Risk Management & Corporate Governance Characteristics in the Malaysian Islamic Financial Institutions

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Abstract

Purpose – Aim to examine the association between board characteristics and risk management committee (RMC) whether it is combined or separate with audit committee in the Malaysian Islamic financial institutions. This study will give an in-depth overview to explore about the risk management and corporate governance practices in the Islamic financial institutions especially on the oversight function and performance.

Design/methodology/approach – This study employs secondary data collected from the Islamic banks' annual reports for the period 2006 – 2009.

Findings – It was found that the existence of RMC is significantly associated with proper governance at the board of directors' level and thus, an effective and adequate Board member with larger size tends to have greater oversight monitoring function towards the company's activities. It is easier to establish a separate risk management committee (RMC) and with greater levels of resources offered by larger boards, there would be less pressure to establish a combined risk management and audit committee. Furthermore, the result shows that company leverage has positive significant relationship with the existence of RMC and separate risk management committee with audit committee (SRMC) where a large proportion of long-term liabilities entail greater financial risk and firms with high leverage are more likely to have debt covenants and higher going concern risks.

Originality/value – Since there are lack of studies conducted in this area, specifically among the Islamic banks in Malaysia, this study will broaden the scope by providing empirical evidence of the relationship between risk management committee and board characteristics in the Islamic financial institutions.

Keywords: Risk Management, Corporate Governance, Islamic Financial Institutions

1. Introduction

In view of the recent aftermath of corporate scandals collapses such as Enron and WorldCom, numerous governance practices initiative around the globe have grown drastically to improve corporate governance, particularly emphasising on the role of risk management function. An effective risk management system is seen to be helpful towards an organisation to achieve its business objectives, enhance its financial reporting as well as safeguard its reputation (Subramaniam, McManus, and Zhang, 2009). Literally, risk is an inescapable element of any business activities and also for the financial risk and a company is also susceptible to business risk or changes in the overall economic climate that can adversely affect the price of its securities (Amran, Abdul Manaf and Che Haat, 2009).

According to the revised MCCG (2007), the board of directors should consist of executive directors and non-executive directors whereby the executive director refers to a leader that is a full time employee and is a part of the management team. Meanwhile the non-executive director is not a full time director within the organization which can be either independent or non-independent director that plays an important role in monitoring the management and executive directors' actions and performance towards corporate governance. A non-executive director is seen as a medium of check and balance that would enhance the board's effectiveness and performance in bringing independence to the board of directors and provide skills diversity and expertise in various areas (Abdullah, 2004).

In addtion, Bukhari, Awan & Ahmed (2013) stated that corporate governance is a fundamental framework to monitor companies' corporate conduct, which is relatively more important for the governance of financial institutions. 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.

Currently, risk management practices in the banking sector are focusing on financial and operational risk towards their products and services. There are many risks involved in the financial institution such as market, credit, equity and operational risk. Risk management is a continuous process that depends directly on changes in the internal and external environment of banks which require continuous attention for identification of risk and risk control. In response to the call to enhance the effectiveness of risk management, banks in Bahrain, like those in many other countries, are required to comply with Basel II (Hussain & Al-Ajmi, 2012). Meanwhile according to Khan and Bhatti (2008), they observed that Islamic banks face another crucial challenge to improving their risk management strategies and corporate governance. Currently, they are extremely exposed to all sorts of risks, such as those relating to interest rates, liquidity, and non-payment (Hassan, 2009).

An effective risk management mechanism is crucial in order to sustain the business growth and continued profitability of the banks irrespective of whether it is conventional or Islamic. A study on the risk disclosure and reporting has been done in Malaysia to explore the availability of such risk disclosure in annual reports for listed companies which focused on non-financial section of the reports (Azlan, Manaf and Che Haat, 2009). However, it is different for financial institutions especially for Islamic banks since there is a common perception that Islamic banks are not based on interest rates. Emphasis on this matter is being highlighted since the Islamic banking needs to be in accordance with Shari'ah rulings which are compulsory and to be strictly abided by for any transaction through contracts.

Therefore, Bank Negara Malaysia (BNM) has published a clear guideline under the Islamic Banking Act 1983 that is Governance of Shari'ah Committee in 2005 which sets out the rules, regulations and procedures in the establishment of a Shari'ah Committee. However, the study on the existence of risk management committee (RMC) in most Islamic financial institutions in Malaysia which is in association with corporate governance practices are still scarce and requires further attention in order to mitigate such financial and operational risks that directly involves Shari'ah rulings and regulations. Thus, it is important to have a study that examines the existence of RMC and the association with board characteristics (independent chairman, non-executive directors, board size, Shariah board size and Shariah education for Islamic financial institutions in Malaysia in order to have greater view and exposure on the association of both risk management and corporate governance practices based on Shari'ah requirements.

In view of the fact that there is no study conducted to examine the existence of corporate governance functions towards risk management in the Islamic financial institutions, this study provides further insight on the association of corporate governance practices in Malaysia that particularly involve the board of directors characteristics and Shari'ah committee towards the establishment of RMC in Islamic financial institutions.

2. Literature review and hypotheses development

Conventional banks have played the role of financial intermediation for many years whereby the interest difference was the main source of revenue that is also supported by charges, commissions, and other fees (Akkizidiz and Khandelwel, 2008). Basically, these banks are focusing on interest rates, accounting, various products and services, risk management activities, as well as long term strategies that mare mainly based on interest rates. However, the Islamic approach or Shari'ah rulings questions about the necessity and validity of the interest in the process of financial intermediation and desires to provide justification on the wealth and income distribution.

The establishment of Islamic banks is intended to cater for the need of Muslims to follow the Shari'ah principles categorizing it into features including the prohibition of interest, the use of profit sharing and other investment activities. The attractiveness of Islamic banks to Muslims is mainly due to the compliance with Shari'ah in their dealings, whether with shareholders, current and investments account holders or others whose funds such banks invested (Mohd Ariffin, Archer and Abd Karem, 2009). Hence, a proper monitoring and governance such as Shari'ah RMC should be established since it is a practice in the commercial banks in order to ensure the risk in any Islamic financial institutions are managed in line with Shari'ah requirements.

Therefore, a combined RMC with AC would not only oversee the risk management function itself but also to be actively involved in financial reporting and related oversight function as well (Alles et al., 2005). However, by having a separate and distinct RMC will allow committee members to fully focus on various risk processes and reports in order to provide a better quality internal monitoring rather than having a combined committee. To ensure the effectiveness of governance towards risk management performance, a separate role between RMC and AC function should be adhered in order to maintain the AC independency and better quality of reporting and monitoring function. However, the BNM guideline does not outline any requirement in having separate or combined RMC with the AC.

The chairman of the board is the representative of the Board's decision in any particular matters and their role is to ensure proper governance towards the organisation activities which separates the role of Chief Executive Officer (CEO) of a company at the management level. Separation of power between the Chairman and the CEO may provide better view in making decision for any critical issues that might impair the organisation's objective and efficiency. However, the effectiveness of the board will be jeopardised or lose its control when there is a duality role in the board whereby the Chairman of the board is also the CEO of the company. This will ensure that conflict of interest between the independent chairman & CEO functions are properly segregated and able to further enhance the company's performance through effective decision making between both parties. Measurement used for this variable is based on dichotomous number "1" which represents independent chairman (separate role as Chairman and CEO) and "0" represents non-independent chairman (combine the role of Chairman and CEO.

Thus the following hypotheses are developed:

H1(a). The existence of an RMC is significantly and positively associated with an independent chairman on board.

H1(b). The existence of a separate RMC is significantly and positively associated with an independent chairman on board.

According to Aktaruddin, Hossain & Yao (2009), the increase in the number of BOD means an increase in disclosure 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. According to Abdullah (2004), the non-executive directors are expected to bring independence role and responsibility into the board of directors in order to have various diversity of skill and experience for better decision making purposes. Non-executive directors should be persons with calibre, credibility and have the necessary skills and experience in order to bring an independent judgment to bear on issues pertaining to strategy, performance and resources including key appointments and code of conducts (MCCG, 2007). Results showed that a high proportion of independent non-executive directors are essential as it allows more effective monitoring and controlling the management's action especially providing information on company's position to safeguard shareholder's interests. This is in line with resource dependency theory suggests that the board of directors or the governor have the ability to span the companies (Zahra and Pearce, 1989). Board of directors are viewed as a medium of communications and interaction with external environment which acts as an alternative mechanism in seeking access to external resources for corporate performance development. This theory also suggests that the role of board in the corporate strategy and board of directors is viewed as a moderator of strategy formulation (Zahra and Pearce, 1989).

Thus the following hypotheses are developed:

H2(a). The existence of a RMC is significantly and positively associated with the percentage of non-executive directors on the board.

H2(b). The existence of a separate RMC is significantly and positively associated with the percentage of non-executive directors on the board

Study done by Goodstein et al. (1994) argued that the smaller boards, between four to six members might be more effective since they are able to make timely strategic decisions, while larger boards are capable of monitoring the actions of top management (Zahra and Pearce 1989). Hence, the larger of board size is likely to entail more resources for the board to allocate to other sub-committee with relevant and suitable qualification and expertise such as risk management to coordinate and be involved with the management. Study done by Gupta (2011) indicates that board size plays an important role in having an effective decision making for the organization. Therefore, the larger the board size shows that the greater view and idea can be provided in other function within the management. The measurement of board size is based on the total numbers of board members available within the organisation.

Thus the following hypotheses are developed:

H3 (a). The existence of a RMC is significantly and positively associated with board size.

H3 (b). The existence of a separate RMC is significantly and positively associated with board size.

To ensure that the Shariah Committee would be able to function effectively, the composition of the Shariah Committee shall consist a minimum of three (3) members (BNM, 2005). This is to ensure that the composition is sufficient to manage the matters related to Shari'ah compliance according to different areas of nature. The study conducted by Besar, Sukor, Muthalib & Gunawa (2009) shows that procedures for Shari'ah review for Islamic Financial Institutions are to include the planning review procedures, executing review procedures, preparation, review of working paper as well as procedures in documenting conclusions and preparation of the Shariah review report. This is to ensure that the Shariah review can be conducted and completed systematically and in a timely manner. Therefore sufficient numbers of committee members on the board should be able to assist in ensuring the effectiveness of the committee activities.

Thus the following hypotheses are developed:

H4 (a). The existence of an RMC is significantly and positively associated with Shari'ah board size.

H4 (b). The existence of a separate RMC is significantly and positively associated with Shari'ah board size.

Conventionally, all registered companies under the Company's Act will have an annual financial report which indicates the company's financial position for the year. In order to have a better understanding on the technical tools in accounting, Raber (2003) suggested that the board of directors should be a financially literate person. Having such competency would allow the directors to make better decision making in order to improve company's corporate image and management's credibility (Haniffa and Cooke, 2000). Thus, the board education is crucial and it is important to have various knowledge and expertise in order to perform better decision making related to the operation activities within the Islamic financial institutions especially when it is involved with Shari'ah rulings practices. The members should have a required knowledge and skills in handling matters within their jurisdictions and law that is related to Islamic principle rulings.

Thus the following hypotheses are developed:

H5 (a). The existence of an RMC is significantly and positively associated with Shari'ah education.

H5 (b). The existence of a separate RMC is significantly and positively associated with Shari'ah education.

3. Research design

As at 31 December 2010, there are 17 Islamic banks listed in the Bursa Malaysia securities. These banks are chosen as a sample study from 2006 to 2009, for four consecutive years. However, 2010 was excluded due to insufficient data available since the annual report for these banks are yet to be published in Bursa Malaysia and will not be included in this study. According to the MCCG (2007), the establishment of RMC is crucial in order to have a quality and effective monitoring mechanism towards business risks in achieving their objectives. Hence, by having this committee within the organisation it can identify and mitigate such risks to ensure the business operation runs smoothly without any cost incurred that may impair business performance. Therefore, this dependent variable is based on the existence of the RMC and whether the committee is separate or combined with AC that can be measured by using dichotomous number of 1 and 0. If there is an existence of such committee within the Islamic bank studied, therefore it is "1" and "0" for nil. Same applies to the separate or combined with AC, whereby "1" refers to separate with AC and "0" is combined with AC.

Table 1 summarises the measurement of the variables used in the study. Independent chairman is related to the separation of duties or roles of a person as the chairman and CEO of the company. Secondly, the non-executive directors (NEXECDIR) which is based on the proportion of non-executive directors to a total number of directors in the board. Non-executive directors refer to directors from outside the organisation that divided to two (2) categories which are the Independent non-executive directors and Non-executive Non-independent directors.

Board education is used to identify the education background of Shari'ah board members in providing assurance towards Shari'ah compliance that is related to Islamic financial transactions. Appointment of the Shari'ah Advisory members are based on the qualified personnel in the Shari'ah or have knowledge and experience in Shari'ah banking which possess necessary knowledge, expertise and experience in fiqh muamalat studies (Central Bank Act 2009). Measurement for this variable is using dichotomous number whereby number "1" represent members that have Shari'ah education/principle and "0" is for others education.

The size of Shari'ah committee focuses on the numbers of Shari'ah commitee size held in the organisation that have the oversight function towards matters related to Shari'ah compliance. Measurement for this variable is based on total number of Shari'ah committee or also known as the Shari'ah Advisory Council within the Islamic bank. There are 2 control variables identified for this study, firstly is the company's size. Studies done by Amran et.al (2007), indicate that size of an organisation is probably influenced by risk management establishment within the organization. This is also aligned with the BNM requirement that Islamic banks setup should establish RMC and governance function (IBA 1983). Thus, log of total asset (LgTA) was used as a proxy for size and being used for book values of assets measurement.

Secondly is the company's leverage which has been used in many studies. According to Abraham and Cox (2007), leverage was measured by long term debt to total asset (TD/TA). Companies that have a large proportion of long-term liabilities entail greater financial risk (Goodwin and Kent, 2006). The data is analysed based on the following logic regression models:

Model 1:

$$RMC = \beta0 + \beta1(INDECHAIR) + \beta2(NONEXEC) + \beta3(BODSIZE) + \beta4(SHARI'AH) + \beta6(EDUCATION) + \beta7(FIRMSIZE) + \beta8(LEVERAGE)$$

Model 2:

SRMC = β0 + β1(INDECHAIR) + β2(NONEXEC) + β3(BODSIZE) + β4(SHARI'AH) + β6(EDUCATION) + β7(FIRMSIZE) + β8(LEVERAGE)

Where,

RMC – Risk Management Committee, SRMC – Separate Risk Management Committee

β0 – Coefficient of intercept, β1 – β8 – Coefficient of slope, INDECHAIR – Independent Chairman, NONEXEC – Non-Executive Directors, BODSIZE – Board Size, SHARI'AH – Size of Shari'ah Committee, EDUCATION – Shari'ah Education, FIRMSIZE – Firm Size, LEVERAGE – Total debt/Total Asset.

Table 1 – Variables for Analysis of Risk Management and Board Characteristics

Types of Variables	Variables	Acronym	Measurement Scale
Dependent	1) Risk Management existence 2) Separate/ Combined Risk Management with AC	RMC SRMC	A dichotomous variable where 1 = the existence of a RMC (either a separate committee or a committee combined with the AC) and 0 = no RMC. A dichotomous variable where 1 = the existence of a separate RMC and 0 = combined RMC with the AC.
Independent	**<u>Board Characteristics</u>** 1) Independent Chairman 2) Non-Executive Directors 3) Board Size	INDECHAIR NEXECDIR BOARDSIZE	A dichotomous variable coded as 1 = company has an Independent chairman and 0 = no Independent chairman. The percentage of non-executive directors on the board calculated by the number of non-executive directors divided by the total number of directors on the board. The total number of directors on the board.
Independent	**<u>*Shari'ah* Board Characteristics</u>** 1) Education 2) Size of *Shari'ah* Committee	EDUCATION SBODSIZE	A dichotomous variable coded as 1 = *Shari'ah* background and 0 = others. The total number *Shari'ah* board of directors on the board.
Control	1) Company size 2) Leverage	Log TA TD/TA	Log (Total Assets) Total Debt to Total Assets

4. Findings

Table 2 indicates the population of RMC and AC formation in Malaysia's Islamic banks from 2006 onwards. By the year 2009, all 17 banks have established RMC at the Bank's Group level as per Bursa Malaysia requirements for public listed companies in Malaysia based on the revised MCCG (2007). Furthermore, among those 17 banks there are 3 banks that have established the RMC which combined with AC in 2006 at the Bank's Group level. However, according to Islamic Banking Act 1983 which was announced by BNM in September 2006, there is no specific requirement stating whether the RMC is to be combined with or separated from AC.

Moreover, it shows that Malaysia is committed in realizing the RMC establishment in the Islamic financial institutions as per BNM guidelines specifically under Islamic Banking Act 1983 for the financial institutions that is listed in the Bursa Malaysia since 2006. Further indicator shows that this is a positive improvement from the financial institutions sector to comply with the guidelines and to have proper governance monitoring through RMC establishment in the organisation.

Table 2 – Risk Management Establishment Combine or Separate with AC

	2006	**2007**	**2008**	**2009**	**Mean**
Separate	14	17	17	17	16.25
Combine	3	0	0	0	0.75
Total	17	17	17	17	17

Descriptive Analysis

Table 3 summarises the key independent variables which are Board size (BODSIZE), Shari'ah Board size (SHARI'AH), independent chairman (INDECHAIR), non-executive directors (NONEXEC), and education (EDUCATION). This table also include the control variables used in this study; firm size and leverage.

Table 3 - Descriptive Statistics of Independent Variables

	N	**Minimum**	**Maximum**	**Mean**	**Std. Deviation**	**Skewness**	**Kurtosis**
BODSIZE	68	5	16	8.06	2.14	0.79	1.61
SHARI'AH	68	0	7	3.66	1.39	0.23	1.08
NONEXEC	68	0.40	1.00	0.87	0.10	-1.49	1.76
INDECHAIR	68	0	1	0.79	0.41	-1.49	0.22
EDUCATION	68	0	1	0.90	0.31	-1.67	2.30
FIRMSIZE	68	$8.42	$11.44	$10.07	$0.67	0.14	0.23
LEVERAGE	68	0.00	1.67	0.88	0.21	-1.83	2.30

Table 3 above shows that minimum value for firm size is RM8.42billion and the highest or maximum value of the firm size among the 17 companies is RM11.44billion. Furthermore, the minimum value on company's leverage is nil and the maximum value is 1.67 which shows that most financial institutions are able to cover their debts over the company's assets. Based on the descriptive analysis above also, it is noted that the maximum number of board of director is 16 people that oversees the organisation as the oversight function monitoring.

However the minimum number of board of director identified in this study are 5 persons with an average of 8 members that sit on the board. Furthermore, the maximum number for Shari'ah Committee size is 7 persons with an average of 3 persons sitting in the committee and an average number of 3 directors were identified for Shari'ah committee members for the period. BNM has established the New Shariah Governance Framework for Islamic Financial Institutions that was only issued officially in May 2011 which supersedes the previous Shariah Governance Guidelines issued in 2004. Hence there is no proper or effective framework that has been set-up to further enhance the Shariah governance prior to 2011.

4.1 Correlation Coefficients

Table 4 above shows the Pearson correlation analysis result between the variables for this study. The result indicates that there is a positive linear correlation between firm size (FIRMSIZE) with RMC. It shows that size of a company is significant against the existence of RMC within the organization which the function is to oversee the company's operation and activities through risk management practices.

Table 4 - Pearson's Correlation between Dependent and Independent Variables

	FIRM SIZE	LEVER AGE	BODSIZE	*SHAR I'AH*	INDE CHAIR	NON EXEC	EDUC ATION	RMC
Model One:								
FIRMSIZE	1							
LEVERAGE	.153	1						
BODSIZE	-.066	-.100	1					
SHARI'AH	.070	.432**	-.068	1				
INDECHAIR	.285*	.112	-.089	.164	1			
NONEXEC	*-0.259	.304*	-.029	.289*	.243*	1		
EDUCATION	.116	.161	-.150	.196	-.053	.138	1	
RMC	.007*	-.032	.046	.208	-.089	-.143	-.059	1
Model Two:								
FIRMSIZE	1							
LEVERAGE	.153	1						
BODSIZE	-.066	-.100	1					
SHARI'AH	.070	.432**	-.068	1				
INDECHAIR	.285*	.112	-.089	.164	1			
NONEXEC	*-0.259	.304*	-.029	.289*	.243*	1		
EDUCATION	.116	.161	-.150	.196	-.053	.138	1	
SRMC	.065*	-.052	-.040	.074	.355**	-.189	-.105	1

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

4.2 Collinearity and Multicollinearity

Before the linear regression analysis could be conducted, multi-collinearity of variables must be checked to ensure better result output. A high tolerance value which is 90% or more shows little collinearity, meanwhile VIF is the reciprocal of the tolerance value. Hence, small VIF value that is 10 or less indicates low intercorrelation among the variables. Table 5 below shows that none of the variables has a value close to 0 and the VIF value indicate variables have value less than 10. Therefore, Table 5 below indicates that this study does not have any issues of collinearity and multicollinearity.

Table 5 - The results of multicollinearity

	RMC		**SRMC**	
	Tolerance	VIF	Tolerance	VIF
FIRMSIZE	0.635	1.574	0.630	1.571
LEVERAGE	0.718	1.393	0.717	1.392
BODSIZE	0.960	1.042	0.958	1.034
SHARI'AH	0.674	1.483	0.672	1.480
INDECHAIR	0.776	1.289	0.774	1.286
NONEXEC	0.679	1.473	0.677	1.472

4.3 Regression Analysis

Table 6 shows the relationship of the existence of RMC and SRMC towards governance characteristics in Islamic financial institutions in Malaysia. The results show that there are several variables noted that have significant relationship between both RMC and SRMC existence with governance characteristics such as board size and company leverage. Therefore, the results are based on logistic regression which analyses the organisational characteristics are associated with the existence of a RMC and whether the RMC is separate or combined with AC.

Table 6 Logistic Regression Result

Panel A: RMC Existence	B	Standard Error	Wald (z-score)	Predicted sign
BODSIZE	0.057	0.318	1.059*	+
SHARI'AH	1.420	0.907	4.136	+
INDECHAIR	5.397	2.123	0.561	+
NONEXEC	-27.962	13.456	0.857	+
EDUCATION	-15.673	1.538	0.117	+
FIRMSIZE	0.866	1.242	0.572	+
LEVERAGE	-5.006	8.600	0.077*	+
Constant	50.533	2.429	0.000	+
Model Summary	-2 Log likelihood		20.979	
Model X Square			0.251	P = 0.437
Nagelkerke R square			0.557	
Panel B: SRMC existence	**B**	**Standard Error**	**Wald (z-score)**	**Predicted sign**
BODSIZE	0.057	0.318	2.332**	+
SHARI'AH	1.420	0.907	2.451	+
INDECHAIR	5.397	2.123	6.460	+
NONEXEC	-27.962	13.456	4.318	+
EDUCATION	-15.673	1.538	0.000	+
FIRMSIZE	-0.558	1.242	0.202	+
LEVERAGE	-5.006	8.600	1.339*	+
Constant	50.533	2.429	0.000	+
Model Summary	-2 Log likelihood		15.670	
Model X Square			0.233	P = 0.862
Nagelkerke R square			0.342	

Notes: *p < 0.10; **p < 0.05 (one-tailed test of significance)

The first hypothesis is on independent chairman, where the function is to ensure there is a segregation of duties between chairman and the CEO role in managing the company. Independent chairman are seen to have strong motivations to maintain his/her reputation (Jensen and Meckling, 1976) and most likely to seek high quality monitoring in order to minimise the possibility of organisational failure. However, based on the result above H1 (a) and (b) is rejected in determining the relationship of independent chairman with the existence of RMC and whether it is separate with AC.

This is in contrast with the study found by Raghunandan et al., (2001), that an independent chairman is significantly associated with AC diligence and manage to reduce issues regarding on earnings management.

Furthermore, according to Chau and Leung (2006) also found that significant negative correlation between AC existence and the presence of an independent chairman. It shows that independent chairman have insignificant relationship with AC and towards RMC existence whereby the chairman independence role is important in monitoring other strategic level of activities and not concerning whether the RMC is separated or combined with AC.

Results show insignificant negative relationship between non-executive directors with the RMC existence and whether the RMC is separate from AC. This result indicates that the non-executive directors are not effectively playing a monitoring role towards the RMC and probably influenced by the management on their decision making. Their role does not importantly contribute to the RMC activities but is required in strategizing other areas of the company's operations. Hence, H2 (a) and (b) is rejected for this study. They tend to play safe in contributing less and managing the company since they are being appointed as outsider who have relationship or not with the company as the independent or dependent directors. This is in contrast with resource dependency theory which indicates that outside directors should bring outside resources such as skills, experience and knowledge into the company. Thus H2 (a) and (b) that hypothesised non-executive directors have significant impact towards the risk management existence and separate with AC is rejected.

Refer to the H3 (a) and (b), it is clearly stated in the regression analysis that Board size has the positive significant association with the existence of RMC and having the separation of RMC with the AC. Thus, both hypotheses are supported by suggesting that the larger boards size are able to allocate more resources required in order to maintain and operate other board committees within the organization. This finding is in line with the best practices of MCCG (2007), where the optimum number of the board members should be determined by the whole board to ensure that there are enough members to discharge responsibilities and to perform various functions in a company. Hence, the larger the number of board members available, the greater the opportunity to have directors with specific competencies to coordinate and involve in other committees such as risk management.

BNM Guidelines on Corporate Governance for Licensed Islamic Banks clearly states that Islamic banking institutions must ensure comprehensive and effective Shari'ah governance framework in managing Islamic banking operations in accordance to Shari'ah principles. Furthermore, Islamic Banking Act (IBA) 1983 also states that Islamic banking institution must be granted license to operate and ensure the establishment of a Shari'ah advisory body or Shari'ah committee in order to advise the bank and banking business operations to avoid any elements that contradict with Islamic rulings. However, regression analysis noted that there is no significant relationship identified between the size of Shari'ah committee with the existence of RMC and separate with AC in the Islamic financial institutions and thus, H4 (a) and (b) is not supported. The reason is that all banks have established a proper RMC that oversees the bank operations risks including the risk that is associated with Islamic products and transactions. In addition, Shari'ah committee is not involved or played their role as the monitoring mechanism in the Shari'ah risk in ensuring Islamic financial product offered is in accordance with Shari'ah rulings.

According to the Table 4.7 above, findings on Shari'ah education on the board committee shows no significant relationship against the existence of RMC as well as the separation of RMC with AC. Therefore, H5 (a) and (b) is not supported for this study. Finding from Hasan (2011) stated that roles of Shari'ah board involve aspects of Shari'ah governance which includes Shari'ah pronouncement (fatwa), supervision (raqabah) and review (mutabaah). Hence, the board may include a member other than those specialized in fiqh al-mu'amalat which should be an expert in the field of Islamic institutions and with knowledge in such area required (Ghayad, 2008) especially in risk management. The main reason of this result is that Shari'ah education is not an important element and directly related with the RMC and separate with AC, but it is important in the Shari'ah RMC. Furthermore, according to BNM Shari'ah Governance Framework which is announced in May 2011 indicate that Islamic banks are required to enhance the role of the board, Shari'ah committee and the management in relation to Shari'ah matters which also include the Shari'ah risk management establishment. However this finding is not supported in this study for the relationship between Shari'ah education with the existence of RMC and SRMC within Islamic financial institution from 2006 to 2009.

Furthermore, the result shows that company leverage is positively associated and significant with the existence of RMC and separate with AC. Companies that have a large proportion of long-term liabilities entail greater financial risk (Goodwin and Kent, 2006). Therefore, highly leveraged firms are more likely to have debt covenants and higher going concern risks. Lenders are more likely to demand better internal controls and related monitoring mechanisms. Consequently, there will be a greater demand for such companies to have a RMC to oversight such risks and with a separate RMC function may provide more effectively in risk oversight

(Subramaniam, McManus and Zhang, 2008).

5. Discussion and Conclusion

The objectives of this study are to examine the existence of RMC establishment in the Islamic financial institutions in Malaysia and to identify whether the RMC is separate or combined with AC of a company. Based on the regression analysis done, the results indicate that existence of RMC is significantly associated with the proper governance at the Board of Directors level and thus, an effective and adequate Board member with larger size tends to have greater oversight monitoring function towards the company's activities.

Secondly, the results also indicate that other factors (independent chairman, non-executive directors, Shar'iah board size and Shar'iah education) have no significant relationship with the existence of RMC and SRMC in the Islamic financial institutions in Malaysia. However, the analysis also shows that the company leverage has the positive significant relationship with the existence of RMC and SRMC in the Islamic financial institutions and thus supports the study done by Goodwin and Kent (2006), where companies that have a large proportion of long-term liabilities entail greater financial risk and firms with high leverage are more likely to have debt covenants and higher going concern risks. Therefore, leverage is one of the important elements in determining the existence of RMC and SRMC in the Islamic financial institutions.

The results indicate that independent chairman is insignificant towards the establishment of RMC either separate or combined with AC. It shows that the chairman is basically concentrating on the strategic issue and direction for the company. This is in contrast with study conducted by Jensen and Meckling (1976), whereby the Independent chairman are seen to have strong motivations to maintain his/her reputation and most likely to seek high quality monitoring in order to have less chance of organisational failure Furthermore, insignificant result was noted for non-executive directors that show they may be providing sufficient resources to the management in terms of strategizing the management directions and objectives through their skills and experience wise, but not in monitoring risk management. This is in line with the study conducted by Abdullah (2004) and Haniffa and Coke (2000) that non-executive directors do not play their important role as a monitoring function.

Insignificant relationship also noted on the Shari'ah committee where this committee is not directly involved with the risk management for a bank but more towards monitoring and advisory function focusing Islamic financial transactions or products that need to be aligned and complied with Shari'ah rulings. Therefore, the education background stated by BNM guidelines that require the members to have specialized jurists in Fiqh al-mu'amalat which is related to any risk management function and these elements are not supported through the analysis done which unable to justify the relevant relationship with the RMC existence and having the separate or combined RMC establishment.

One of the limitations of the study is the incomplete or insufficient information on Shari'ah disclosures and characteristics such as education background on specific or specialized jurists in Shari'ah principles and also the member's role and duties which is not clearly specified in the annual report. Hence, due to the announcement made by BNM on the Shari'ah governance framework which is effective in 2011 shall further improvise Malaysian Islamic financial institutions performance in disclosing more information (financial and non-financial) in their annual reports. Thus, future research may examine the relationship of the existence of Shari'ah RMC as per BNM guidelines of having such committee in the Islamic financial institutions. This study needs to perform in a longer period of study in order to have better results when using the regression model in identifying the relationship between variables. Lastly, future study should incorporate more independent variables that can be used to measure on the financial and non-financial performance for the Islamic financial institutions such as ratios, disclosure and transparency.

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