gender diversity relationship. Females in the board proxy used for Gender diversity and dependent variables were accounting-based measures including ROE, ROA, and ROS of firm performance. Females in the boards were further categorized into three forms. The study applied two-stage least square and concluded that Turkey is a non-financial industry characterized by male dominance and directorship but gender diversity is essential attribute in the improvement firm performance.

Qian (2016) explained the ratio of females (in Asian countries) in the board increased to 9.3% in 2013 as compared to in 2012 when it was only 7.5%. The study found out that the organizations with two women on board have high performance and the presence of female in the board positively affects the corporate firm performance. Bremholm (2015) investigated 250 firms from Tokyo stock exchange and concluded that the existence of foreign directors and ownership was positively associated with firm performance.

2.1 THEORY AND HYPOTHESIS DEVELOPMENT

The stakeholder theory explains the higher Size board may enhance probability of representation of stakeholders and dominance of one stakeholder may reduce (Ghayad, 2008). However the study can find diversified results in literature. Al-Saidi and Al-Shammari (2013); Kalsie & Shrivastav, 2016) and Adusei (2011) concluded that BOD’s size enhances firm productivity. While Yasser, Mamun, and Rodrigs (2017), Guest (2009) and Bukair & Abdul Rahman (2015) concluded that BOD’s size and firm performance are negatively associated. Orozco et al. (2018) concluded that board size nit significantly affects the financial and reputational performance. The main causes of large board size are delay in decision making and poor communication which leads to low firm performance (Guest, 2009). However, presence of large Shariah scholars in the board enhances the capabilities in terms of scholars having different skills, Knowledge and different schools of fiqah. These capabilities of shariah board make the board productive in sense of better interpretation of products and operations.(Hamza, 2013).

So we expect that large board size in Pakistani context is not efficient because the companies are owned by Families and the board members are usually their relatives or close family friends (Ineffective boards). The large board leads to increased communication problems and delay in decision making. So the large board negatively affects the credit rating due to the increase in cost and delay in decision making. Large Shariah board will provide a better explanation of products and operations and result of this will be high performance.

H$_1$: The presence of large numbers of directors (BSZIE) on board negatively affects the credit rating of Islamic banks.

H$_2$: The presence of large numbers of scholars in the Shariah board (SBSZIE) positively affects the credit rating of Islamic banks.

There are 253 positions of Shariah board held by only top 10 Shariah scholars which means the top ten Shariah scholars held 25.3 positions each (Unal & Ley, 2009). We suggest that Shariah scholars interlock enhances the expertise and knowledge which promotes the high innovation and development of new services and products in Islamic financial industry. Hence, the monitoring system is improved with the induction or existence of experienced and knowledgeable Shariah scholars, which may result in high Shariah compliance and there will be decrease in default risk.

H$_3$: There is positive association between the Shariah board interlock (SBI) and Islamic banking credit rating.

The Shariah scholars evaluate or develop Islamic financial products, therefore they must have good knowledge of economics, accounting, and finance (Levy & Rezgui, 2012). In this way, we suggest that Shariah scholars must have good accounting and finance knowledge so that they might be able to analyses the financial issues in-depth and provides valuable opinions or solutions according to Shariah. In this way the Islamic bank can get high compliance with Shariah and default risk can be reduced.

H$_4$: The percentage of the presence of Shariah scholars having good accounting and finance knowledge (SBAKF) positively associate with Islamic bank's credit ratings.

Bremholm (2015) supported the presence of foreign director improve firm performance. The independent foreign director on the board increases the expertise of the board and the monitoring of functions in management can also be enhanced (Mi et al. 2012). The theory of diversity argues that diversified firms are innovative and competitive but they face managerial issues. So we suggest that if the Shariah board member should have geographical diversity then competitive advantage can be gained because scholars of different geographical areas can have their own different expertise. The result of high expertise, innovative Shariah experts and high monitoring over management leads to high business growth and low-risk default.

H$_5$: The number of foreign members on the board of directors (FDIR) positively affects the Islamic bank credit rating in Pakistan.

H$_6$: The number of foreign members in the Shariah board (SBFM) positively affects the Islamic bank credit rating in Pakistan.

The male directors in the Asia Pacific regions have background knowledge of science and female directors have Law and accounting-based educational knowledge (Yi, 2011). The study set up mixture of findings in the literature. Alvarado et al. (2011) concluded gender diversity not associated with firm profitability. So we expect that due to more accounting background knowledge enhance the credit rating due to improvement of monitoring over agents (Management).

H$_7$: The presence of women in the board of directors (WB) positively affects the credit rating of Islamic banks.

Wang et al. (2015) confirmed that INED, s in the board is one of the keys determine of firm's success. Only few studies addressed the issue of INED, s importance and its effect on credit rating with reference to Islamic financial institutions. The highly independent board enhances the firm credit rating. (Grassa, 2016). The study expects the presence of more INED,s in the board will improve the process of monitoring over management which results in no misallocation of funds or no frauds and firm default risk can be decreased.

H$_8$: The high number of INED, s (BIND) in the board of Islamic banks is positively associated with credit rating.

The Shariah compliance monitoring can be achieved through the supervisory board, Shariah committee, and Advisory board, etc. The monitoring purpose of Shariah compliance can be achieved more efficiently and effectively through Shariah supervisory board because the Shariah advisory board and Shariah committee role is limited to advise and suggestions respectively. So the management may reject the suggestions or advises of the committee or board (Grassa & Matoussi, 2014). Further,there is a negative association found between the credit rating of Islamic banks and Shariah supervisory role (Grassa, 2016).

So we expect that the maximum Shariah compliance can be achieved by the supervisory board because the monitoring on Islamic bank management (in Shariah's perspective) can be increased.

H$_9$: The presences of the supervisory Shariah board (SBSA) positively associate with credit rating of Islamic banks.

3. METHOD

3.1 SAMPLE

The study sample size consists of all the banks which are purely Islamic banks and operating Islamic windows. There are 21 banks providing Islamic bank services in Pakistan among which 5 are purely Islamic banks and 16 are Islamic windows operating banks (Bulletin 2018). The initial sample size is composed of all the Islamic banks operating in Pakistan (21Banks). 5 of banks could not qualify for our sample due to established or commenced after 2013. Further 2 banks are also not part of our sample due to unavailability of desired variable data for study from them. So our final sample consists of 13 Islamic banks for the period of 2013-2017.

3.2 DEPENDENT VARIABLE

The study's dependent variable is Credit rating. The study focuses both short term and long term credit rating issued by the PACRA and JC-VIS. The long term credit rating is measured in the ordinal scale used by the Ashbaugh-Skaife et al. (2006). The data of credit rating is collected from the credit rating agencies' reports. Table 1 presents the credit rating scale.

Table 1: Credit rating Classifications (Long Term)

Debt rating	Rating	Score Grade
Aaa	7	Inv*
Aa+	6	Inv
Aa	6	Inv.
Aa-	6	Inv
A+	5	Inv
A	5	Inv
A-	5	Inv
Baa+	4	Inv
Baa(BBB)	4	Inv
Baa-	4	Inv
Ba+	3	Spec**
Ba (BB)	3	Spec
Ba-	3	Spec
B+	2	Spec
B	2	Spec
B-	2	Spec
Caa+	1	Spec
Caa(CCC)	1	Spec
C	1	Spec

Inv*= Investment, Spec**= Speculative

3.3 INDEPENDENT VARIABLE

The study takes both board and Shariah board attributes in Board Structure as an independent variable. The description of these variables is given in Table 2.

Table 2: Board structure variables (Description)

Board Attributes	
Board size (BSIZE)	Number of directors in the board
Board Independence(BIND)	Independent director's percentage in the board of directors
Foreign director (FDIR	Foreign director's percentage in the board
Women directors(WB)	Women director Percentage in the board
Shariah Board Attributes	
Shariah Board Size (SBI)	Number of the scholars in the Shariah board
Shariah Board Interlock (SBI)	Percentage of the scholars in the Shariah board providing their services of various Islamic Financial institutions (Minimum 5 institution)
Shariah board Members AFK (SBAKF)	Percentage of scholars sitting on the Shariah board with Accounting/Finance Knowledge
Shariah Board Supervisory/Advisory (SBSA)	Dummy variable=1, if the Shariah board has a supervisory role, other wise 0

3.4 REGRESSIONAL MODELS

In the study, the three Long term Credit Rating (LCR) regression models are

$$LCR1 = \beta_{01} + \beta_{11}BSIZE + \beta_{21}BIND + \beta_{31}FDIR + \beta_{41}WB + \epsilon \quad (1)$$

$$LCR2 = \beta_{02} + \beta_{12}SBSIZE + \beta_{22}SBI + \beta_{23}SBAKF + \beta_{24}SBSA + \beta_{25}SBFM + \epsilon \quad (2)$$

$$LCR3 = \beta_{03} + \beta_{13}BSIZE + \beta_{23}BIND + \beta_{33}FDIR + \beta_{43}WB + \beta_{55}SBSIZE + \beta_{63}SBI + \beta_{73}SBAKF + \beta_{83}SBSA + \beta_{93}SBFM + \epsilon \quad (3)$$

The terms β_{ij} are the regression coefficients.

4. RESULT AND DISCUSSION

Table 3 explains the descriptive statistics of Board structure, Shariah board Structure, and Credit ratings. The average number of directors sitting on the board is 8 (Median). The board independence is 32% (Median=33%). The level of foreign board members on the board is 17% and women on the board are only 2.81 (mean).The average size of the Shariah board is 3 (Median) and the number of Shariah board members sitting at more than 5 positions is 43.33% (Mean). There are 50% members of board of directors have who finance knowledge. The average of long term credit rating 6 (Median) is less than the average of short term credit rating 7 (Median).

Table 3: Descriptive Statistics.

Governance attributes	Mean	Median	Mode	SD	Range	Min	Max
Board size	8.6	8	7	1.55	6	6	12
Board independence	31.7%	33.33 %	25 %	12.29 %	71.43 %	0 %	71.43 %
Foreign Board Director	17.3 %	0 %	0 %	23.5%	66.7 %	0 %	66.67 %
women in board	1.81 %	0 %	0 %	4.40 %	14%	0 %	14.2%
Shariah Board size	2.3	3	3	1.04	3	1	4
Shariah board interlock	43.3 %	33.33 %	33 %	34.46 %	100 %	0 %	100 %
Shariah Board AFC	51.03 %	50 %	100 %	39.16 %	100 %	0 %	100 %
Shariah Board Foreign Member	4.23 %	0 %	0 %	11.89 %	50 %	0 %	50 %
Shariah board Super / advisory	0.1	0	0	0.36	1	0	1
Short term credit rating	6.7	7	7	0.58	2	5	7
Long Term credit rating	6.1	6	6	0.64	2	5	7

Table 4: Correlation Matrixes.

Variables	Board size	Board index	Foreign Board Dir	women in board	Shariah Board size	Shariah board interlock	Shariah Board AFC	Shariah Board Foreign member	Sariah board Super/ advis	Long term credit rating
Board size	1									
Board independence	-0.10	1								
Foreign Board Director	-0.04	-0.45	1							
women in board	-0.04	-0.08	0.38	1						
Shariah Board size	0.130	0.034	0.309	0.245	1					
Shariah Board Interlock	0.329	-0.23	0.183	0.132	0.336	1				
Shariah Board AFC	-0.16	0.215	-0.16	0.302	0.266	0.079	1			
Shariah Board Foreign member	0.329	-0.27	0.530	0.569	0.446	0.451	-0.02	1		
Shariah board super/advisory	0.227	-0.12	0.480	0.165	0.350	0.332	0.116	0.570	1	
Long term CR	-0.26	0.037	-0.09	0.387	-0.03	0.139	0.099	0.093	-0.407	1

Table 5: Logistic Regression results (Long term credit rating =Dependent) The Effect of Corporate Governance and Shariah governance attributes on Islamic banking Long term credit rating.

Coefficients (Estimated) & Z score (P values)						
Board Attributes	***Model 1***	P value	***Model 2***	P value	***Model 3***	P value
Board size	**-.477***	0.01			**-0.828***	<0.01
Board independence	-.020	0.44			.011	0.72
Foreign Board Director	**- .036***	0.01			-.023	0.27
women in board	**.341***	0.00			**0.362****	0.03
Shariah Board Attributes						
Shariah Board size			-.247	0.43	-.023	0.95
Shariah Board Interlock			.0138	0.12	**.026***	0.01
Shariah Board AFC			**.012*****	0.10	.000	0.94
Shariah Board Foreign Member			**.140***	0.01	**.123****	0.04
Shariah board supervisory			**-6.75***	0.00	**-6.772***	<0.01

*** Significant at 10%,** significant at 5 % and * significant at 1 %

Table 4 shows the correlation between the variables and found no multicollinearity. In Table 5, Model 1 explains the Board size and foreign board director are significantly negatively affecting the long term credit rating. The association of Women members on the board is positive towards Long term credit rating. The large board size leads to delay in decision making and women's presence can improve the monitoring system. Model 2 explains the Shariah board attributes' relationship with Long term credit rating. Shariah board's accounting and finance knowledge and Shariah board's foreign members positively affect the credit rating in a significant way. Both results enhance the Shariah board quality which results in high Shariah compliance and Long term credit rating goes high. The presence of accounting and finance knowledge-based Shariah scholars enhances the monitoring power of Shariah board. As the foreign members of Shariah board have experience of international organizations, so international exposure can improve quality of Islamic banking products and monitoring which results in high long term credit rating. While the Supervisory Shariah board negatively affect the credit rating. Model 3 explains that board size is significantly negative but women membership of board causes significantly positive effects on the long term credit rating. The Shariah board interlock and Shariah board foreign members are positively associated with Long term credit rating but supervisory Shariah board negatively affects the Long term credit rating. The presence of those Shariah scholars sitting at more than 5 other Islamic financial institutions can enhance the monitoring because they are high reputed scholars due to their work. Appointment of high reputed Shariah Scholars gains the confidence of investors which results in pools of funds available for Islamic banks at low cost.

5. CONCLUSION

From the last two decades, Pakistan has introduced and developed the Islamic banks or Islamic windows operating side by side with the Conventional Banks. So, this study explains the issue of Islamic bank governance which is valuable and important for government, international organizations, Islamic financial scholars, institutes, and customers. Especially, Shariah governance effect on credit rating which has not been discussed earlier in Pakistani context provides new analysis for Sukuk perspective.

The study applied the methodology used by Ashbaugh-Skaife et al. (2006) and Grassa (2016) to find out that the Islamic banks supported by strong corporate governance get the advantage of higher credit rating as compare to weak or poor governance Islamic banks in Pakistan. The study's contribution is to investigate the relationship of Shariah board attributes and credit rating. The study finds that Long term credit rating (a) is negatively associated with board size, (b) is negatively associated with number of foreign directors in the board, (c) is positively associated with the number of women in the board, (d) is positively associated with Shariah board interlock, Shariah board accounting and finance knowledge and Shariah board foreign members and (e) is negatively associated with Supervisory Shariah board. The study recommended that Credit rating agencies i.e PACRA and JC-VIS must give weightage to Shariah governance attributes in the evaluation of credit rating procedure. It might be convenient for investors to measure the level of shariah compliance of Islamic banks if Shariah governance attributes become component of credit rating. So, high Shariah compliance will give confidence to investors and these results the bank can access to low-cost sources of funds.

6. AVAILABILITY OF DATA AND MATERIAL

Data can be made available by contacting the corresponding authors. Further the data also available in annual reports of Islamic banks.

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