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Validating the Mediating Effects of Risk Governance on Islamic Banking Systems

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Abstract

The role financial institutions sector in economic activities with higher capitalization ratio have the impact to alleviate credit and market risks including measuring in loan-to-deposit ratio. Good risk governance cannot be denied when the failure of financial systems does not exempt the Islamic financial institutions. Some of the recent examples for the collapses of Ihlas Finance House of Turkey, the Islamic Bank of Africa, Dubai Islamic Bank and Investment Companies of Egypt. The failure of financial market in OECD countries demonstrate Islamic banks are not much different from conventional banks. Another issues raised in this paper is the financial crisis which reveals risk-related issues resulted from mismanagement of risk at organizational level including various stakeholders. The aim of this paper is to investigate the significant roles of risk governance as the mediating variables between the risk management initiatives and the banks corporate performance. Early empirical study define risk management as a process which managers capabilities identifying and mitigate risk. There are vast reason of explaining the necesity of governance to avoid risk-related failure of financial marketis due to systems complexity and high risk exposures. The risk governance concept is founded from the agency theory, stakeholder-based governance theory, and delegated monitoring theory. The stakeholder based governance present the ideas whereby banks need to provide multiple benefits relationship include customer, supplier, distributors and employees. This research explores the secondary data relevant to analyze the risk governance effects of the 50 international Islamic banks between the periods of 2008-2013. The necessary statistical testing was applied for hypothesis testing and the model construct validation. The expected outcome from the analysis is to tightened the contruct to ensure level of capital is sufficient, minimizing moral hazard and prompt corrective action framework by incorporating the elements of corporate governance.

Keywords: Financial Risk Management; Corporate Governance; Risk Governance; Islamic Banking.

1. Introduction

The need for effective risk governance cannot be denied, in reference to the cases of the collapsed of several Islamic financial institutions as the Ihlas Finance House of Turkey, the Islamic Bank of Africa and Investment Companies of Egypt (Ali, 2007). Nevertheless, the nature of the causes and consequences of the failure of financial market in OECD countries demonstrated that Islamic banks are different from conventional banks.The recent case of major bank failure is the Fannie Mae, Freddic Mac, Lehman Brothers in mid September 2009 (Flannery, 2009).

The Islamic financial market has been phenomenal in some parts of the world. Economic growth in Gulf Cooperation Council (GCC) and Malaysia has shown a remarkable in market conditions especially on the aspect of monetary growth. Sound economic growth aligned with progressive government projects has not only able to maintain but to sustain the GCC and Malaysia financial sectors. For the GCC, high oil price, large fiscal and trade surpluses, and government vast financial reserves have allowed this region's states to maintain stable economic growth of their gross domestic productivity (GDP). The studies by Matoussi and Grassa, (2012) confirm that, banking industry in GCC is closely linked to oil export as this commodity has been pivotal since1940s.Oil revenues were the main driver behind GCC economic growth. In supporting the fact, in 1970s there are numerous of foreign banks have expanding their operationsin the GCC countries. In this respect, the some of the pioneer Islamic banks developed in GCC were Kuwait Finance House (incorporated in 1977), Dubai Islamic Bank (established in 1975), Al-Rahji Bank (registered in 2006) and Bank Islam Malaysia Berhad (operating since 1983). Today, total population of GCC countries is around 49.8 million in 2013 as compare to 33.2 million in 2004 (IMF, 2014). Recent turbulance in GCC essentially by extenal economic environment such as financial crisis, food crisis and partly from domestic reforms.

Being the country with 60.4 % with Muslim population would essentially propel the Islamic banking in Malaysia to significant heights. According to World Bank (2014) Malaysia population increase 29.79 million in 2012 to 30.26 million in 2013.The growth of Malaysia economy could be divided into two phases. The first phase was when Malaysia economy was heavily rely on producing tin and rubber during 1970s, followed by a more diversified economy in 1990sby becoming the exporter of electronic and electrical components, palm oil and natural gas. Second phase is the post-Asian economic crisis during 2000-2010. In 2010, Malaysia launched New Economic Model (NEM), primarily driven by private sector with substantial support by the government projects. In fact, Malaysia currently is operating under The 10th Malaysian Plan which is covers the period of 2011-2014. Vision 2020 provides a solid platform for Malaysia to achieve country with high income and develop nation with significant support by private sector. In the context Malaysia, it started in response of the growing demand for Islamic banking from consumers during the financial crisis in 1987 when consumers faced an interest rate hike for their loan repayments. Study conducted by Haque (2010) has discussed first phase of development of Islamic bank in Malaysia started as soon as the establishment of Islam Malaysia Berhad (BIMB) in July 1983 and Bank Muamalat Malaysia Berhad (BMMB), was established on 1 October 1999 under the Islamic Banking Act 1983 when Bank Islam Malaysia Bhd managed to present Islamic financing as a model suitable both for Muslims and non-Muslims after the financial crisis in 1897. Malaysia established its High Level Finance on Corporate Governance in 1998, following on from the drastic downturn of the Malaysian economy in 1997. Malaysian Code of Risk Governance was announced by the Bank Negara Malaysia (Malaysia Central Bank) which became to be effective on 2012. The Code divided into three parts (i) overview and risk governance guidelines (ii) 13 principles of risk governance (iii) implementation policy (BNM, 2013).

2. Literature review

Financial Sector in Malaysia and GCC

One of the foremost objectives of the banking and other financial sector services are to promote monetary and financial stability conducive to the sustainable growth of a particular country's economy. Towards this end, the banks play a crucial role in the development of a progressive and inclusive financial sector which entails preserving the core foundations of financial stability at all times, ensuring effective and efficient financial intermediation, and contributing towards economic growth and development. The nation's economic condition can be fundamentally observed through the Gross Domestic Productivity (GDP) and the size of the monetary supply within the economy activities. Table 1.1 and Table 1.2 illustrates that a steady GDP growth and money supply is expected to continue to increase in year 2015 as activity in the financial services, tourism and construction sectors expected to increase with countries development plan (NBK Economic Research, 2014).

Table 1: Real GDP growth (annual %)[1]

Year	Malaysia	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UEA
2009	-1.5	2.5	-7.1	3.9	12.0	1.8	-4.8
2010	7.4	4.3	-2.4	5.0	16.7	7.4	1.7
2011	5.1	2.1	10.2	4.0	13.0	8.6	3.9
2012	5.6	3.4	8.3	6.0	6.2	5.1	4.4
2013	4.7	3.9	0.3	4.4	6.1	3.0	4.7
2014[e]	5.2	2.8	-0.6	3.6	5.8	3.3	2.4
2015[e]	5.0	2.6	3.1	4.2	6.6	3.7	3.7

Table 2: Money Supply growth (annual %)

Year	Malaysia	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UEA
2006	13.6	14.9	21.7	24.6	39.6	20.4	23.2
2007	7.9	39.3	19.1	37.4	39.5	20.1	41.7
2008	10.5	19.7	15.8	23.3	19.7	18.0	19.2
2009	7.7	5.8	13.4	4.7	16.9	10.8	9.8
2010	7.3	10.5	3.0	11.3	23.1	5.2	6.2
2011	14.6	3.4	8.2	12.2	17.1	13.3	5.0
2012	8.8	4.1	6.5	10.7	22.9	16.5	4.4

Meanwhile, the scenario shown in Table 1.3 shows that financial indicator for GCC and Malaysia. A trends in domestic credit provided by financial sector is slightly higher for Malaysia especially after 2007, however the credit quality remains weak for Saudi Arabia. This means Saudi Arabia has recovered from the global crisis due to stagnancy in saving deposit and high deficit of implementing mega development project of the Grand Mosque (Hassan and Ahmed, 2012). These figure indicate the size of domestic public investment made by each government to stimulate economic activities.

Table 3: Domestic Credit Provided by Financial Sector (% of GDP)

Year	Malaysia	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UEA
2006	114.6	40.3	62.4	27.8	41.7	21.3	49.0
2007	109.4	48.0	68.8	32.7	50.7	16.1	60.2
2008	110.8	57.8	65.3	29.0	51.6	-3.7	73.0
2009	131.1	71.2	86.8	40.1	76.1	0.5	103.5
2010	127.0	67.1	68.4	37.1	71.6	-0.1	95.6
2011	128.2	71.6	55.0	33.1	71.5	-4.1	84.1
2012	134.0	73.1	47.9	35.3	78.6	-10.2	76.5

It is proven that countries that experienced large lending activities typically also experienced increase in macroeconomics vulnerabilities besides high risk in financial sector. A related issue is how Islamic banks strike the balance between multitude attributes including depositors, shareholders, bondholder, creditor, group or legal entity. However, relevant and critical efforts are required to create right liquid assets available. The two main drivers of the efforts are the corporate governance and risk management (support this with references please). Risk governance can be defined as the ways in which directors will be responsible to optimize and monitor risk in the organization. Most of the environment demanded corporate governance to apply proper strategy in order to mitigate risk of the banks. It is done by boards responds in timely manner besides required efficient reporting

[1]Source: MENA Economic Outlook (January 2014) ;The World Bank
Note: e = estimate

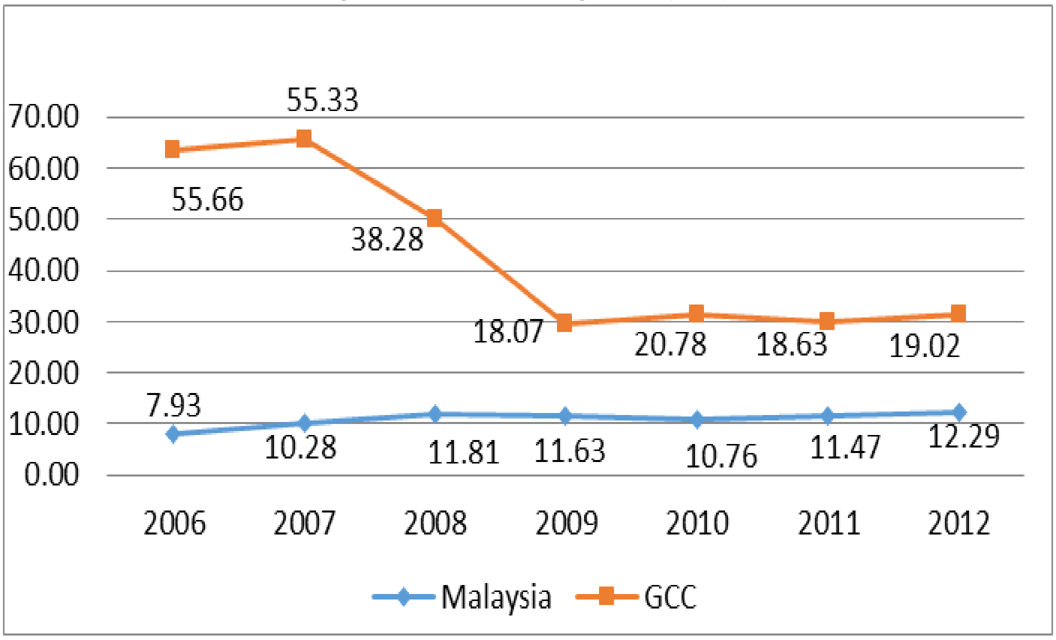
systems. Although Islamic bank in GCC countries is quite remarkable in terms of its growth, however, after global financial crisis and European debt crisis, Islamic banks signaling alarming condition of its profits since these countries badly affect by regional crisis. Hence, there is an issue in managerial expectation on risk governance and bank performance.

a) Low and declining trends of Islamic Banking Performance

1 The return on average assets (ROA) is commonly used in measuring profits against the assets mobilised by a bank for generating profits. The ratio is an important indicator of the intensity of assets of a company. A lower ROA ratio reflects a higher asset-intensity of the company, and vice versa. Besides, a more asset-intensive bank requires a larger amount of money to continue producing revenue. Meanwhile, return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. It reveals how much profit a bank earned in comparison to the total amount of shareholder equity found on the balance sheet. ROE is one of the most important financial ratios and profitability metrics. It is often said to be the ultimate ratio or the 'mother of all ratios' that can be obtained from a bank's financial statement.

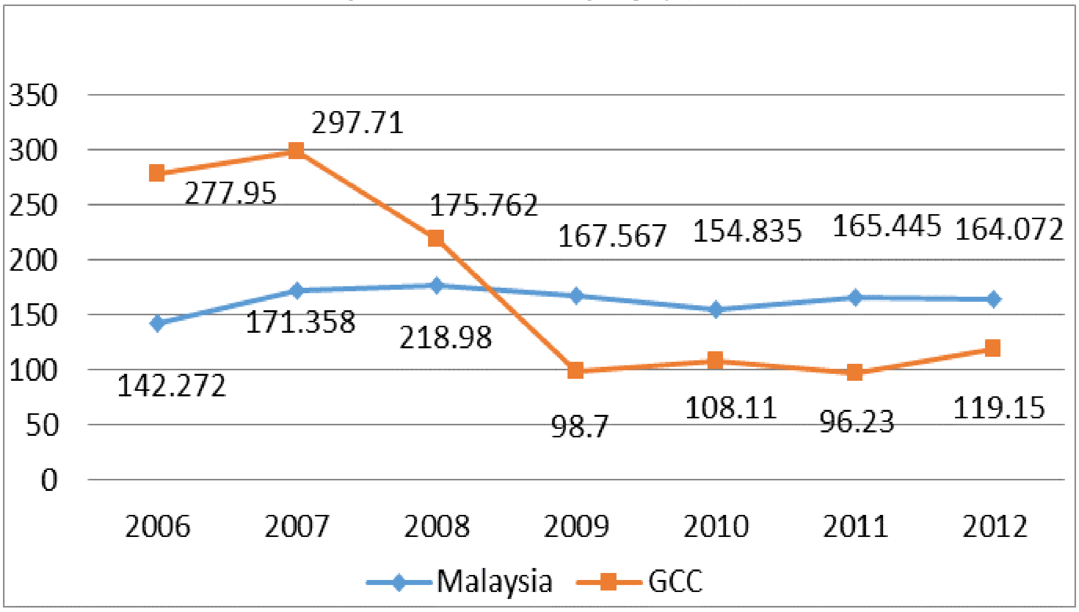
Figure 1 and Figure 2. reveals the performance of Islamic banks in Malaysia and GCC. These figure shows that both return on average assets and return on average equity experience decline capacity during global financial crisis between 2008-2009. Definitely, most of Islamic bank demonstrate inabilty to generate income due to unfavorable economic condition. The difference of ROA is used an indicator to measures bank efficiency, whereas ROE reflect bank leverage. ROA and ROE is a concern primarily for bank otherwise bank cannot run their business at a sufficient return on equity if they hold to much equity capital. Holding large amount of debt capital is not the solution because debt does not absorb losses and can introduce more risk into the equation. The long term survival of banks is to maintain high amount of equity capital complement with prudent risk management.

Figure 1: Return on Average Asset (ROA)[2]



[2]Sources: Bankscope, author analysis of selective banks

Figure 2: Return on Average Equity (ROE)[3]



There were many reseachers believes that credit risk affect bank performances.It is proven that the failure of banks monitoring loan growth activities and directly involved with asset-backed securities and derivative product causes by credit risk (Lepetit, 2012). This is because credit risk causes by human behaviour; that is people make decision. The decisions that that they make are consequences of their incentives and incentives of the shareholders whom they represent. The existence of of credit risk and bank's lending activities occur once individual select any Islamic bank to invest in. Money deposited at banks generate credit risk if regulators frequently shut down banks, which can lead to losses for their clients. To understanding what motives are shareholders and managers is important aspect of a counterparty credit risk profile.

For this reason, credit risk is the principles cause bank failure. The technique Islamic banks mitigate risk are similar to those conventional banks. Virtually Islamic bank minimum standards set by Islamic Financial Services Board, IFSB (2013) principles of credit risk besides all Islamic bank instruments must in compliance with *Shariah.* The Islamic bank model has different asset and liability side. Liabilities side including saving and investment deposits (profit and loss). On the assets side banks use *murabaha, bai-muajjal, salam, ijara, musharaka and mudaraba.* The problem of asymmetric information problem when credit risk in any modes of financing (*murabaha, bai-muajjal, salam, ijara, musharaka and mudaraba)* may arise when counterparty defaulting in paying debts in full and in time. This leads to the following question: Does is the relationship between corporate governance, risk management and risk governance capture the bank performances? The empirical answer is not self-evidence. Interestingly, recent activities of regulators across the globe strengthen the financial system which leads to further reluctance to take on credit risk. Surprisingly, Figure 1.3 display total deposit received by customer followed by Figure 1.5 displays credit risk exposure in term of loaned money to the customer. Note that total deposit ratio and equity loan ratio. Total deposit ratio is slightly higher for GCC as compare to Malaysia Islamic banks. In Figure 1.4, we can see GCC bears the exposure to loaned money when it start to declined from year 2006 until year 2012. This of course is reasonable since GCC Islamic bank margins are low and regulatory capital requirements high.

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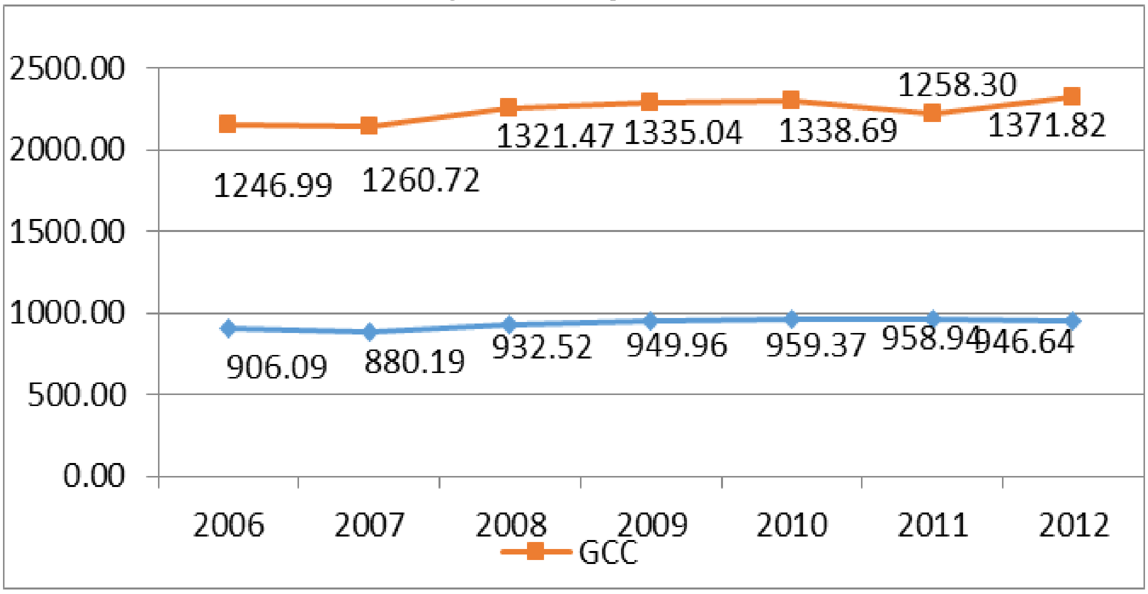
[3]Sources: Bankscope, author analysis of selective banks

Figure 3: Total Deposit Ratio[4]



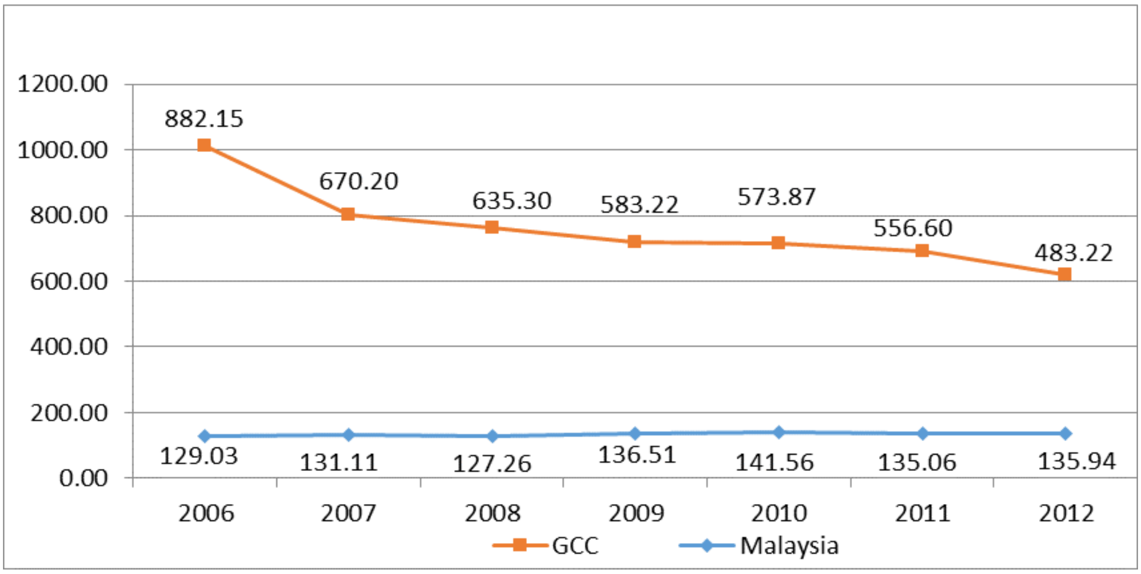


Figure 4: Equity Loan Ratio[5]

Figure 4 provide insights of equity loan ratio (liquidity ratio) which explain the ability for bank to repay its short-term liabilities by evaluating components of current assets and current liabilities. In the same manner, it illustrates a rapid decrease trend in equity loan ratio for GCC alongside flattening of equity loan ratio in the context of Malaysia.

[4] Sources: Bankscope, author analysis of selective banks
[5] Sources: Bankscope, author analysis of selective banks

b) Increasing Tends of Risk Governance on International and Conventional Financial Systems

Table 4: Risk Governance Key Milestone

Year	Risk Governance Key Milestone
September 2005	Important milestone events to the introduction of risk governance influences over the International Risk Governance Council (IRGC) in Geneva, Switzerland. This independent organization has developed:- (i) harmonize the concepts of risk governance, (ii) anticipating major risk issues, (iii) providing risk governance policy advice for key decision-makers, (iv) identifying 13 risk management factors affected the risk governance and (v) principles of 'good governance'.
February 2009	Ortwin Renn published his book "Risk Governance: Coping with Uncertainty in a Complex World", which provide additional insights of Risk Governance Framework. There are five consecutive phases proposed in Risk Governance Framework:- (i) pre-assessment (ii) appraisal (iii) characterization and evaluation (iv) management (v) communication
August 2011	Risk Governance Index being proposed by Sujatha Vaidun Vidyadhar and Martin Hovey effective on 28 August 2011.
November 2012	Central Bank of Malaysia launched Guidelines on Risk Governance effective on 23 November 2012.
March 2014	Risk Governance Framework at micro and macro level introduced by Alexander Cedergren and Henrik Tehler.

Table 4 highlighted risk governance milestone. In recent studies, Cedergren and Tehler (2014) developed risk governance framework at micro and macro level. They point out differences risk governance from positive and normative approaches. A Risk Governance Index (RGI) being introduce by Vidyadhar and Hovey (2011) capture the behaviour of board and its influences on company performances. Elements of this risk governance index, were assigned as (i) company's risk stance and risk appentite (ii) risk policies and procedures (iii) risk culture (iv) strategy in risk management (v) risk committee (vi) stress testing and scenario analysis (vii) training of directors (viii) risk reporting and disclosure (ix) chief risk officer (CROs).Therefore, our aim in this research is to further develop risk governance index. The existing risk goverance index failed to provides how score range translate into concern for each of these element. The important element that being develop does not properly fit for the risk governance under the landscape of Islamic banking. The key question for policymakers is how to develop mechanisms to avoid this risk. Such criticisms ultimately drove academics into introducing measures of this research will suggest an improvement in RGI.

Theoretical Foundation

In Islamic finance, agency theory takes into consideration the transparency to its investment holder. Bank shareholders act as principal and managers as an agent. Agent will exercise control over investment decision based on profit and loss of the bank (Iqbal, 2008). We infer that agency theory also exist in Islamic banking. Shamsuddin and Ismail (2013) acknowledges that Islamic agency *(wakalah)* relationship between agent manager *(mudarib)* and investor or borrower. Agency theory takes into action when principal is only concerned about profit or return whilst agent benefited from compensation. There is also empirical evidence that, agency theory in Islamic banking based on several fundamental of corporate governance (Hasan, 2012).

The literature reveals by Wilson (2009) identify that information asymmetric in Islamic banking preventing in its poduct such as *Mudarabah* and *Musharakah*. Selmier (2013) investigate the performance of financial institution focusing in China and East Asian. In this study, they justify that banking theory with information economics cannot be separated from political economy and development economics. This is because bank act as information besides capital intermediaries. Most of the time, bank gather information about consumers, industries, investors and etc. These information being passed through their action and some information have been disclose. This research specifies East Asian banking tended to focus more on SME lending while China banking model today deals with buyers, exporter, dealmakers in order to strength their economy through financial intermediaries.

The adoption of stakeholder based governance theory is a response to complexity and changes in agency theory. The origins of stakeholder's theory have been found by Adam Smith (Freeman, 1984). Thus, the diffusion literature provides Fontrodona and Sison (2006) emphasizes that bank not only have to offer just kind of good or services but also to distribute it fairly. As according to stakeholder-based governance theory, there are multiple relationships when it include customer, supplier, distributors and employees (Al-Shamali, Sharif & Irani, 2013). For instance, Iqbal and Mirakhor (2011) proposed assumptions holds of stakeholder-based governance theory (i) stakeholder have rights to participate in decision making process (ii) managers have fiduciary duty to serve the best interest of stakeholder (iii) objective of the firm must benefited all party not only shareholders.

The main ideas of stakeholder based governance theory are exposed theoretical concept in Islamic finance has been introduced by Iqbal and Mirakhor since 2004. The standard of stakeholder theory for Islamic model are different from Anglo-Saxon, European model, Japanese model, Latin model or even Confucion model while the aim of Islamic models is to maintain and promote principles social justice not just to shareholders but to the stakeholders.Confirming past research on these topics,Tse (2011) reviews some benefits and problems of stakeholder and shareholder after financial crisis. This paper identifies three advantages of stakeholder theory. First, it create fair value towards internal and external stakeholder. Second, good relationships linking stakeholder and management. Thirdly, the advantages issues related to improvement in decision making process.

Theoretically, Al-Shamali, Sharif and Irani (2013) study stakeholders-based governance theory in the setting of Middle East. The interview with five bank results shows that Islamic banks servicing multiple stakeholders inside and outside of the bank. The stakeholders exist among employees, clients, community, businesses and *Shariah* board. The problem then arises when theories and reality were inconsistent which fails to adopts flexibility. Bank supervisor communicate with bank employees in the practices of risk management. Shareholders have ability to involved with corporate governance process. Board responsible to develop strategic plan for bank to ensure bank profitability.

Risk Management and Bank Performance

Risk management in Islamic banks is not diffent from conventional bank. Islamic bank has to follow guidelines made by Financial Services Board (IFSB) in terms managing risk. These risks were included credit risk, market risk, liquidity risk, operational risk, foreign exchange risk, mismatch risks and interest rate risk (Karim & Archer, 2013). The goal of risk management is controlling risk when qualitative and quantitative assessment of risk exits. Proper financial risk management can increase value of bank and hence shareholder values. Buzzwords such as risk management must be oversight by bank professionals to ensure awareness of risks embedded in the balance sheets and off balance sheets of banks (Bessis, 2011).

Financial risk arise from changing market conditions involving prices, volatility and recession. Based on financial management theories, bank performance made up of various financial ratio. Financial ratio is a comparison between one financial institution to another. Common financial ratio used to assess Islamic banks performances are (i) profitability ratio (ii) liquidity ratio (iii) solvency ratio (iv) debt ratio (v) capital adequacy ratio and etc (Chen & Liao, 2011).

Risk management mechnanism of banks established in two categorized (i) internal risk management and (ii) external risk management (Crouhy, Galai & Mark, 2014). Internal risk management is about management process, structure and policy should comply with regulations and provide clear decision making and accountability. Internal risk management critical for senior management and boards of directors who responsible for carefully processes for identifying, assessing and managing risk. Internal risk management include bank specific variables (Pugliese, Minichilli & Zattoni, 2014). To evaluate internal risk management various measurement were used including credit risk, market risk, liquidity risk, operational risk. External risk management is about demand for disclosing internal risk management to the outsider. Investors, financial analysts, external stakeholders, suppliers,customers and regulators, demand for disclosing risk externally. They want better information on the various scope of financial risks to ensure they can better evaluate organization and make more informed decisions. External variables reflect environmental variables that are expected to affect financial institution profitability (Khediri, Charfeddine & Youssef, 2015). The most widely used approach in calculationg external risk management were; inflation rate, gross domestic product,taxes, deposit rate and central bank lending rate.

The literature done by Hassan and Kayed (2009) reveals that risk management in Islamic finance is sharing the risk between the borrower and lender with the fixed interest income. There are two process of risk management by *Shariah* point of view (i) negative S*hariah* screening and (ii) positive *Shariah* screening. Risk management from Islamic perspective prohibited any *gharar* transcation and does not involved with complex derivatives activities. Siddiqi (2009)document that risk management in Islamic framework should be risk sharing between fnanciers and producers, debt not traded, free from interest rate practices, funds raise through equity and business not allow too involved with high risky project.

Corporate Governance and Bank Performance

Obviously, Al-Jarhi (2006) states that in Islamic finance, good corporate governance allows depositors to have some influences in decision making process since banks and financial institutions received funds from these investors. The involvement of investor in decision making process reduces risks of failure besides promotes profits. Contrary, conventional banks give utmost attention to the speculative activities; such as gambling and highly risky investment project portfolio. Absent of interest, some author, McNeil et al., (2005)argue that risk management elements should be embedded in a corporate governance. There were cumulative of study support the implication of Corporate Governance (CG) on banks performance. Theoretically, corporate governance is divided into two perspectives which are external governance and internal governance. Both governances have greater and special attention to ensuring the stability of the banking system. Within the internal bank management such as management, board or director, employees, internal audit, remuneration committee, board independent play an important roles. Extenal governance consists of statutory and contractual provisions that determine the costs of active shareholderparticipation in the management process. At the same time as external corporate governance mechanism, represent by the regulation, regulator, external auditor, credit rating, and accounting standard.

In line with this, Dedu and Chitan (2013) study internal corporate govenance and bank performances for Romanian analyze with fixed effects model (FEM) and pooled least squares. In order to perform a valid test, data were collected from Bucharest Stock Exchange from 2004-2011. Result revealed that internal corporate governance (ICG) negatively influence banking performances (ROA, ROE, Z-score). Ideally, this research have introduce internal corporate governance index (ICGI). Highlighting, experienced managerial board (MB) improve bank performances (ROA, ROE).

In contrast Wasiuzzaman and Gunasegavan (2013) did a comparative study of the performance of Islamic and conventional banks in Malaysia, over the period of 2005-2009. The independent t-test and regression analysis was carried out to analyze the variables such as, board size, and board independence. . There is significant differences between the two bank types were found for all the variables, except for profitability and board independence. The results shows that all variables except for liquidity board characteristic and type of bank, were found to be highly significant in affecting banks profitability.

Risk Governance in Banking Sector

This study links the two strands of literature by investigating the influences risk governance and modern financial institutions were highlights in Scandizzo (2013). The key findings above mention, all stakeholder consist of shareholder, depositor, government, bondholder that will bear the risk, only shareholders earns profits. Therefore, the scholars believe it is important to determine the linkages of risk management and corporate governance interrelated. In fact, failure of financial institution severe real economy for consequences generation.

While according to Bassens, D., Derruder, Witlox,B.F. (2011) in their research, studied on 253 scholars in 212 Islamic Financial, suggest institutions to identify the role, power and specialties' of *Shariah* boards on Islamic financial services. They used interlocking directorates' methodology with the theory that inter-firm interlocks reflect actual flows within and between cities through the movements of *Shariah* board scholars. The internal variable that influence the study are the *Shariah* board memberships and movement of *Shariah* scholars. They found that, well connected Gulf cities and mainstay financial centres outside Middle East are networked by interlocking board memberships.

Indeed, some commentators argue that chief financial officer influences audit planning of 52 Swedish listed companies during the year 2003-2004, Hellman (2011) discovered that CFOs seek to influence audit planning, especially with regard to internal controls and the selection and scope of entities subject to audit. The method used was an interview question to analyze the variable is chief financial officer's influence.

Given the increased importance of risk governance Xue Wang's (2010) took the initiative for comprehensive research, increased disclosure requirements and corporate governance decisions with the evidence from chief financial officers (CFO) in the pre (1998-2001) and post (2002-2005) Sarbanas-Oxley Periods. These results show that CFOs of firms with strong internal controls receive higher compensation and do not experience significant changes in forced turnover rates. While, CFOs with weaker internal controls receive lower compensation and experience higher forced turnover rates after the passage of Sarbanas-Oxley Act (SOX). The analytical framework used in this study is based on the difference-in difference research design revealed compensation variables such as salary, bonus and total compensation. The actual impact of control variables was measured by regressing stock market returns, firm size, age and tenure of executive officers. He also measured the executive turnover variable.

Research Framework

This study is an effort to identify the factors that currently affect Islamic banks performance. Proposed conceptual framework for this study details in Figure 1.5. The dependent variables of banks performance is influenced by the two independent variables; risk management and corporate governance. The two independent variables are also interrelated as explained trough risk governance.

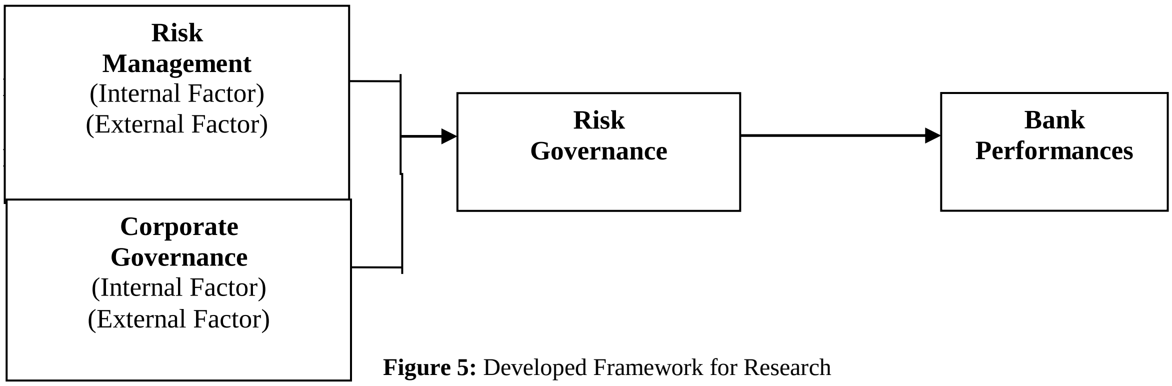


Figure 5: Developed Framework for Research

In this research, we formulate the risk management model to examine the relationship between the Islamic banks performance using the set of internal and external banking characteristics. Internal risk management is evaluated by analyzing financial ratios which formed as credit risk, operational risk and liquidity risk. While external risk management are best measure by GPD growth rate, central bank lending rate and inflation rate. An important indicator in comparing corporate governance and Islamic bank performances would be address in the relevant internal and external corporate governance. The relevant internal corporate governance describes as total number of CEO meeting, board size and total number of internal audit meeting. In regards to external corporate governance variables which include investigating external audit meeting, accounting standard and number of credit rating.

3. Methodology

In this study, Bankscope database and annual report will be the source for quantitative data collection. Bankscope database was chosen to minimize the bias arising from accounting practice and accounting standard. There are 36 financial ratios available in Bankscope which can be compared across banks and countries (Pasiouras, Tanna & Zopounidis, 2005). We conduct our balance panel data analysis on a micro data set of established and emerging Islamic banks: Malaysia and GCC countries. Information of bank financial statement and annual report is gathering from Bank-scope over 28 banks for the period 2006-2012.

Table 5: List of Islamic Banks Included

No	List of Bank	Country
1	Bank Islam Malaysia Berhad	Malaysia
2	Bank Muamalat Malaysia Berhad	Malaysia
3	Maybank Islamic Berhad	Malaysia
4	Hong Leong Islamic Bank Berhad	Malaysia
5	Public Islamic Bank Berhad	Malaysia
6	RHB Islamic Bank Berhad	Malaysia
7	Affin Islamic Bank Berhad	Malaysia
8	AmIslamic Bank Berhad	Malaysia
9	Alliance Islamic Bank Berhad	Malaysia
10	HSBC Amanah Malaysia Berhad	Malaysia
11	CIMB Islamic Bank Berhad	Malaysia
12	ABC Islamic Bank	Bahrain
13	Bahrain Islamic Bank	Bahrain
14	Al-Baraka Islamic Bank	Bahrain
15	Shamil Bank of Bahrain	Bahrain
16	Kuwait Finance House	Kuwait
17	Boubyan Bank	Kuwait
18	International Bank of Kuwait	Kuwait
19	Al Rajhi Bank	Saudi Arabia
20	Bank Al-Jazira	Saudi Arabia
21	Bank Al-Bilad	Saudi Arabia
22	Islamic Development Bank	Saudi Arabia
23	Bank Dhofar	Oman
24	Qatar Islamic Bank	Qatar
25	Qatar International Islamic Bank	Qatar
26	Dubai Islamic Bank	United Arab Emirates
27	Sharjah Islamic Bank	United Arab Emirates
28	United Arab Bank	United Arab Emirates

4. Finding

The following Table 6 provides insights into the development of variables definition and notation signify the measurement considered in this study. On examining Islamic bank’s performance, we will be analyzed on the basis of some restricted variables as follows:-

Table 6: Descriptive of the variables

Variables	Description	Formula	Indicator	Sources
1. Endogenous Latent Variables (Dependent Variables)				
ROA	Return on Average Assets	Pre-tax profits / Average Assets	Bank Performances (BP)	Bank scope
ROE	Return on Average Equity	Pre-tax profits / Average Equity	Bank Performances (BP)	Bank scope
PM	Profit Margin	Net Income / Total Operating Income	Bank Performances (BP)	Bank scope
2. Mediating Variables (Risk Governance Variables)				
CRO	Chief risk officer	Total number of Chief Risk Officer	Risk Governance (RG)	Annual Report
RCM	Risk committee members	Total number of Risk committee members	Risk Governance (RG)	Annual Report
SC	*Shariah* members	*Shariah* composition	Risk Governance (RG)	Annual Report
3. Internal Risk Management Variables (Exogenous Variables)				
LLP	Loan Loss Provision	Loan Loss Provision / Gross Loan	Credit Risk	Bank scope
CAR	Capital Adequacy Ratio	Total capital / (Capital and Current Account)+ 50% (unrestricted investment account)	Operational Risk	Bank scope
TDR	Total Deposit Ratio	Total customer deposits / Total funding	Liquidity Risk	Bank scope
4. External Risk Management Variables (Exogenous Variables)				
GDP	Gross Domestic Product	Real Gross Domestic Product (%)	Macro-economics	World Bank
CBLR	Central Bank lending rate	Interest rate charge by Central Bank to private sector	Macro-economics	World Bank
INF	Inflation Rate	CPI annual % change in the basket of goods and services in specified year.	Macro-economics	World Bank
5. Internal Corporate Governance Variables (Exogenous Variables)				
CEO	CEO meeting	Total CEO meeting per year	Corporate Governance	Annual Report
BS	Board Size	Total Board composition	Corporate Governance	Annual Report
REM	Remuneration meeting	Total of board remuneration meeting per year	Corporate Governance	Annual Report
6. External Corporate Governance Variables (Exogenous Variables)				
EA	External Audit	Total number of external audit meeting	Corporate Governance	Annual Report
AS	Accounting Standard	1=comply with AAOIFI standard 0=otherwise	Corporate Governance	Annual Report
RR	Credit Rating	Total number of subscribes credit rating agency	Corporate Governance	Annual Report

Four steps that usually taken in validation of structural equation modelling are: specification, identification, estimation, and evaluation and modification. Based on agency theory, stakeholder-based governance theory, and delegated monitoring theory has been designed for this research (Figure 1.6). This formative model posits a composite variable that summarize the common variation in a collection of indicators. In this model, RG = Risk Governance, RM = Risk Management, CG = Corporate Governance, BP= Bank Performances. In the below model, ROA, ROE, PM are the measurement items for bank performances while CRO, RCM, SC are measurement items for risk governance. Risk management items were indicate as LLP, CAR, TDP, GDP, CBLR, INF whereas corporate governance items were measures as CEO, BS, REM, EA, AS and RR. Error in the equation shows as e13 and e24 will indicate the residual in the regression equation. In this study the measurement model refers to the following table below (Table 7).

Table 7: Variables in the Proposed Model

Variables Types	Variables
Exogenous observed	Risk Management (LLP, CAR, TDP, GDP, CBLR, INF) Corporate Governance (CEO, BS, REM, EA, AS, RR)
Exogenous variables	Risk Management & Corporate Governance
Endogenous variables	Bank Performance (ROA, ROE & PM)
Mediating	Risk Governance (CRO, RCM, SC)

Two exogenous variables in the propose model are risk management and corporate governance. Risk management act as exogenous variables to bank performance (based on agency theory). Alternatively corporate governance act as an exogenous to bank performances (based on agency theory). Risk governance act as mediating variables (based on delegated monitoring theory). Bank performances are chosen as the indicator for the endogenous variables (based on stakeholder-based governance theory). The direct path for this study is to risk governance and to the bank performance. Direct effect should be significant. However, when mediating variables enters in the above model, the effect will be either reduced or insignificant. If it is reduced but still significant, then, the mediation effect is called 'partial mediation'. If the effect is reduced up the level where it is no longer significant, then, 'complete mediation' has occurred. The measurement model evaluate the observe variables combine to develop the underlying construct.

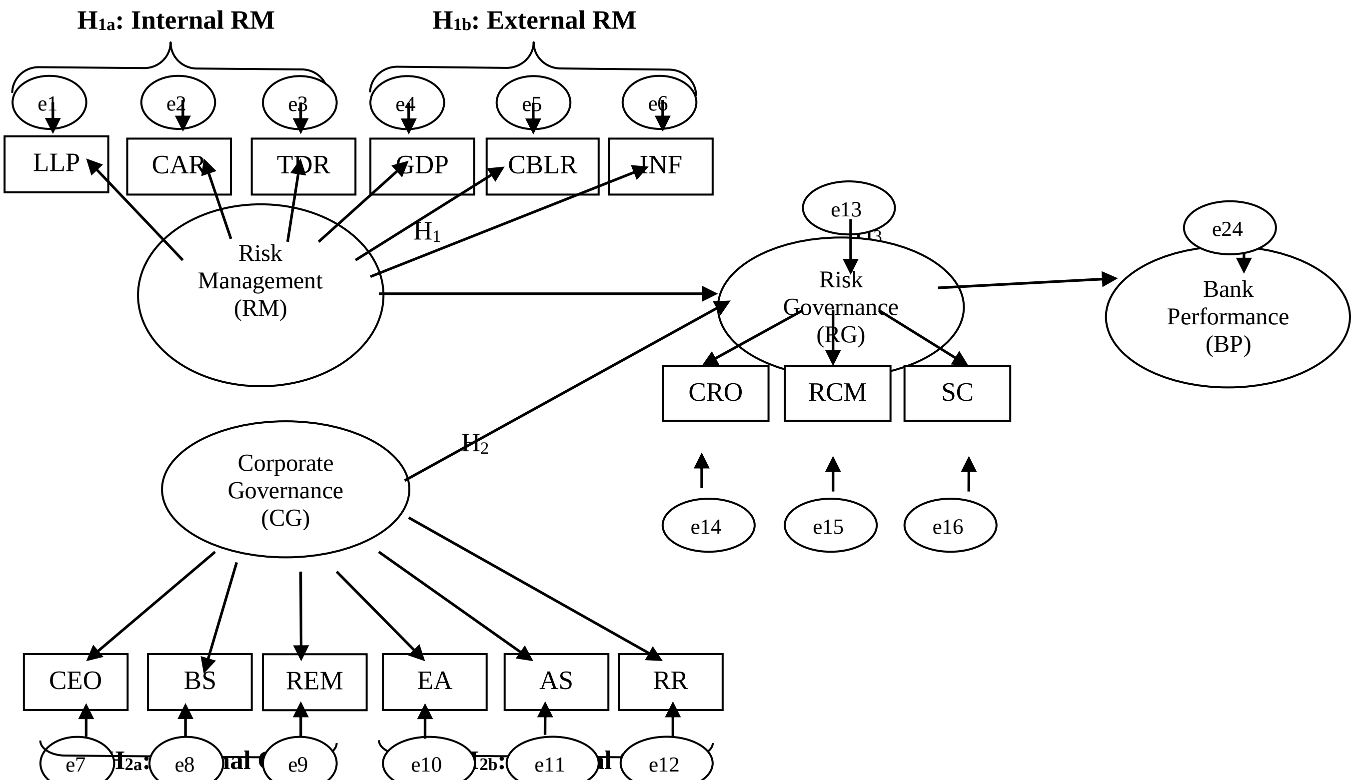


Figure 6: Proposed Path Diagram in SEM

Technically, data collection were discusses briefly in this chapter. Highlighted, secondary data were extracted from Bankscope, annual report and audited financial statement from respective banks during data collection process. The reason for selecting annual report as the data collection source is due to the credibility of the annual report, easily assessable. Bankscope database was chosen to minimize the bias arising from accounting practice and accounting standard. As mention previously mixed method design are conducted in this study. Data analysis technique that will be used in this research is the Structural Equation Modelling (SEM).

5. Conclusion

There is no coherent and significant answer whether the sub-prime crisis may have direct effect to the banking system in GCC and Malaysia. This raises the question of whether Islamic banks performance can survive when there is turbulence in international financial markets. It may have an impact but how big risk governance effect toward Islamic banks in these country will require an attempt to explain the shortcomings.

This study is important since there are increasing risk governance application in Islamic banks for cases in Malaysia and GCC. The increasing of roles and expectations on the Chief Risk Officer (CRO) who is responsible to oversight risk governance practices is another factor to consider. The elements monitor events affecting clients' performance on an ongoing basis, regardless of whether or not they are meeting the obligations.

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