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Relationship of Islamic Bank's Profitability with Corporate Governance Practices

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Abstract
This research has been done to find the impact of good corporate governance practices on the profitability of Islamic banks. The main objective of this study is to identify the impact of corporate governance on the profitability of Islamic banks of Pakistan. The corporate governance measures used are ethics and corporate social responsibility. The profitability is measured through the ratios of return on assets (ROA) and return on equity (ROE). The sample used for the study was Islamic banks of Pakistan. A well-designed, structured and verified questionnaire was used to collect data. Data was analyzed by using regression analysis. The findings of the study revealed that all these variables of corporate governance have a significant relationship with the profitability of the banks. The profitability of Islamic banks of Pakistan tends to increase with the adoption of good corporate governance practices. Thus better profitability can be achieved by using good corporate governance practices and by being more ethical and by working for society. The study was limited in terms of time and small sample size. The future prospects of the study are wide.

INTRODUCTION

The concept of corporate governance cannot be exactly defined. For understanding, it can be thought of as a system or procedure by which companies and their managers are directed and controlled. The concept not only includes the management but it includes a fair, transparent and an efficient administration which is capable to meet the desired objectives. This is a practice or procedure which structures, operates and controls a company so that its long term strategic goals can be achieved. In this way, all the legal requirements can be fulfilled and the shareholders can be satisfied.

Corporate governance can be defined as a combination of rules and regulations, laws and practices though which corporations attract human and financial capital. Thus they perform in an efficient manner, work for the society and maximize the value for its shareholders.

Corporate governance refers to the organizations which include the rules and regulations and the business procedures which can direct the relationship between stakeholders and managers (Oman, 2001).

The Code of Corporate Governance in Pakistan was circulated in March 2002 for the first time. Prior to this it was noticed that the existing business schools were not focusing on developing strong corporate governance. Thus Pakistan Institute of Corporate Governance was developed to focus on training of directors, staff of SECP and stock exchanges and bringing awareness about corporate governance. This institute was developed to form a bridge between regulators and corporations who are the two prominent stakeholders in the corporate world. Sec 37 of SECP has made it compulsory for all listed companies to fulfill the code of corporate governance. Moreover, the companies have to represent their non executive directors.

Banks are generally more obscure than non-financial firms and due to this reason the government interfere more in the banking industry (Levine; 2004)There are less chances of a well governed bank to fail because it will more likely allocate capital efficiently. They also assure that capital in other firms is being allocated in an efficient manner. It can thus bring financial stability which will encourage growth and investment.

Different studies have considered firms for their research on corporate governance. This study is mainly important because there is lack of empirical evidence on the topic within the context of Pakistan, with special reference to Islamic banks in Pakistan. This research adds value by contributing to the banking literature by investigating the relationship between importance of good governance system in banks and the profitability of Pakistani Islamic banks. They can now have the knowledge that how they should adopt corporate governance practices to improve their profitability.

LITERATURE REVIEW

Corporate Governance

The duties of directors and managers are assigned and their accountability towards stakeholders and investors is defined by the rules and standards of organizations. These rules and standards constitute corporate governance. (Prowse, 1998) The OECD Organization for Economic Co-operation and Development (2004) defines it in the way that business corporations are controlled and directed by a system and this system is corporate governance. This system comprises the rules and regulations which direct the relationship between the managers,

stakeholders and shareholders of corporations. It proves to be a factor to growth and financial stability by supporting market confidence and economic efficiency.
The primary point in corporate governance of the firm was laid out by Berle and Means (1932). They found that when ownership and management were separated, scattering of ownership was created which made it difficult to monitor the management. Demb and Neubauer (1992) says that
Corporate governance is the process which ensures that corporations are approachable regarding the rights of their stakeholders. Monks and Minow (1996) explains that corporate governance shapes the direction and profitability of corporations.
Neubauer and Lank (1998) outline the concept of corporate governance by saying that it is a system of processes which control and direct the corporations and account for them. Corporate governance explains all the factors which have an effect on institutional processes. These include the process such as appointing the regulators who are involved in organizing the services. Turnbull (1997)
According to Selznick (1994) governance is more than management and has to consider all the interests that affect the feasibility, moral character and competence of an enterprise. Corporate governance is the principal agent relationship problem as traditionally discussed. Mayer (1997)
According to Mallin (2007) corporate governance is the way the companies govern their businesses and this depends on which stage of corporate governance development are they.
Banks which have followed and executed the reform policies have improved their profitability. These policies which were implemented in 1990's have helped them to devise principles for better corporate governance mechanisms. Ineffective corporate governance mechanisms in banks are pointed out as the main factors contributing to the recent financial crisis. Profound changes in this area are necessary to reinforce the financial sector stability. For creating the foundations for a new order of the financial market, new regulations and guidance are presented. (Marcinkowska, 2012)
Effective corporate governance in bank will lead to:

- Increased efficiency in bank activities.
- Minimized risks.
- Increased growth of banks in markets.
- Investor confidence leading to strategic way to enter in capital markets.
- Stabilized economy.
- Low cost of capital.

Ethics
From the earliest civilizations, man has sought to govern individual and group behavior through
behavioral standards, codes, principles and rules. Maheshwari & Ganesh (2006) says that the basic objectives of these codes were founded in the ultimate survival of the civilization or group. It served both to strengthen security and protection, while enhancing mutual existence and peace within the group. These standards gave rise to the concept of 'ethics'.
Literature provides two broad meanings for the concept of ethics. Firstly ethics is defined as the quality which constitutes good and bad human conduct. Huberts, Van den Heuvel & Punch (2000) and Sullivan and Shkolnikov (2006) says that it is associated with principles that concerns right and wrong and the significance of the impact of these choices on others. Secondly, ethics is seen to be underpinned by a set of social values by means of which the actions of individuals can be tested. In a social group, such as an organization, the ethical standards are often defined using social values as base. So, ethical values are those values which are in agreement with these social values.
Maheshwari & Ganesh (2006) says that the core values of a group or organization should lead to specific habitual behaviors and become the standards for future behavior. Sullivan & Shkolnikov (2006) express ethics as the collection of values and principles that govern the conduct in an individual or group. These principles form the basis of integrity and provide guidelines for conflict resolution and optimizing mutual benefits of people existing in groups.
Huberts et al. (2000) explains that ethics as a set of principles are often defined in a code such as societal laws or a code of conduct in organizations. These codes provide a framework for individual actions. An ethical code contains the ethical norms to which a corporation commits itself in respect of individual conduct by members of the organization. Ethics comes from the word "ethikos" and "ethos" which means custom or habit. Ethics are the customs and values of different people and groups. It includes concepts such as responsibility of what is right and wrong or good and evil. (Wikipedia; 2006a)
Ethics involves that how the behavior of a person should be. Values relate to the beliefs which determine that how a person is actually behaving. What is considered to be ethical is determined by the specific group or society. People can have and do have both ethical and non-ethical values. The ethical values are related directly to what is right or good. Confusion arises over ethics because debates circle on what people actually do in reality

instead of focusing on what they are supposed to do. (Walker; 2001)
Sullivan and Shkolnikov (2006) argue that ethics is the collection of values and principles that govern the conduct of an individual or group. This point of view is supported by the Parr Center for Ethics (2007) who states that one's ethics is the systematization and application of one's values. Usually people's ethics will differ when their values differ, but people with similar values may arrange or structure them differently in ranking of importance. Different ethics may be present in people with similar values. For instance, two people may both value courtesy, but while one may view getting straight to the point in a conversation as courteous behavior, this conduct may be viewed as rude by another person with a background and culture that considers unhurried conversation courteous.
The increasingly conscience market of the 21st century demands more ethical business procedures. (Wikipedia; 2006a) Corporate governance has a definite and clear ethical character. Companies are required to take accountability for their influence on society and on their stakeholders. Importance of corporate governance corresponds with an increase in the emphasis of ethics of business. (Rossouw; 2005)
The survey results of KPMG (2001) found that in many organizations, training on the code of ethics is too little and thus is not effective. Also, it is not focused on new entrants and managers which are an important part to be focused on. Mostly, ethics criteria did not form any part of performance. No reward or promotion criterion is associated to it. So ethics are not properly followed. It may then be concluded that coordinated and continued effort is needed to integrate corporate governance, performance, ethics and values.
Maheshwari and Ganesh (2006) agree that organizations are monitored by a set of ethical standards as determined by professional and legal bodies, governments and other public interest groups. They agree that, due to conflicting interests of different organizational stakeholders, managers and employees face the dilemma of identifying ethically appropriate decisions and behavior. Thus, it has become imperative to have an ethical orientation among the people who manage, and work in an organization.
Richtermeyer, Greller and Valentine (2006) explain that the concern for ethical decision-making and ethics programs increased significantly following fraudulent scandals, the abuse of managerial power by some prominent organizations and the strong social condemnation of their business practices. Berenbeim (2006) says that ethics programmes may be considered as more than an exercise in minimizing the risk of potentially harmful employee conduct, but is rather a modern hallmark of business excellence.
Ethical congruence is a condition when an individual's decision is coherent and is aligned with the organizational code of ethics and values. It is in the organization state where there is an association between values, behaviors and perceptions. (The Ethics Resource Centre, 2007) Corporate governance ensures that firms take the responsibility to direct and control their matters in a way that the interests of stakeholders are preserved. The processes forming corporate governance system ensures that the corporation will act in a manner that is transparent, fair and accountable. (Rossouw; 2005)
The corporate governance aspect deals with introducing the procedures through which the values are attained and ethics is considered a behavioral guide. (Sullivan and Shkolnikov; 2006) Berenbeim (2006) is of the opinion that the implementation of corporate governance programs that are consistent with the core values of an organization will enhance the social capital of the company by increasing the goodwill received from stakeholders. Because of the above-mentioned thoughts and points, most corporate governance documents such as the King Report (2002) propose the implementation of a code of ethics (code of conduct).

Corporate Social Responsibility
Corporate Social Responsibility (CSR) is a concept in which the corporations put together their environmental and social affairs in the business procedures and interact with the stakeholders. This trend is clearly visible globally as more and more business owners have started to pay attention for social implications of their activities. Commission of the European Communities (2006)
Maignan & Ferrell (2001) explains corporate social responsibility (CSR) as a citizenship function with social, ethical and moral responsibility among a company and its customers. Chaudhry & Krishnan (2007) says that corporate social responsibility is fast gaining importance as more and more firms are realizing its value. They say that recently, business owners all over the world have started to think in terms of integrating CSR activities into their core business strategies and started to assess its effect seriously.
Moir (2001) defines corporate social responsibility as a commitment by business towards ethical behavior when it all begins. Baker (2008) says that it is not only about how the companies manage their business operations to create an overall positive image on the society. But, as Carroll (1979) expresses, it covers all the four kinds of responsibilities which are ethical, economic, legal and discretionary, and which companies have to make a strategic decision.
Enquist, Edvardsson, and Sebhatu, (2007) finds out that CSR's role in tackling problems concerning corporate responsibilities of a company and its link with the society and environment has been a very controversial subject. Mostly it is perceived that CSR is not what is written in company's code of conduct or annual reports. The thing

being written is only one portion of total CSR plans used by the company. Generally, social responsibilities of an organization have to include all the three bottom lines: Economic lines, Ecological lines and Social lines.

Wood (1991) says that the under lying theme of CSR is that business and society are not two different units but are interlinked. Freeman, Wicks, and Parmar (2004) describes that business and ethics should be seen as connected. Governance is more than management and has to take care of all the interests that have an effect on the moral character, feasibility and competence of an enterprise. Selznick (1994)

The customers are the co-creators of value so CSR and CG are also integrated like any other resource of the firm to give value to its stakeholders. According to van den Berghe and Louche (2005), CG and CSR can work jointly to bring honesty, transparency, and accountability in the organizational processes. Marsigla and Falautano (2005) have recommended that corporate governance and CSR ideas are progressing from charitable activities to valid strategies to recover the confidence of both society and clients at large.

Jamali, Safieddine, and Rabbath (2008) discusses that Both CG and CSR are supposed to give ongoing benefits and ensures the continued existence of the business. When it is implemented with corporate governance in organization, it helps to attract employees, managers, owners and other stakeholders that in return give long-lasting affects to the organizational profits. Business has the responsibility that extends further than the maximization of profit. It should have positive role in society. People having the same perspective believe that firms have social obligations as well. (Bonn and Fisher; 2006)

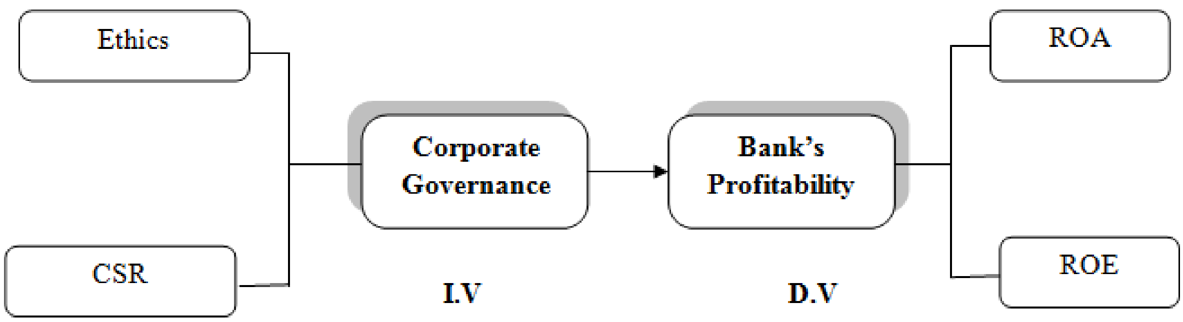
Firms have to bring social sustainability. Human resource practices are incorporated with organizational justice and demand for an ethical governance system. The needs of different stakeholders are seen and different methods of governance are implemented depending on how a corporation views its social responsibility obligations. (Simmons; 2004) Corporate social responsibility is a point of every firm which cannot be ignored and is an important part of the strategy of the firm. (Galbraeth; 2006)

Corporate Governance and Firm Profitability

The essential feature which should be present in any entity to call it a business is that it should have the intention to earn profit. There are many studies which show that there is a strong linkage between corporate governance and profitability. This study also finds out the impact of corporate governance on the profitability of the banks.

Firms having weak corporate governance are seen to perform in a poor manner. (Core, Guay and Rusticus; 2004) The correlation between financial profitability of a firm and corporate governance was explored by Bhagat and Bolton (2008)

Theoretical Framework



DEPENDENT AND INDEPENDENT VARIABLES

The independent variable is corporate governance which uses two measures or components which are ethics and corporate social responsibility (CSR). The dependent variable is profitability which is evaluated through two components; return on assets (ROA) and return on equity (ROE).

RESEARCH OBJECTIVES

Following are the major objectives of the study:

Main objective

The main objective of this study is to identify the impact of corporate governance on the profitability of Islamic banks of Pakistan.

Sub objectives include:

i. To examine the effect of ethics on corporate governance and consequently on the profitability of the banks.
ii. To see the impact of Corporate Social Responsibility on corporate governance and bank's profitability.

Research Hypotheses

The hypotheses obtained after the literature review are presented as follows:

H1: There is a significant relationship between Ethical Practices and the Profitability of Islamic banks.
H2: There is a significant relationship between Corporate Social Responsibility and the Profitability of Islamic banks.

RESEARCH METHODOLOGY

The study is of causal nature. Hypotheses are tested through descriptive research design. Descriptive research includes observation, questionnaire, case study or interview. The research tool adopted by me is questionnaire.

POPULATION AND SAMPLING

Population

Population is the collection of all members or entities about which the researcher is interested to draw the conclusions (Huysamen, 1994). The researcher should clearly identify the population before selecting sample size Wilson (2010). The population of this study is;

- Islamic banks in Punjab, Pakistan.

Sampling

Sample is that part of population from which the data is actually collected (Moore; 2009). The sample was selected on the basis of convenience sampling technique. This was done on the basis of corporate governance data available. On convenient base five Islamic banks were selected. They are as follows:

- Albaraka Bank
- Bank Islami
- Burj Bank
- Dubai Islamic Bank
- Meezan Bank.

The employees of these banks were asked to fill the questionnaires.

Tools and Instruments

Research depends on the measurement instrument used. The researcher has to use some tool to collect the data. The tool or instrument used to collect data in this research was questionnaire. The questionnaire is most appropriate tool used in descriptive research. A well-designed, structured and verified questionnaire was used to collect data.

A questionnaire for measuring two variables was developed based on the five point Likert Scale.

The variables used for this purpose are:

Variable	Definition
Ethics	It is the quality which constitutes good and bad human conduct.
CSR (corporate social responsibility)	It is a commitment by business towards social and ethical behavior when it all begins.

The questionnaire consisted of two parts.

The first part was related to the variable of ethics. 20 questions were asked to check this variable. The second part was related to the variable of CSR about which 16 questions were asked. So, there were a total of 36 questions in the questionnaire.

The likert scale is used for the variables having statements for each variable as follows:

Constructs	No. of items	Reference	Year
Ethics	20	Schwepker	(2001)
CSR	16	Selznick	(1994)

Data Collection

Primary data was acquired by giving out the questionnaire to the relevant people who were the bank's employees. The questionnaires were given by hand to the employees and about 40-50 questionnaires were sent by email to different branches of the sample banks.

In order to collect primary data, 250 questionnaires were used and data collection was done personally from 20 branches of Islamic banks of our sample.

Total questionnaires sent	Response Received	Percentage of response
250	215	86%

DATA ANALYSIS AND RESULTS

Data Processing

Data was analyzed by using the statistical tool of SPSS version 16. Different statistical techniques were used to test the hypotheses. The statistical method used for analysis is regression.

Data Analysis

To confirm the significant relationship between the Profitability of Islamic Banks and Ethics and CSR, the current study selected the Ethics and CSR as a predictor variable and profitability of the banks as a predicted variable.

Cronbach's Alpha

To check the internal reliability of the instrument, Cronbach's alpha was applied. The value of alpha lies between 0 and 1. In our case, the value of Cronbach's Alpha is 0.761, which is above the threshold level suggested by Hair et al (2006) of 0.6.

Regression

First of all, we need to discuss the goodness of research model.

ANOVA[b]

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	220.324	4	55.081	2922.064	.000[a]
	Residual	1.791	95	.019		
	Total	222.115	99			

a. Predictors: (Constant), ETHICS, CSR
b. Dependent Variable: ROA

When considering ROA, The results of ANOVA test confirm the goodness of the research model. In this study, the F-Test value is 2922.064 and it is significant with $p < 0.000$.

ANOVA[b]

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	32013.365	4	8003.341	169.526	.000[a]
	Residual	4484.956	95	47.210		
	Total	36498.321	99			

a. Predictors: (Constant), ETHICS, CSR
b. Dependent Variable: ROE

While considering REO, The results of ANOVA show the value of F-Test to be 169.526 which also confirms the goodness of research model and shows that it is significant with $p < 0.000$.
Now, we discuss the results of model summary.

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.996[a]	.992	.992	.13730

a. Predictors: (Constant), ETHICS, CSR

The table of model summary explains the percentage change in the predicted variable due to the predictor variables. According to the results of the study, the 99.2% change in the ROA of Banks is due to Ethics and CSR.

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.937[a]	.877	.872	6.87096

a. Predictors: (Constant), ETHICS, CSR

For ROE, the table of model summary explains that according to the results of the study, the 87.2% change in the ROE of Banks is due to the Ethics and CSR.

Ethics

The first hypothesis is related to the ethical behavior followed by the bank in its code of conduct. This hypothesis postulates that ethics will have an effect on the profitability ratios of return on assets (ROA) and return on equity (ROE) of Islamic banks. The proposed hypothesis is:

H1**:** There is a significant relationship between Ethical Practices and the Profitability of Islamic banks.

Regression Results:

IV	DV	β coefficient	p-value
ETHICS	ROA	0.008	0.046
ETHICS	ROE	0.039	0.038

The regression results of the study confirm the significant positive relationship between Ethics and ROA of the banks. The value of regression coefficient is (β=0.008) and the value of p is significant ($p < 0.05$) at 0.046. The regression results of the study also confirm the significant positive relationship between Ethics and ROE of the banks. The value of regression coefficient is (β=0.039) and the value of p is significant ($p < 0.05$) at 0.038.
This acceptance of hypothesis shows that by following ethical behavior, the profitability and profitability of banks can be increased

Corporate Social Responsibility
The second hypothesis which is about CSR practices postulates that corporate social responsibility will have an effect on the profitability ratios of return on assets (ROA) and return on equity (ROE) of Islamic banks. The proposed hypothesis is:
H2: There is a significant relationship between Corporate Social Responsibility and the Profitability of Islamic banks.

Regression Results:

IV	DV	β coefficient	p-value
CSR	ROA	0.020	0.043
CSR	ROE	0.086	0.045

The regression results of the study confirm the significant positive relationship between CSR and ROA of the banks. The value of regression coefficient is (β=0.020) and the value of p is significant ($p < 0.05$) at 0.043. The regression results of the study also confirm the significant positive relationship between CSR and ROE of the banks. The value of regression coefficient is (β=0.086) and the value of p is significant ($p < 0.05$) at 0.045.
The acceptance of the hypothesis shows that the profitability of the banks increased when they follow the practices of corporate social responsibility.

FINDINGS
The purpose of this research was to find out the impact of corporate governance practices on the profitability of Islamic banks. This research relates that how different variables of corporate governance affect the profitability of banks.
The first hypothesis states that there is a significant relationship between ethical practices and profitability of Islamic banks. Results also showed a significant positive relation with the profitability of banks. The ratios increased when the bank behaved in a more ethical manner. These ethical practices are drawn from the bank's ethical code which is made for the betterment of all including employees, general public and owner. By acting on these principles, the profitability of banks will tend to rise.
The second hypothesis was that corporate social responsibility and profitability of bank has a significant relationship. The analysis of the variable of corporate social responsibility with ROA and ROES shows that as the bank will follow the practices of corporate social responsibility, it will move towards better profitability. It showed a positive relationship with bank's ratios of ROA and ROE. Thus we can conclude that by acting on the concept of CSR, the profitability of the bank can be increased. All banks are linked with society and the one doing work for the society will definitely have an edge over others in the form of better profitability.
Thus we found that how different measures or variables of corporate governance have an influence on the profitability of the Islamic banks. From the above discussion, it is found that there is a significant relationship between corporate governance practices and the profitability of banks. The banks should, therefore, follow good corporate governance system in order to have better profitability.
SUGGESTIONS AND RECOMMENDATIONS
After carrying out the research on the topic of corporate governance and its relation to bank's profitability, different suggestions which can be presented are as follows:

- The code of corporate governance should be compulsory to adopt.
- Proper implementation of corporate governance code will lead to have the chances of better profitability.

This will lead to the economic development of the country.
- Government should encourage the enhancement of corporate governance.
- Attention should be paid on better implementation of corporate governance in the banks.
- Awareness should be brought among employees and general public related to this concept.
- Improved models for practice in Pakistan should be proposed.
- Banks should give more attention and importance to the concept of CSR.

LIMITATIONS

The limitations of this study are discussed here now.
- The most important constraint was time.
- Small sample size due to lack of time and also because of using convenience sampling.
- The study is conducted on Islamic banks only which are very few as compared to the conventional banks.
- Different approach of each bank regarding corporate governance concept.
- Less awareness regarding corporate governance among the employees.
- Lack of knowledge on concept of corporate social responsibility.

FUTURE IMPLICATIONS

The future implications for this study can be following:
- Research can be done on conventional banks of Pakistan.
- A comparative study can be drawn on corporate governance of Islamic and conventional banks and their profitability.
- A study can be conducted for comparison of developed and developing economies.
- More variables of corporate governance can be considered.

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