



# An evaluation of corporate governance practices of Islamic banks versus Islamic bank windows of conventional banks

## A case of Pakistan

Khuram Shahzad Bukhari

*Institute of Management Sciences, Bahauddin Zakariya University,  
Multan, Pakistan*

Hayat M. Awan

*Air University, Multan, Pakistan, and*

Faareha Ahmed

*Institute of Management Sciences, Bahauddin Zakariya University,  
Multan, Pakistan*

### Abstract

**Purpose** – The purpose of this paper is to explore the perceived importance of management about various corporate governance dimensions being practiced in the Pakistani Islamic banking context.

**Design/methodology/approach** – AHP is applied to analyze the corporate governance indexes and its dimension of five Islamic banks and 12 conventional banks which are providing Islamic banking facilities (Islamic bank window) throughout Pakistan. These dimensions included board of directors (BOD), Shari'ah supervisory board (SSB), audit, investment account holders (IAH), and information disclosure & transparency.

**Findings** – The study reveals that the most significant dimensions which affect the corporate governance in Islamic banks are BOD and SSB, while the significant factors for Islamic banking windows are almost all dimensions of corporate governance. The correlation, regression, and ANOVA tests are applied to check the contributions of various factors of corporate governance mechanisms. These results indicate that there is a significant difference between Islamic banks and Islamic banking windows regarding the BOD and SSB. On the other hand, no significant difference is seen for the rest of the factors. The dissatisfaction level of customers reduces with the increase in the audit and BOD governance and all other factors have no impact in the case of Islamic banking windows; whereas in Islamic banks, in addition to audit and the SSB, information disclosure also significantly reduces the dissatisfaction level of customers. The concern of customers decreases significantly with the increasing level of IAH in the case of Islamic banking windows whereas in the case of Islamic banks a significant impact is seen for BOD, information disclosure, audit and IAH, but improvement in the governance of these rather increases the concern of customers toward compliance of Shari'ah and SSB has no contribution towards the concern of customers.

**Originality/value** – This study has practical significance for conventional and Islamic banking policy makers for understanding the requirements of their stakeholders and aligning them with the fundamentals of Shari'ah compliance according to the guidelines provided by the code of corporate governance so as to get better insight into the relationship between customers' motives behind using Islamic banking products.

**Keywords** Pakistan, Banks, Islam, Corporate governance, Islamic banks, Islamic corporate governance, Shari'ah compliance, Customer satisfaction, Analytic hierarchy process

**Paper type** Research paper



## 1. Introduction

In its essence, corporate governance facilitates relationships among owners, board of directors (BOD), investors and other stakeholders of an enterprise so as to create an enabling environment for the smooth attainment of their ultimate objectives. According to the OECD (1999, p. 11):

[...] corporate governance can be taken as a set of relationship between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring the performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.

Although corporate governance is a fundamental framework to monitor companies' corporate conduct, it is relatively more important for the governance of financial institutions. This greater emphasis of governance is mainly because of the reason that the funds being managed by different banks belong to different account holders and investors. This implies that any misconduct on the part of the bank may have adverse impact on its stakeholders and may possibly give rise to agency issues and conflict of interest between the management and those who have shown their trust in banking with the financial institution for better management of their funds.

Given the increased importance of corporate governance, many countries have developed their own nationally defined codes of conduct for effective corporate governance. In Pakistan, the SBP took the initiative for development of corporate governance code of conduct so that a comprehensive guidance on corporate governance be provided to the BOD and management of the financial institutions. Due to its relatively recent introduction, monitoring of corporate governance in Pakistan poses a challenge with regards to the assessment of corporate governance compliance and its impact on banking sector performance. Therefore, this study is designed to explore the perception of various dimensions (BOD, Shari'ah Supervisory Board (SSB), audit, disclosure and transparency) of corporate governance being practiced by Islamic banks in Pakistan. The remainder of this study will first discuss the theoretical principals related to corporate governance for banks. After the conceptualization of the framework of the study, the next section is about the research design to guide the preceding work of this study toward a summary of the main findings and conclusion of this study.

## 2. Literature review

### 2.1 *The evolving need for corporate governance*

Governance is taken from the Greek word "kybernan which does mean to steer, guide or govern. Corporate governance when broadly defined means the relationship of the firm to all its stakeholders and the society" (Yasser, 2011, p. 204). The very characteristics of "centralized" and/or "distributed" control have always been the pivots in any debate but the two specific words always remain connected by any means. When it comes to learning about a "firm" or a "corporate infra-structure", this centralized entity in fact controls the distributed activities throughout societies which in turn build a trend in economics of that culture. Viewed along these lines, it is evident that a firm plays a major role in organization and setup of the economic activities and re-construction of the entire economy with grip on production factor and thus holds extreme significance since it directly controls the market

mechanism and its flows (Coase, 1998). Azid and Asutay (2007) reveals that the conventional definition of economics raises concerns about the present day structural existence of firms and their working process in attracting and controlling the market. The ongoing trend in terms of quantitative growth is far beyond that of qualitative growth since the induction of multinational or transnational culture in the world has the sole aim to increase production on massive levels without taking into account other factors. This has led to a new era in defining and studying the very entity firm as the qualitative factors are overlooked by quantitative factors thus changing the entire economics and its control. In the modern day the concept of economic control has been turned down by the mass production and the remainder is merely property ownership. In this respect the whole infrastructure and framework of a firm is revolutionized, and the control variables are also replaced with the new organizational setup which controls and employs the property in its new way and thus reflects the present day structure of a firm. This leads to distinction in theory and practice of ownership and control issues of economy and, as a result, a new issue of principal and agent relationship has emerged in the model and structure of firms (Berle and Means, 1932). In the framework of the aforementioned neo-classical firm, with conventional theories and new practices, its traditional model is not working properly because of its imperfection as the nature of the economic and legal relationships has entirely changed. This signifies the failure of the market mechanism and the desperation among its believers and practitioners (Joskow, 2002).

In such widely changing circumstances regarding the working of firms, theorists are unanimous for governments to take charge of the governance of these firms and determine the role by which these firms should work and follow processes, i.e. law related to partnership, corporate, agency, etc. Moreover, due to the ruling out of market mechanisms and disinterest in new structures by its practitioners, there is also a need to raise the interest of stakeholders in firms by providing them protection in terms of their social and economic cost concerns (Ricketts, 2002; Garvey, 2003). Like other institutions, a firm is also a component of our society and community. A new approach was adopted by which the responsibilities of looking after and protecting the interests of all the components of the firm and society on moral and ethical grounds were handed over to the firm itself. This could be possible only if firms adopt a wider perspective of stakeholders which includes the customers, society, and environment (Turnbull, 1997). Leaders of a nation play a significant role in laying the foundation of a governing body which maintains the organizational setup and contributes towards the management of ethical issues. Moreover, the management of a firm on all levels should focus on customer satisfaction besides their economical objective to control the economy and overall achieve the essence for the presence of a firm's existence (Azid and Asutay, 2007). The organization of firms in the past was not as complex as it is in the present age. This requires extensive work to understand the modern firm's behavior in an Islamic framework (Bashar, 1997). Governance was adopted as a weapon against agency issues (Beasley, 1996). Gompers *et al.* (2003) described the improvements were a result of implementing a governance structure. Improvements imply the alignment of the interests of principal and agents and successful control over the organization measured through better performance.

### *2.2 Unique agency relationships in Islamic financial institutions*

The agency problems in Islamic financial institutions are unique to other financial institutions and they need separate and different ways of examining and solving

the issues. There are many reasons for this but the most important reason is the different kind of operations and contracts in Islamic banks that result in a widening of separation and control issues which lie under the agency theory. Managers in Islamic banks are not only supposed to maximize the benefits of shareholders but they are also obligated to work under Shari'ah rules and regulations (Archer *et al.*, 1998). The need to comply with Shari'ah basically makes the difference between Islamic finance and the other modes (Sarker, 1999). The investment account holders (IAHs) and the Islamic banks have such contracts between them which allow the banks not to involve IAHs in the decision-making process and management of their funds; therefore, the managers get a chance to share in profits and not in the losses. So the terms and conditions and the contracts in Islamic banks enhance the agency-related problems (Karim, 2001). The banks that provide services complying with Shari'ah should be given a separate section of examination because they are the institutions that do not only put efforts into maximizing the investment funds of their shareholders but also for taking all actions in a Shari'ah-compliant manner (Safieddine, 2009). Another reason to study and find solutions regarding agency problems in Islamic financial institutions is described by Hassoune and Volland (2005): the unbeaten growth rate of Islamic banking. This rate has gone even beyond the conventional banking growth rate enabling international finance to move its interest towards it. The growth rates of Islamic banks are predicted to increase from 10 percent to 15 percent annually prompting the world to study its structures even more deeply and find solutions regarding agency issues in particular (El-Hawary *et al.*, 2007). Islamic banks are experiencing the highest growth rates and their expansion has reached up to 50 countries and these numbers does not only represent Muslim countries. These reasons highlight the fact that agency issues are bigger and their dynamics should be tackled separately from other institutions (Safieddine, 2009).

### *2.3 Shari'ah compliance makes the real difference*

Boosting up the stake holders' value is the goal of all businesses and both Islamic and conventional banks do this by all means because they know that their stability and financial performance lies in the trust that their stakeholders give to them. But what makes the difference is the obligation of Islamic banks to reassure their stakeholders that all the activities are performed in compliance with Shari'ah and that the institution values their religious beliefs like their financial interests (Grais and Pellegrini, 2006). In the First International Conference on Islamic Economics (1976) (Warde, 2000), Islamic Economics and Finance was formally declared as a discipline. Its main aim was to convince and make financiers, economists, legal professionals, corporate governance experts, and politicians familiar with the ideals of Islamic economics. Islamic corporate governance (ICG) lays its foundation in the connection between the spiritual and material paradigm. It endeavors to produce a just socio-economic system (Bhatti and Bhatti, 2009). Normally, a firm lays stress on earning more and more profit and decreasing the cost of a product. It is few and far between that it gives place to ethical and moral values while doing business. Firms keep an eye when the market is bullish and when it is bearish (Bilas, 1983; Naqvi, 1994). Besides earning profit, firms have moral and ethical obligations too because they are an incorporated part of the society (Morrison, 2000). There is a really important role of religion and moral values in building up and developing an enterprise culture. While earning profit, the firms should also take into account their stakeholders as a part of their moral obligations (Mannan, 1992; Sen, 1993; Boatright, 2002). If the economic agents derive their

inspiration from Islamic ideals, they are well guided in the discipline of consumption, production, and distribution. They find a balance between price and profit. A Muslim entrepreneur not only takes into account the wages but also the welfare of society instead of accumulating wealth by all means (Choudhury *et al.*, 2006; Azid and Asutay, 2008).

#### *2.4 Separation of ownership and control rights in Islamic financial institutions*

As mentioned above, Islamic financial transactions are different from the conventional banking sector in the sense that instead of giving a fixed amount of money to the customers, Islam has introduced contracts including equity participation, profit sharing, and profit and loss sharing. Islamic banks give their investment holders the profit on their investments which depends on the profit that the bank has acquired involving risks for the account holders (Errico and Farahbaksh, 1998). IAHs and shareholders are the two types of capital providers that the Islamic banks have. Among these two, IAHs give the resources to the agent which is the management appointed by the shareholders (Grais and Pellegrini, 2006). Though both IAHs and shareholders are the principals, the former is not given the rights to monitor the actions of the agent. This creates a unique sort of agency issue between the agent and the principal which is bigger in comparison to the conventional banking sector (Safieddine, 2009). In such a case, it would be much more probable for agents to think about self interest and work for their own gains. They will be provided with greater chances of showing less overall bank profit to the account holders who have no way of investigating and knowing about their returns. Archer *et al.* (1998) state that this separation of ownership and control rights of IAHs creates lack of disclosure and transparency of information between agent and the principal which adds up to agency-related issues. This lack of transparency often causes less reliability on the part of the bank as the account holders cannot see the bank's performance (Grais and Pellegrini, 2006). Karim (2001) raises another very strong point noting that some Islamic banks use off-balance sheets items for the investment accounts and in this way they can easily hide the information from IAHs. Islamic banks hide the figures representing revenues and expenses of the investment account. To sum up, the uniqueness in agency issues of Islamic banks comes from the separation of ownership and control rights of IAHs and the likelihood and power of managers to maximize their own profit by not fulfilling the promise to their customers of conducting all activities according to Islam (Safieddine, 2009).

#### *2.5 Corporate governance in Islamic banking*

The conventional banks do emphasize earning profits but Islamic banks keep profits in line with Islamic Shari'ah (Archer *et al.*, 1998). The concept of ICG is not studied in detail (Bhatti and Bhatti, 2009). The governance in Islamic corporations should be very strong because the issues in Islamic finance present significant concerns related to the depositors which may appear as agency problems for the firm (Hassan *et al.*, 2009).

Kuran (2005) stated that the history of Islam does not reveal the concept of corporation and the Muslims of early times used to develop organizations called "waqf" which was actually a trust used for the welfare of society like providing drinking water, helping the poor in their tough times, giving wedding clothes to underprivileged brides, and helping people for their pilgrimages. Waqf was different from a corporation because it was run by a single person and its governance was done by the same individual. Although scholars argue that the concept of corporation does not exist in the classical Islamic set of rules, the *Qur'an* and the life of our Holy Prophet (P.B.U.H) has described the way of doing each and



every thing including decision-making processes in one's life, and that way is called Shari'ah. Shari'ah is actually the road which all the Muslims should choose to get to their final destination (Bhatti and Bhatti, 2009). We can get the definition of ICG by adding Shari'ah rules to the proposed stakeholder model of corporate governance. ICG means that a firm is governed by Islam and Shari'ah, and the firms need to consider the effects of Shari'ah policies and practices on corporate policies and practices (Bhatti and Bhatti, 2009). Governance of an Islamic corporate structure is done in such a way that each person associated with the bank is actually the shareholder to the bank, which implies that success of the bank means success of the shareholder (El-Gamal, 2005).

The contributions of Hassan *et al.* (2009) provide the foundation of our study. Both of them mentioned the differences between Western and Islamic concepts of corporate governance. The Anglo-Saxon model of corporate governance has the objective of protecting the rights of the shareholders; on the other hand there is the European model that is based on the preposition that corporations should work for the welfare of all stakeholders. The Islamic model of corporate governance is somehow a modified form of the European model because it considers all the stakeholders and not just the shareholders. Stakeholders are the people who affect or are affected by the firm (Freeman and McVea, 2001).

## 2.6 Framework of Islamic corporate governance

**2.6.1 Decision making.** In an Islamic framework of ICG, the process of decision making is done through "Shura", which means that a body of scholars is formed who have command on rules and regulations as well as on Islamic ideals. This body of scholars is called a SSB. The SSB makes sure that all activities in the organizations are in accordance with Islamic law (Hassan *et al.*, 2009). This group of advisors ensures the compliance of Shari'ah in the organization. The SSB grants permission for the financial activities in an organization through fatwas and later on it judges whether transactions are in accordance with the Shari'ah. It also verifies the deduction and payment of zakat. The SSB also advises how to dispose of illegal earnings in charity. The SSB also ensures how to distribute fairly the income and expenses among shareholders. After passing through the above-mentioned stages, the SSB issues a report in which it endorses to comply with Shari'ah. There are some issues which arise with the formation of the advisory body. It has independence, confidentiality, competence, consistence, and disclosure. The disadvantage with respect to monetary gains sometimes goes to banks. This disadvantage emerges when some decisions of the SSB impose sanctions on the use of earnings and sometimes prohibit accumulating such profit which was gained through an investment not congruent with Islamic Shari'ah. It is common practice that bank managers tend to violate their advices and secure profit that in other words was earned through illegal investment; but SSB advisors seldom go astray from their decisions because it does bother them about their reputation (Grais and Pellegrini, 2006). This concept is taken from the Shura of early Muslim history when it consisted of elder tribal members who would solve a problem after discussing it with the other members of the council. The *Qur'an* tells us about this by saying that Muslims consult others in making a decision and they should neither be afraid nor should be doubtful once the decision is made because the one who believes in Allah should trust Him (Bhatti and Bhatti, 2009).

What makes a difference in corporate governance and ICG is the role of Shari'ah in the decision-making process (Choudhury and Ziaul Hoque, 2006).

*2.6.2 Disclosure and transparency.* Islam has laid stress on the disclosure of information. The word of account is used several times in the *Qur'an* and means that a human being is accountable to Allah Almighty. He has provided man with countless blessings so he should conduct economic and financial activities with justice and honesty. Accountability should be there for the community. All the required information should be transparent to the related persons so that truth will be maintained all across the firm (Bhatti and Bhatti, 2009). Transparency is most important in order to epitomize an ethical business and honest dealings (Abu-Tapanjeh, 2009).

*2.6.3 Audit.* An audit makes sure that every activity in the firm is done in a Shari'ah-compliant manner. It informs the management and BOD about the Shari'ah rules, in particular financial and economic decisions. It also develops a report to show the shareholders whether the management is complying with Shari'ah rules or not. It also makes sure that zakat is fairly distributed (Lewis, 2005).

*2.6.4 Board of directors.* ICG means corporate governance in the light of the Islamic perspective of corporate governance. The BOD is very important while describing the corporate governance of any firm (Hussain and Mallin, 2003). The BOD size sometimes tells the level of disclosure and transparency that a firm holds. According to Aktaruddin *et al.* (2009), the increase in the number of BOD means an increase in disclosure. He has also stated that if the number of independent non-executive directors on the board is higher than there will be more likelihood of transparency in the organization. The role of the BOD is significant for any corporation, particularly when we study agency relationships as it is the BOD that works for the stakeholders by overseeing all the activities of the firm and making sure that shareholder rights are not threatened (Hassan *et al.*, 2009).

### 3. Methodology

This study explores the dimensions of corporate governance, defines indexes of corporate governance and its dimensions, and investigates establishment of the relationship of corporate governance to the Pakistani banking sector particularly associated with the Islamic financial services. The research questions identified for this study are stated as:

- RQ1.* How do the dimensions of corporate governance perceptions of Islamic banks differ from the Islamic banking windows of conventional banks in Pakistan?
- RQ2.* What dimension of corporate governance has the most significant effect on the corporate governance index of Islamic banks and Islamic banking windows?
- RQ3.* Which dimension has more impact on the concern and dissatisfaction regarding the compliance with Shari'ah?

This study uses a survey methodology. The survey method chosen is cross-sectional in nature. The rationale for utilizing a cross-sectional methodology as opposed to a longitudinal one is due primarily due to the type of scale employed in the study.

The study is descriptive as it attempts to determine what the dimensions of corporate governance are, and then establish their relationship with Islamic financial institutions. The main research methodology consists of a data collection instrument and interview. The data collection instrument consists of a structured questionnaire with a Likert scale.

### 3.1 Research model

The research model designed in this study is given below. In the current research model, the numbers of items per dimension are established in the qualitative part of the study, and the ultimate numbers of dimensions are determined by factor analysis.

### 3.2 Sample and population

The target population is composed of presidents, secretaries and directors of banks because these are the people involved in the development and establishment of corporate governance policies throughout the bank. Data are collected from the target population of the Islamic banks and the conventional banks offering Islamic banking services. The target respondents reside in the head offices of all the target banks. Head offices of most of the banks are in Karachi. The main data source consists of respondents (presidents, secretaries, and directors), therefore we reached out personally to them through our own contacts and references.

### 3.3 Sampling design

Hair *et al.* (1998) cautions that researchers should not factor analyze a sample of fewer than 50 observations. We conducted a survey of 17 banks including both pure Islamic and conventional banks offering Islamic services for their customers. A total of 60 questionnaires were sent out to the respondents after obtaining their consent, out of which 50 were returned. The lower number of returned questionnaires is due to the fact that there are only a few persons in the organizations who are able to answer for the questions related to the policies of corporate governance, so forcing more people to fill the questionnaires would throw doubt on the genuineness and authenticity of the results. The respondents have been informed of the purpose of the research and that their responses would be treated with secrecy and kept completely confidential. They have been also informed that no individual identifiable information would be disclosed or published, and that all results would be presented as aggregate summary data. The data from the returned questionnaires were entered into SPSS 17 for analysis in batches as the survey responses accumulated.

### 3.4 Data collection and instrumentation

Data are collected by means of a structured questionnaire comprised of questions relating to five dimensions of corporate governance, namely BOD, SSB, audit, disclosure of information and transparency, and IAHs. The BOD contains 19 questions subdivided into categories of BOD composition, BOD policies, and BOD commitment. The SSB has 12 questions also divided into two categories of SSB composition and SSB policies. The audit has nine questions. Disclosure and transparency have 20 questions each. IAH has six questions in the questionnaire. The total number of questions is 60.

Some questions are measured on a seven-point Likert-type scale that varied from 1 (never) to 7 (every time).

## 4. Results and findings

### 4.1 Analytical hierarchical process

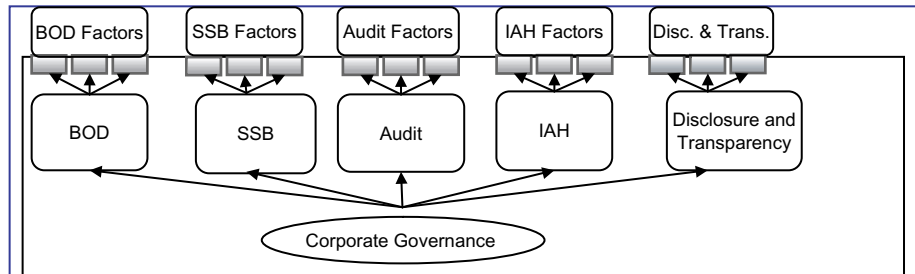
In order to achieve the second objective of this study, an analytical hierarchical process (AHP) was designed. The AHP is a multi-criteria decision making (MCDM) method. MCDM is a well known class of decision making that was introduced by Saaty (1980)



which addresses decisions problems that are related with a number of decision criteria. Common MCDM methods include priority based, distance based making, and outranking. Each method has its own characteristics on the basis of this so they can be classified as deterministic or stochastic or fuzzy method, or depending upon the number of decision makers, as single or group decision making method (Figueira *et al.*, 2009). The AHP is used to prioritize a number of alternate parameters by taking into consideration a set of qualitative as well as quantitative criteria. This is achieved by making pair wise comparisons provided by the decision makers. AHP results in a hierarchical ladder of the determinants, where the upper hierarchy ladder is considered a goal of the decision process, second ladder establishes a selection criterion that is further subdivided into sub criteria at lower hierarchy ladders, and finally the last ladder represents the alternative decisions to be evaluated (Awan *et al.*, 2011).

The AHP is applied on the model shown in Figure 1. The local and global weights of the BOD, SSB, audit, information disclosure and transparency, and IAH and their sub-factors are computed. Then, these global weights are used to compute the weighted indexes of corporate governance and its six dimensions. These weighted indexes are listed in Table I.

We learn from the descriptive statistics in Table I that the mean value of corporate governance for Islamic banking windows and Islamic banks are 0.6613 and 0.5642, respectively. This difference is significant ( $p = 0.07$ ). In the case of Islamic banking windows, the SSB and disclosure of information are the best among the indexes of all dimensions. The index for IAHs is relatively low. It is suggested that the construction of board is still the key dimension in corporate governance for Islamic banking windows of conventional banks; also we see that the index for IAHs is quite low, therefore these banks should consider the protection of rights of IAHs. In the case of Islamic banks,



**Figure 1.**  
The research model of corporate governance for the banking industry in Pakistan

	Islamic banking window		Islamic banks	
	Mean	SD	Mean	SD
BOD	0.5272	0.1871	0.7309	0.1280
SSB	0.7300	0.2485	0.4519	0.1820
Audit	0.6191	0.2257	0.6089	0.2650
Disclosure	0.6364	0.2872	0.5473	0.1437
IAH	0.468	0.2782	0.5476	0.2320
Corporate governance	0.6613	0.1718	0.5642	0.1594

**Table I.**  
Weighted indexes of corporate governance and its dimensions

BOD and audit are best among indexes of all the dimensions. The index of the SSB is quite low. Therefore, these banks should consider strengthening the function of the SSB.

#### 4.2 Analysis of variance

Analysis of variance (ANOVA) is conducted on the dimensions of corporate governance to see difference between Islamic banks and Islamic banking windows as shown in Table I.

In order to test whether there is a significant difference between Islamic banking windows and Islamic banks regarding various dimensions of corporate governance, the ANOVA test was used. Table II shows significant differences between Islamic banking windows and Islamic banks with respect to the SSB and BOD dimensions of corporate governance. The respondents of Islamic banking windows attach more weight to the SSB whereas the respondents of Islamic banks rate more the dimension of the BOD. The respondents of both the categories of Islamic banking more or less have insignificant difference regarding the dimensions of audit, information disclosure and IAHs. However, the corporate governance has a significant difference ( $p = 0.07$ ) between Islamic banking windows and Islamic banks.

#### 4.3 Regression and correlation

Regression and correlation analysis is used to see the impact of various dimensions of corporate governance on itself and the customer dissatisfaction level and concern regarding Shari'ah compliance.

	Sum of squares	df	Mean square	F	Sig.
Audit				0.019	0.891
Between groups	0.000	1	0.001		
Within groups	2.695	48	0.056		
Total	2.697	49			
Disclosure and transparency				1.216	0.276
Between groups	0.080	1			
Within groups	3.156	48	0.080		
Total	3.236	49	0.066		
IAH				0.898	0.348
Between groups	0.064	1			
Within groups	3.410	48	0.064		
Total	3.474	48	0.071		
BOD				13.964	0.000
Between groups	0.418	1			
Within groups	1.438	48	0.418		
Total	1.857	48	0.030		
SSB				14.437	0.000
Between groups	0.780	1			
Within groups	2.593	48	0.780		
Total	3.373	49	0.054		
Corporate governance				3.348	0.073
Between groups	0.095	1			
Within groups	1.364	48	0.095		
Total	1.459	49	0.028		

**Table II.**  
Analysis of variance

To see the contribution of different dimensions of ICG, we applied correlation and regression techniques. We checked the multicollinearity problem among all the dimensions of corporate governance through the Pearson correlation coefficient. Andersen *et al.* (1993) narrated that any correlation coefficient exceeding 0.7 leads to the multicollinearity problem. The results in Tables III and IV reveal that there is no problem of multicollinearity among all the dimensions of corporate governance as no correlation coefficient exceeds 0.70 in both Islamic banking windows and Islamic banks.

The Pearson correlation coefficients between different dimensions of corporate governance are listed in Tables III and IV for Islamic banking windows and Islamic banks, respectively. The BOD governance has significant positive relation with SSB, audit, and information disclosure index at 1 percent significance level for Islamic banking windows. As the core factor of corporate governance, the BOD governance influences the SSB, audit and information disclosure mechanism directly. A favorable information disclosure, strong SSB and audit governance can monitor and counter balance the BOD, improve the construction of the BOD and its other functions and complete related governance mechanisms. However, the inter relationship of the BOD and the SSB and audit for Islamic banks more or less has a similar pattern as that of Islamic banking windows, only information disclosure has no role in the case for Islamic banks.

The information disclosure index has significant positive relationship with SSB and IAH. Reliable, relevant, and timely information disclosure helps conventional banks operating Islamic banking to be transparent in their governance, fulfill the need for accountability, and accept monitoring from IAHS, the SSB and markets, all of which can stimulate Islamic banking windows which improves IAH and SSB governance. The participation of IAHS and fulfillment of SSB also help to improve the behavior of information disclosure and increases it. Whereas the interrelationship of information disclosure with the BOD, SSB, audit, and IAHS is insignificant in the case of Islamic banks. Therefore, this dimension has no role in the improvement of the governance of all these dimensions.

		Audit	Disclosure	IAH	BOD	SSB	Overall
Audit	Pearson correlation	1					
	Sig. (one-tailed)						
	<i>n</i>	36					
Disclosure	Pearson correlation	0.483					
	Sig. (one-tailed)	0.001	1				
	<i>n</i>	36	36				
IAH	Pearson correlation	0.294	0.325				
	Sig. (one-tailed)	0.041	0.026	1			
	<i>n</i>	36	36	36			
BOD	Pearson correlation	0.779	0.407	0.216			
	Sig. (one-tailed)	0.000	0.007	0.103	1		
	<i>n</i>	36	36	36	36		
SSB	Pearson correlation	0.661	0.420	0.414	0.459		
	Sig. (one-tailed)	0.000	0.005	0.006	0.002	1	
	<i>n</i>	36	36	36	36	36	
Overall	Pearson correlation	0.850	0.674	0.520	0.700	0.881	
	Sig. (one-tailed)	0.000	0.000	0.001	0.000	0.000	1
	<i>n</i>	36	36	36	36	36	36

**Table III.**  
Correlation coefficient  
between dimensions of  
corporate governance  
(Islamic banking  
windows)

		Audit	Disclosure and transparencies	IAH	BOD	SSB	Overall
Audit	Pearson correlation	1					
	Sig. (two-tailed)						
	<i>n</i>	14					
Disclosure	Pearson correlation	0.428	1				
	Sig. (two-tailed)	0.127					
	<i>n</i>	14	14				
IAH	Pearson correlation	0.367	0.008	1			
	Sig. (two-tailed)	0.197	0.979				
	<i>n</i>	14	14	14			
BOD	Pearson correlation	0.634	-0.140	0.546	1		
	Sig. (two-tailed)	0.003	0.633	0.043			
	<i>n</i>	14	14	14	14		
SSB	Pearson correlation	0.682	0.449	-0.061	0.592	1	
	Sig. (two-tailed)	0.000	0.107	0.835	0.026		
	<i>n</i>	14	14	14	14	14	
Overall	Pearson correlation	0.938	0.531	0.283	0.729	0.917	1
	Sig. (two-tailed)	0.000	0.051	0.326	0.003	0.000	
	<i>n</i>	14	14	14	14	14	14

**Table IV.**  
Correlation coefficient  
between dimensions of  
corporate governance  
(Islamic banks)

The index of audit has a significant positive relationship with IAHS and SSB for Islamic banking windows. The strict audit helps IAHS and members of Shari'ah boards to improve the framing and compliance with Shari'ah which leads to the enhancement of customer image regarding Shari'ah-compliant services of Islamic banking windows. The participation of IAHS and fulfillment of the SSB will also help to improve the functions of audit. In the case of Islamic banks the audit is the only dimension significantly related to the SSB; therefore stronger and strict audit governance improves the framing and compliance with Shari'ah by the SSB and in reciprocity the fulfillment of the SSB will help to improve the audit governance.

The index of SSB is significantly related to IAHS in the case of Islamic banking windows. The strong and strict compliance with Shari'ah and monitoring of this compliance by the SSB improves IAHS governance and in counterbalance the participation of IAHS stimulates improvement in SSB governance. However, the indexes of SSB and the index of IAHS indicate no relationship, which leads to the indifferent behavior to each other.

Each explanatory variable has been regressed against the corporate governance index of both Islamic and Islamic banking windows of conventional banks in order to check the impact of each variable on corporate governance. Comparative results as shown in Table V revealed the variation explanation in the corporate governance by information disclosure ( $R^2 = 0.438$ ) and IAHS ( $R^2 = 0.249$ ) for the Islamic banking windows, which is more significant with regard to the corresponding dimensions of corporate governance index of Islamic banks. Whereas, for pure Islamic banks audit ( $R^2 = 0.810$ ), SSB ( $R^2 = 0.827$ ) and

BOD ( $R^2 = 0.492$ ) explains greater variation than that of Islamic banking windows, thus found to be more significant in corporate governance indexes of these dimensions of pure Islamic banks. These results revealed that practices and policies of the SSB and audit are strong in Islamic banks whereas the Information disclosure and IAHs have strength in Islamic banking windows.

The impact of corporate governance is measured qualitatively like customer dissatisfaction due to divergence by managers from performing like tasks in a Shari'ah-compliant manner (dissatisfaction) and customer concern about Shari'ah compliance (concern). The results are shown in Tables VI and VII. The dissatisfaction of customers is significantly related to corporate governance ( $R^2 = 0.990$ ) and SSB ( $R^2 = 0.558$ ) in the case of Islamic banks. The dissatisfaction of customers reduced with an improvement in the corporate governance and SSB in the case of Islamic banks, whereas in the case of Islamic bank windows this relationship is moderate ( $R^2 = 0.098$ ) with  $p = 0.042$  and with SSB insignificant. This leads to the negligible role of SSB towards dissatisfaction of customers toward the compliance with Shari'ah in banking services provided by Islamic banking windows. So far as the concern of customers towards

**Table V.**  
Regression coefficients for dimensions of corporate governance

	$R^2$	Islamic banks			Conventional banks with Islamic windows (IBBs)			
		$\beta$	$T$	Sig.	$R^2$	$\beta$	$T$	Sig.
BOD	0.492	0.729	3.688	0.003	0.475	0.700	5.714	0.000
SSB	0.827	0.917	7.958	0.000	0.770	0.881	10.875	0.000
Audit	0.870	0.938	9.394	0.000	0.714	0.850	9.409	0.000
Disclosure	0.222	0.531	2.170	0.051	0.438	0.674	5.315	0.000
IAH	0.004	0.283	1.024	0.326	0.249	0.520	3.554	0.001

**Table VI.**  
Regression coefficient of dissatisfaction with dimensions of corporate governance

	Islamic banking windows				Islamic banks			
	$R^2$	$\beta$	$T$	Sig.	$R^2$	$\beta$	$T$	Sig.
BOD	0.123	-0.388	-2.343	0.026	0.562	0.790	3.160	0.020
SSB	0.016	-0.124	-0.696	0.492	0.558	-0.788	-3.134	0.020
Audit	0.176	-0.449	-2.798	0.009	0.901	-0.956	-8.031	0.000
Disclosure and transparency	0.020	-0.225	-1.284	0.209	0.919	-0.965	-8.956	0.000
IAH	0.007	0.157	0.886	0.382	0.112	0.216	0.541	0.608
Overall	0.098	-0.355	-2.116	0.042	0.990	-0.996	-26.963	0.000

**Table VII.**  
Regression coefficient of concern with dimensions of corporate governance

	Islamic banking windows				Islamic banks			
	$R^2$	$\beta$	$T$	Sig.	$R^2$	$\beta$	$T$	Sig.
BOD	0.200	-0.019	2.996	0.005	0.609	0.805	4.071	0.003
SSB	0.031	0.474	-0.170	0.866	0.609	0.195	0.598	0.565
Audit	0.134	-0.030	2.442	0.021	0.354	0.647	2.544	0.032
Disclosure and transparency	0.030	0.402	-0.280	0.782	0.411	0.686	2.827	0.020
IAH	0.228	-0.050	-3.236	0.003	0.577	0.787	3.830	0.004
Overall	0.032	-0.502	-0.107	0.915	0.330	0.630	2.435	0.038

compliance with Shari'ah, the SSB and corporate governance played no role both for Islamic banks and Islamic banking windows. However, in the case of Islamic banks, corporate governance, BOD, audit, information disclosure and IAHS are all positively related to the concern of customers, which means that the strengthening of all these dimensions increases the concerns of customers. This result seems to be strange but this opinion of increase in the concern of customers is derived from the opinions of the management. Whereas in the case of Islamic banking windows, corporate governance and the concern of customers are insignificantly related and BOD and audit are positively related with concern. However, an increase in the governance of IAHS leads to reduced concern of customers.

## 5. Conclusion and discussion

The major results of this research provide an initial overview of corporate governance of Islamic banks and Islamic banking windows in Pakistan. Although this study covers only one country, which might be considered as a limitation for this research, the results revealed a good amount of evidence regarding the factors that affect corporate governance in both kinds of banking systems and the significant differences concerning supervisory bodies, audit, disclosure, and corporate governance practices. It also explains the most inspired source of corporate governance in pure Islamic banks, audit and disclosure, which plays a critical role in formulating bank strategy and oversight management actions based on Shari'ah compliance.

As indicated by the ANOVA test (Tables III and IV), the strength of inter-relationship of the Shari'ah board with other dimensions of corporate governance of Islamic banking windows, the strengthening of SSB governance will lead to improvements in the governance of all other dimensions of corporate governance. However, in the case of Islamic banks there is need to increase the effectiveness of governance of the BOD in order to enhance quality of other corporate effectiveness. The contribution of the dimensions of corporate governance toward reducing the dissatisfaction level of customers toward compliance with Shari'ah for the provisions of Islamic banking services is quite significant. Hence, the management and the regulating bodies should take the initiative to improve the image for customers through bringing the improvement in the governance of Shari'ah board of the Islamic banking industry. Priority index calculated showed that the composition of the SSB and its reporting system is quite strong in the case of Islamic banking windows but the critical factors which demand to be strengthened are BOD development of vision/mission and orientation training provision to chairmen, presidents, and members of the BOD. With the improvement of these critical factors for Islamic banking windows it is expected that the corporate governance will be improved. Whereas in the case of Islamic banks these results revealed that the composition of the SSB, its reporting system, and knowledge and orientation of the chairmen, presidents, and members of the BOD towards Shari'ah is quite strong. However, these banks are weak in terms of existence of corporate governance committee and its reporting system. Second, these banks have deficiencies of disclosure of information like the disclosure of profit to the public paid to IAHS and the bank entering into leasing, remittance, sales, and purchase with directors, holding more than 5 percent shares. It is suggested that the BOD of these banks should modify the policy of disclosure of information so that the corporate governance of these banks can be improved.



Due to the importance of the banking sector with reference to its role as a channel for resource mobilization in a developing country like Pakistan, any unexpected event/failure of banking institutions may have dangerous consequences for the economy as a whole. Therefore, it is extremely important for the BOD, management, and other stakeholders to provide a safe and conducive banking environment that can ensure social acceptance and compliance with the ethical motives of the investors. This study serves the purpose by mainly providing a comparative understanding of corporate governance-related issues for pure Islamic banks and conventional banks with Islamic banking windows/branches. To resolve the agency-related issues and minimize the conflict of interest given by the existence of dual banking systems in Pakistan. Further study may be designed to explore the relationship between better corporate governance practices and their impact on business performance of banks including financial performance as well as non-financial performance.

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#### Corresponding author

Khuram Shahzad Bukhari can be contacted at: [khurambukhari@bzu.edu.pk](mailto:khurambukhari@bzu.edu.pk)

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