2019-06

Religious entrenchment and agency costs

Nawaz, T

http://hdl.handle.net/10026.1/13642

10.1016/j.econlet.2019.03.032
Economics Letters
Elsevier

Religious entrenchment and agency costs

Tasawar Nawaz[a]
Department of Accounting, Finance and Economics
Plymouth Business School, Plymouth
PL4 8AA, the UK.
Email address: tnawaz@plymouth.ac.uk

Nader Shahzad Virk
Department of Accounting, Finance and Economics
Plymouth Business School, Plymouth
PL4 8AA, the UK.
Email address: nader.virk@plymouth.ac.uk

Abstract

The entrenchment effects of 20 prominent Shariah scholars show an increase in the agency costs for the Islamic banks in our study. This supports the notion that managers may provide concessions to external non-shareholding stakeholders to pursue their personal agendas.

Keywords: Entrenchment, Shariah scholars, agency costs, Islamic banks, non-shareholding stakeholders.

JEL Classification: G30, G34, G38, M12, M48.

[a] Corresponding author.

1. Introduction

Entrenched managers can seek opportunities that compromise the value maximisation principles to enhance their control over firm as well as personal perquisites (Shleifer and Vishny 1989). Likewise, firms with entrenched (concentrated) ownership, despite the benefit to limit the managerial opportunistic behaviour (Holderness and Sheehan, 1988), are associated with issues related to poor information disclosure systems, private benefit seeking at the expense of minority shareholders, among others (Morck, Shleifer and Vishny 1988, LaPorta, Lopez-de-Silanes, Shleifer and Vishny 1998, LaPorta, Lopez-de-Silanes and Shleifer 1999).

Nawaz and Virk (2019) identify another type of entrenchment that is only present in Islamic corporations/banks.[2] Islamic banks (IBs) tend to have Sariah Supervisory Boards (SSB) in a co-governance capacity along with typical board of directors and executive/board subcommittees to ensure the Shariah (Islamic law/jurisprudence) compliance.[3] They document that few prominent Shariah scholars (SSs) entrench SSBs: every second SSB's seat in the Gulf Cooperation Council (GCC) IBs belong to one of top 20 SS for a sample of approximately 50 banks during the period of 2007 to 2016. They name this feature *"SS entrenchment (SSE)"*.

We empirically examine, using executive remuneration data of 30 listed IBs in the GCC region, the relationship between agency costs and novel measures depicting SSE. To best of our knowledge this study is first of its kind.

2. Background literature

[2] The Islamic corporations that have mandate to incorporate Shariah law – forbids payment or receipt of interest (Riba in Islamic terminology), speculative trading, excessive risk taking – in their investment and financing dealings. Furthermore, Islamic funding models are based on risk sharing with the borrower in contrast to risk-taking model of lending in conventional banking systems. Safieddine (2009) report that because of the risk-sharing model, Shariah principles require designing saving accounts that make depositors/investment account holders' return non-interest bearing and gives IBs discretion in to pay a return that based on IBs overall profitability or for that matter losses. In addition to these covenants, IBs are also restricted on the use of many derivative products, including reasons such as excessive uncertainty, writing credit over credit, or derivative transactions that defer the transfer of money/capital and commodity/product in future (Obaidullah, 2005).

[3] Corporate governance and control practices are mediated so that managers/owners functioning is in the best interests of the company and other stakeholders. However there are possibilities where managers may collude with non-shareholder stakeholders in order to reinforce their entrenchment strategy resulting in weakened internal discipline and control mechanisms.

The members of the SSBs' are appointed by the shareholders of the bank and they report to the board of directors (Safieddine, 2009).[4] Effectively, they are employed by the bank, and their remuneration is proposed by the management and approved by the board (Iqbal and Mirakhor, 2011). In principle, SSBs are required to submit an unbiased opinion in all matters pertaining to their assignment. However, their employment status generates an economic stake in the bank, which may lead to situations where the independence of SSB is compromised. The literature on the role of SSB and its impact on different corporate aspects of IBs from disclosures on CSR, bank performance, IBs' risk taking/sharing is fast populating (Mallin, Farag, and Ow-Yong 2014, Mollah and Zaman 2015, Farag, Mallin and Ow-Yong 2018, Nawaz, 2017, Safiullah and Shamsuddin 2018). More often, the evidence in these studies shows that increasing size of SSB have positive impact on bank performance, CSR disclosures, agency costs and reduces IBs' operational risk.

The high concentration of the reputed SS can also be a window dressing tactic employed by management where they play to the gallery to attract the Muslim clienteles assuring Shariah compliance. Nonetheless, this high concentration of SSs creates an additional source of entrenchment that may have corporate governance related implications for investors, Islamic firms and regulators alike. In itself the SSBs are regarded Shariah governance checks on corporate decision makers to comply with Islamic covenants and have nothing to do with the conventional governance constraints on managers' pursuit of self-interest that improve firm value maximizing behaviour. This raises issues on the fairness and diligence of the managers and/or board of directors of IBs in forming independent SSBs, operationalisation and integrations of SSBs in the firm decision-making process, lack of competitive labour pool to choose SSs and finally how SSB themselves should be regulated soliciting Shariah prudence and conscientiousness as mandated.

3. Data, method and estimations

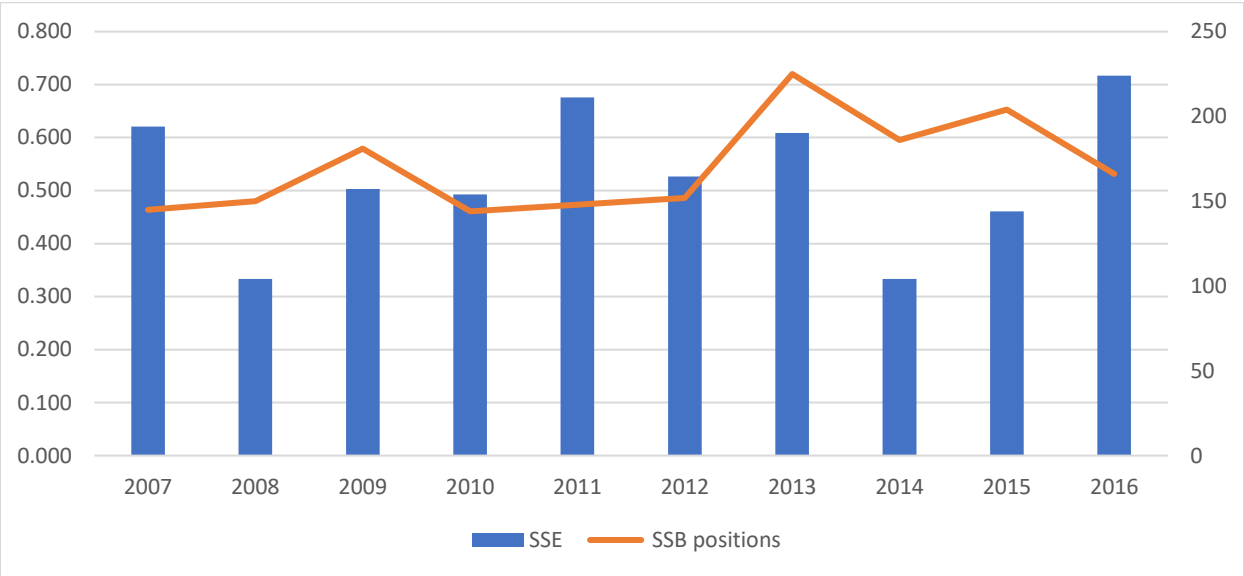
The data in our work is retrieved from three different sources for the cross-section of IBs in the GCC region over the period 2007–2016. The firm related and financial variables are downloaded from

[4] The corporate governance mechanisms in the Islamic financial institutions (IFIs) and IBs relative to conventional corporations are different: former have dual board structure and latter have unitary boards.

Bankscope and Datastream. The rest of variables are hand collected from the annual reports and the websites for details on the list of variables, how they are constructed, and data source, see table A.I in the Appendix A.

Figure 1

Shariah scholar entrenchment (SSE) on Shariah supervisory boards (SSB) in GCC Islamic Banks



The summary statistics of the variables are presented in the appendix table A.II. The measure of SSE proposed in Nawaz and Virk (2019) gives the proportion of prominent SS sitting on SSB for bank *i* in year *t*: $SSE_{i,t} = \frac{No.of\ Top20\ Shariah\ scholars\ on\ the\ board_{i,t}}{size\ of\ SSB_{i,t}}$ shows on average every second board seat is occupied by one of top 20 Shariah scholar in the GCC region.

Figure 1 shows that aggregated board seats of SSBs for the cross-section of 30 IBs in the Gulf Cooperation Council (GCC) region along with the percentage of SSE for the sample period in our work. The occupancy of board seats by the prominent SS across years is substantial ranges from 33 percent to 72 and there are on average approximately 170 board seats available in our sample period. Implying that the top 20 Shariah scholars on average are resident of 85 board seats in the sample examined in our work.

To assess the relationship between agency costs of the sample GCC IBs, we test the following specification:

$$EComp_{i,t} = \alpha_i + \beta_{SSE} SSE_{i,t} + \gamma_{i,j} X_{i,j,t} + \varepsilon_{i,t} \quad (1)$$

where $EComp_{i,t}$ is the proxy estimate for agency costs, β_{SSE} describes the level of Shariah entrenchment and $X_{i,j,t}$ are 'j' control variables for 'i' IB. These control variables comprise corporate governance and firm related features of IBs. In consideration to regional homogeneity of the GCC region with respect to culture, language, Islamic jurisprudence, regulatory frameworks to define, implement and monitor Sharia compliance, we employ pooled regression technique. Furthermore, to account for panel structure of the data, we compute t-stats for the regression coefficients using robust standard errors.

Our baseline specification, as shown column 1 of table 1, shows that SSE is positively linked to measure of agency costs for the sample banks: with the increased occupancy of SS the agency costs rise. We note that agency costs increase for IBs that have large firm complexity, capitalization and long-term liabilities. However, IBs with increasing total assets, leverage and asset growth are able to reduce these costs. Inclusion of corporate governance related variables such as size of board of directors and ratio of independent directors (NED) on the conventional board of the unitary corporate governance system shows that both the variables reduce agency costs. As several studies have shown that size of SSB improves firm performance (Mollah and Zaman 2015, Safiullah and Shamsuddin 2018), we include SSB in the last specification of table 1 to uncover if that also plays a discerning role in reducing agency costs. Although we witness that is not the case: coefficient on lnSSB is positive but insignificantly estimated.

Table 1 Shariah scholar entrenchment and agency costs

Dependent variable: Executive Compensation	(1)	(2)	(3)	(4)
Constant	0.755***	0.701***	0.833***	0.695***
	(20.98)	(17.62)	(20.55)	(16.98)
SSE	0.00820***	0.0121***	0.0104***	0.0123***
	(3.040)	(4.893)	(4.344)	(4.875)
lnSSB				0.00103
				(0.440)
lnTA	-0.0472***	-0.0472***	-0.0480***	-0.0472***

	(-36.48)	(-34.48)	(-36.42)	(-34.29)
lnCapital	0.0395***	0.0407***	0.0354***	0.0410***
	(12.42)	(12.76)	(13.22)	(12.71)
lnLiabilities	0.0171***	0.0175***	0.0230***	0.0175***
	(5.585)	(6.223)	(9.047)	(6.163)
Leverage	-0.0411***	-0.0461***	-0.0446***	-0.0466***
	(-4.447)	(-4.781)	(-5.166)	(-4.801)
lnAg	-0.0136	-0.00362	-0.00619	-0.00405
	(-1.507)	(-0.398)	(-0.730)	(-0.437)
lnSub	0.00591***	0.00442**	0.00618***	0.00427**
	(3.271)	(2.460)	(3.852)	(2.334)
lnBSize			-0.00662***	
			(-5.028)	
NED ratio			-0.0297***	
			(-3.255)	
Country effects	-	+	+	+
Year effects	-	+	+	+
Observations	283	283	283	282
Adjusted R-squared	0.471	0.523	0.542	0.552

Robust t-statistics in parentheses
*** p<0.01, ** p<0.05, * p<0.1

The results in table 2 column 1 show that the effect of larger SSB is unstable and insignificant when we include conventional board and NED ratio in our specification. In the next two specifications, we include variables pertaining to the audit quality in the sample IBs. We divide these controls into internal and external checks. The specification 2 in table 3 is augmented by size of audit committee (AC) and ratio of independent directors on AC (ACIND) and shows that increasing size of AC reduces agency costs. Moving forward, we include two a dummy variables, One, AuditQuality that takes the value of 1 if the external auditors belong the top four accounting firms[5] and zero otherwise; two Accounting Standards that takes the value of 1 if IB adhere to accounting and financial reporting standards specified by International Financial Reporting Standards IFRS and is zero otherwise.

Table 2 Shariah scholar entrenchment, corporate governance practices and audit quality

Dependent variable:	(1)	(2)	(3)	(4)

[5] PricewaterhouseCoopers (PwC), Deloitte, Earnest & Young (EY), and KPMG are the leading global accounting firms and have ventured into provision of professional services e.g. management consultancy, tax and human resources advisory services, in addition to their initial business expertise of auditing services. This has resulted in a regulatory dilemma: reports of compromised auditing practices and conflict of interests are overbearing in this industry. To this extent, Financial Reporting Council (FRC) in the UK is considering banning the accounting firms from earning lucrative consultancy fees at businesses they audit following a series of corporate scandals, see for details https://www.theguardian.com/business/2018/oct/08/accounting-auditors-consultancy-frc-kpmg. These issues has put lack of competition and inadequacy of auditing reports under the spot in the sector when this monitoring mechanism is meant to be independent and is entrusted to serve public interest by supporting transparency and integrity in business. Resultantly this should provide a fair view of the company for stakeholders just not shareholders of the company.

Executive Compensation					(5)
Constant	0.834***	0.905***	0.811***	0.827***	0.799***
	(19.27)	(19.58)	(14.12)	(13.83)	(13.64)
SSE	0.0103***	0.00764***	0.0116***	0.0113***	0.0157***
	(4.296)	(2.922)	(4.378)	(4.331)	(3.119)
lnSSB	-0.000233	0.000413	0.000498	-0.00404	-0.00262
	(-0.0991)	(0.177)	(0.219)	(-0.700)	(-0.451)
lnSub	0.00622***	0.00524***	0.00250	0.00256	0.00236
	(3.764)	(2.937)	(1.393)	(1.407)	(1.286)
lnBSize	-0.00663***	-0.00376*	-0.00421**	-0.00421**	-0.00467**
	(-5.000)	(-1.775)	(-2.151)	(-2.153)	(-2.335)
NED ratio	-0.0298***	-0.0308***	-0.0254**	-0.0552	-0.0484
	(-3.214)	(-3.397)	(-2.466)	(-1.558)	(-1.318)
lnACSize		-0.0123***	-0.00891**	-0.00890**	-0.00738*
		(-2.804)	(-2.076)	(-2.091)	(-1.655)
AC-Independence ratio		-0.0274	-0.0112	-0.0111	-0.00410
		(-1.228)	(-0.501)	(-0.501)	(-0.182)
AuditQuality dummy (Big4=1)			0.0262***	0.0258***	0.0265***
			(3.567)	(3.481)	(3.539)
Accounting Standards (IFRS=1)			-0.0127**	-0.0131**	-0.0137**
			(-2.440)	(-2.529)	(-2.577)
SSBNED				0.0242	0.0203
				(0.838)	(0.704)
SSENED					-0.00302
					(-0.377)
Control variables	+	+	+	+	+
Observations	282	282	282	282	282
Adjusted R-squared	0.552	0.677	0.685	0.685	0.684

Robust t-statistics in parentheses
*** p<0.01, ** p<0.05, * p<0.1

The increasing agency costs when IBs have the leading accounting firms as external auditors display another kind of widespread weakness in corporate monitoring practices. Because for the lack of competition in the accounting industry, the sector is riddled with issues of conflict of interest, where firms (IBs) approach them for various business needs such as advisory services, legal services, and bankruptcy services, among others. Our results support this conflict of interest prevailing in the global accountancy and auditing sector. Nonetheless, where the big four accounting firms have become a "one-stop shop," and are riddled with the risk of conflict of interest, the adoption of financial reporting standards[6] such as IFRS reduces agency costs for IBS in our work.

Guided by the discerning evidence on the role of SSB and our results, we create two interacting variables between SSE and NED and SSB and NED to see, for example, if the entrenchment effect on

agency costs weakens or the NED effect is stronger than SSE. Our results show that coefficient on SSE remains positive and highly significant: the impact of SSE entrenchment is independent of the effect of NED, who in themselves play a positive monitoring role is reducing agency costs for the IBs while negative coefficient on SSENED is insignificantly estimated.

4. Conclusion

Given the idiosyncrasies of IBs governance system, we report that potentially agents in the IBs may pursue their entrenchment agenda by exploiting the limited pool of SSs. This results in infestation of few SSs occupying several board seats on SSB across IBs in the region. Our results are robust to inclusion of variables controlling for firm characteristics, corporate governance practices e.g. internal and external auditing controls and financial reporting procedures. We note that managers potentially exploit the external non-shareholding stakeholders when the internal mechanism is efficient: with increase in no. of independent directors on conventional boards agency costs tend to decrease for the IBs studied in our work. The colluding and compromising state of business is also implied by the increase in agency costs when external audit is carried out by the four leading accounting firms.

We suggest that IBs, policy makers and regulators should standardise Islamic laws so that the pool of SSs could be widened to limit SSE and exploitation of them by the management. We recommend either non-Shariah experts should be made part of oversight conducted by SSB as NED perform in the conventional boards or for simplicity and efficiency of monitoring procedures SSB should be merged into the conventional boards to circumvent the connivance related issues that may allow entrenched managers to pursue their agenda.

References

Farag, H., Mallin, C. and Ow-Yong, K., 2018. Corporate governance in Islamic banks: New insights for dual board structure and agency relationships. *J. Int. Fin. Mark., Inst. Money*. *54*, 59-77.

Holderness, C.G. and Sheehan, D.P., 1988. The role of majority shareholders in publicly held corporations: An exploratory analysis. *J. Fin. Econ. 20*, 317-346.

Iqbal, Z. and Mirakhor, A., 2011. An introduction to Islamic finance: Theory and practice. John Wiley & Sons, Singapore.

La Porta, R., Lopez-de-Silanes, F. and Shleifer, A., 1999. Corporate ownership around the world. *J. Finac. 54*, 471-517.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R.W., 1998. Law and finance. *J. Pol. Econ. 106*, 1113-1155.

Mallin, C., Farag, H. and Ow-Yong, K., 2014. Corporate social responsibility and financial performance in Islamic banks. *J. Econ. Beha. & Org. 103*, 21-38.

Mollah, S., Zaman, M., 2015. Shari'ah supervision, corporate governance and performance: conventional vs. Islamic banks. *J. Bank. Financ.* 58, 418–435.

Morck, R., Shleifer, A. and Vishny, R.W., 1988. Management ownership and market valuation: An empirical analysis. *J. Fin. Econ. 20*, 293-315.

Nawaz, T. and Virk, N., 2019. A unique form entrenchment in Islamic Banks and its impact on performance and firm risk, *working paper*.

Nawaz, T. 2017. Exploring the nexus between human capital, corporate governance and performance: Evidence from Islamic Banks. *J. Bus. Ethics*. https://doi.org/10.1007/s10551-017-3694-0.

Obaidullah, M. (2005) Islamic Financial Services, Islamic Economics Research Center, King

Abdulaziz University, Jeddah, Saudi Arabia. Scientific Publishing Centre, Jeddah, Saudi Arabia.

Safieddine, A., 2009. Islamic financial institutions and corporate governance: New insights for agency theory. *Corp. Gov.: An Int. Rev. 17*, 142-158.

Safiullah, M. and Shamsuddin, A., 2018. Risk in Islamic banking and corporate governance. *Pac. Basin Financ. J. 47*, pp.129-149.

Shleifer, A. and Vishny, R.W., 1989. Management entrenchment: The case of manager-specific investments. *J. Fin. Econ. 25*, 123-139.