

2022-05

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<http://hdl.handle.net/10026.1/19078>

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10.1016/j.intfin.2022.101559

Journal of International Financial Markets, Institutions and Money

Elsevier BV

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## Journal Pre-proofs

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PII: S1042-4431(22)00047-6  
DOI: <https://doi.org/10.1016/j.intfin.2022.101559>  
Reference: INTFIN 101559

To appear in: *Journal of International Financial Markets, Institutions & Money*

Received Date: 14 September 2021  
Revised Date: 25 January 2022  
Accepted Date: 6 April 2022

Please cite this article as: N. Shahzad Virk, T. Nawaz, P. Molyneux, A Canary in a Coalmine! Religious agency and its impact on the performance of Islamic banks, *Journal of International Financial Markets, Institutions & Money* (2022), doi: <https://doi.org/10.1016/j.intfin.2022.101559>

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## **A Canary in a Coalmine! Religious agency and its impact on the performance of Islamic banks**

### **Abstract**

We examine the impact of religious agency on the performance of GCC Islamic banks. Our results show that a high proportion of prominent religious scholars on Shariah supervisory boards (SSB) improves financial performance. However, when a prominent Shariah scholar chairs the SSB there are negative performance effects. With the high concentration of a few Shariah scholars, our findings have twofold implications: first, future research should develop approaches to test Shariah governance effectiveness in relation to the assigned mandate of SSBs; second, there is a need for revisiting Shariah compliance mechanisms to mitigate the embeddedness of Shariah scholars and their influence on Islamic bank performance.

**Keywords:** Islamic banking, Shariah governance, entrenchment, conflict of interest.

**JEL classification:** G21, G3, G34, L25.



## 1. Introduction

Entrenchment is a contentious issue in the corporate governance literature. This may cause managerial misalignment to a firm's interests because of the perennial conflict of interest problem (Jensen and Meckling, 1976; Joseph et al., 2014). The empirical evidence shows that managers proactively pick projects that increase their control (Shleifer and Vishny, 1989) and entrenched managers tend to choose investment and financial policies that are not aligned to other stakeholders in the firm (Hu and Kumar, 2004; Kang et al., 2006, among others). Additionally, Core et al. (1999) and Joseph et al. (2014) note managerial entrenchment negatively affects firms' operational and financial performance. The entrenchment of large owners may also result in influencing investment decisions serving their interests at others' expense, namely by expropriating minority shareholders (Claessens et al., 2002; Dyck and Zingales, 2004; La Porta et al., 1999; and Williams and Ryan, 2007).

Virk and Nawaz (2018) identify that a few Shariah scholars are ubiquitous on Shariah Supervisory Boards (SSBs) – a religious governance system that prevails in the so-called dual governance system of Islamic commercial entities.<sup>1</sup> We aim to examine the impact of this religious entrenchment on the performance of Islamic banks (IBs).<sup>2</sup> Typically, the function of religious/Shariah governance (SG) is dispensed through Shariah Supervisory Boards (SSBs) (Ullah et al., 2018).<sup>3</sup> Prior evidence shows that IBs' performance is positively linked to the increasing size of SSB and when SSBs are assigned a supervisory role (Mollah and Zaman,

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<sup>1</sup> They report that across 47 Islamic banks (IBs), in the Gulf Cooperation Council (GCC) countries, 20 famous Shariah scholars occupy every second seat on SSBs.

<sup>2</sup> The application of Islamic restrictions/rules prohibit IBs from engaging in services and transactions that are interest bearing (riba – in Islamic terminology), speculative trading or investments (gharar and maysir, respectively), and requires IBs adopt a risk sharing model between borrower and lender (Nawaz, 2019). Following this IBs, other Islamic financial institutions as well, operate with a mandate to keep their financial and investment decisions within the ambit of Islamic jurisprudence/Shariah.

<sup>3</sup> The mechanisms to achieve Shariah compliance in the decision-making process differs in different segments of the Islamic Financial Industry (IFI), in which country the financial institution operates and type of Islam practised in that country. Differences in legal systems, regulatory frameworks, and the prevalence of Islamic banking practices along with linguistic and cultural differentiations can also influence homogeneity aspects across Muslim countries.



2015). Nawaz (2019) finds that board size and CEO power have a significant positive impact, while SSB size has the opposite effect when performance measures are market-based. Safiullah and Shamsuddin (2019) document that SSB with supervisory credentials improves IBs' profit efficiency.

Here, we note that earlier studies do not account for religious entrenchment that is shown to increase agency costs in Nawaz and Virk (2019). Therefore, we argue potentially the evidence in previous studies suffer from an omitted variable problem given the high concentration levels of a few SSs across the SSBs in GCC banks. Using the proposed measures in Virk and Nawaz (2018) to capture entrenchment in the network of Shariah scholars, we account for Shariah scholar entrenchment (SSE) and different aspects of SSBs and Shariah compliance on firm performance of GCC Islamic banks with book-based and market-based performance metrics. That is, we aim to uncover the effectiveness of dual board structure on the performance of GCC IBs in the light of SSE.

Gözübüyük et al. (2020) examine the network centrality of Shariah scholars and note that the costs of the Shariah scholar network outweigh their financial benefits linked to repute, legitimacy, and other factors. Virk and Nawaz (2018) document that entrenched scholars have incentives to enhance agency gains at localised and regional levels. Thus, entrenchment levels across Muslim countries and regions may be sectioned and segmented. The differences in Shariah compliance procedures may also create fragmentation namely, a few markets may be out of reach of Shariah scholars nominally for types of Islam practised in various countries, for example, Shariah compliance in Iran is organised through the central bank, whereas in the GCC it is mainly through SSBs. Therefore, to account for the heterogeneity in procedures to define, implement and monitor Shariah compliance across countries, we restrict our study to IBs operating in the GCC countries. The GCC region form a homogenous and substantial economic block in the Islamic finance market: in 2018 the GCC Islamic banking market makes up 45





percent of the total assets held (2.19 trillion USD) by all Islamic financial institutions (IFSB report, 2019).

The GCC offers a quasi-experimental setting that has substantial political, cultural, linguistic and religious similarities. The political system is also autocratic in which royals have a stronghold in channelling state wealth through banks and IBs. We extend this line of research by focusing on the top 20 scholars who are heavily consolidated in the GCC banking sector. This allows us to focus on the entrenchment of prominent Shariah scholars (PSS) that potentially shape a smoothing mechanism concerning the peculiar political-cultural contexts of GCC countries (Virk and Nawaz, 2018).

Our results show that the dominance of a few SS positively influences GCC IB performance whether we use the book- or market-based measures. Nonetheless, once we interact SSE levels with a dummy variable that captures if a PSS also chairs the SSB, we find adverse performance linkages. The positive SSE-performance result is consistent with earlier studies: it shows that after accounting for SSE the majority of governance variables known to affect the performance of IBs, such as SSB-size and the number of conventional directors, become insignificant. In sum, these findings show that SSE subsumes the impact of SG variables that have been used to capture the impact of SG in the prior literature.

However, when it comes to a negative relationship between the performance and interaction term of SSE and SSB-chair, our results ignite a new discussion while settling the prior ambiguities related to SG-performance relationships found in the literature (Mollah and Zaman, 2015; Nawaz, 2019 and Safiullah and Shamsuddin, 2019). That is, if there is acute entrenchment at the SS level then first, the positive SG-performance relationship is more confounding than appropriate. Second, the negative relationship between the performance of GCC IBs and SSE when one of the entrenched PSSs chairs the SSB should guide future research in designing experiments that evaluate the performance of Shariah scholars. This



implies there should be an inspection of SS performance, especially when they are entrenched, by relevant, standardised testing approaches.

The remainder of the paper is structured as follows: section 2 provides a literature review of general IB performance and GCC IBs in particular, then develops testable hypotheses for the empirical work. Section 3 describes data, section 4 outlines empirical methods and findings, and section 5 discusses empirical findings and section 6 concludes.

## **2. Background literature and hypotheses development**

Islamic finance is booming, especially in Asia and the Middle East and by the end of 2018, was valued at 2.19 trillion USD, compared to 195 billion USD in 2001 (Reuters and Standard, 2016). The IFSB Stability (2019) report shows that approximately 72 percent of the International Islamic Financial Services (IIFS) industry is held/managed by Islamic banks.

The empirical literature has investigated Islamic banking and its performance relative to conventional banks rather extensively. Issues analysed include performance, risk, and to a lesser extent, the role of Shariah Supervisory Boards (SSBs) and governance issues in the Islamic banking business model (Mollah and Zaman, 2015; Safiullah and Shamasuddin, 2018; 2019; Nawaz, 2019, among others). Expanding on this, in section 2.1 we summarise studies that have examined the performance of IBs and section 2.2 summarises related literature and develops testable hypotheses.

### *2.1. Islamic banking performance*

Numerous empirical studies have considered Islamic bank performance (e.g., Ashraf et al., 2017; Mollah and Zaman, 2015; Nawaz, 2019). Banks' performance has been assessed in terms of efficiency, stability and soundness, to produce an evidence base, which has led to divergent conclusions. Johnes et al. (2014) analyse the efficiency of 45 Islamic and 207 conventional banks across 18 countries during 2004-2009 and report that Islamic banks are on a par with



their conventional rivals in terms of gross efficiency. In a comparable study, Alqahtani et al. (2017) report that the profitability, capitalisation, and liquidity of Islamic banks outperformed that of conventional banks over the period before the 2007-08 global financial crisis. Bourkhis and Nabi (2013) pair match a sample of 34 banks of each type from 16 countries and report no significant differences between the performance of the two types of banks during the financial crisis. These results contradict the theoretical foundation of the Islamic banking business model that aims to enhance the soundness and stability of the financial system. Using principal component analysis, Bitar et al. (2017) compare the soundness of Islamic banks vis-a-vis conventional banks operating in 33 countries during 1999-2013 to reveal that Islamic banks are more efficient, more profitable and have lower credit risk.

Only scant attention has been paid to the link between governance and bank performance in general and Shariah governance in particular. Mollah and Zaman (2015) show that IBs' performance is positively linked to the increasing size of SSB and when SSBs are assigned a supervisory role. Nawaz (2019) analyses the impact of corporate governance mechanisms, belonging to conventional and Shariah co-governance, on IB's market-based performance. He finds that board size and CEO power have a significant positive impact, while SSB size has the opposite effect. His work also shows that Shariah compliance is not homogenous across IBs and corporate governance mechanisms are lax especially in large IBs. Safiullah and Shamsuddin (2019) document that the composition of SSB, with supervisory credentials, is conducive to improving Islamic banks' profit efficiency. Their results are consistent with Mollah and Zaman (2015). In sum, the foregoing literature provides mixed evidence with some studies reporting Islamic banks to be better performers than conventional banks while others finding little difference between the two types of banks.

## *2.2. Shariah scholar entrenchment and hypothesis development*



Entrenchment at any level (managerial or ownership) has strong implications for corporate governance. Entrenched managers may seek higher wages and larger perquisites from shareholders, increasing overall agency costs, as well as proactively designing investment policies to increase their control (Shleifer and Vishny, 1989). Furthermore, entrenched managers often choose investment and financial policies that are not aligned to other stakeholders in the firm (Hu and Kumar, 2004; Kang et al., 2006, among others). In addition, Core et al. (1999) note that managerial entrenchment has negative effects on firms' operational and financial performance. Sheifer and Vishny (1989) also report that firm managers entrench themselves to counter disciplinary forces and thus, make themselves valuable to shareholders and costly to replace.<sup>4</sup> Concentrated ownership is often linked to a lack of transparency, low disclosure quality, and entrenchment. To this effect, Claessens et al. (2002) find that deviations between control rights and cash flow rights of the largest shareholder diminish firm value, which is consistent with entrenchment effects.

Virk and Nawaz (2018) show that 20 PSS dominate the religious compliance in the GCC Islamic banking industry. They document that there are conditions that may spur entrenchment of a small number of Shariah scholars whether they stem from self-serving and opportunistic agency behaviour or their ability to steward an industry that needs them for reputational, stability and legitimacy reasons when the industry is yet evolving and suffers from a lack of standardisation.

We argue that in SSE there are, besides the limitations on human productivity, also issues of adverse selection and moral hazard for SSs when filling their role prudently. The sum of issues underpinned by a conflict of interest of religious scholars and asymmetric information

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<sup>4</sup> Corporate managers are monitored in several ways to ensure they function in shareholders' interest. Nonetheless, the literature questions the effectiveness of such mechanism that include board monitoring (Fama and Jensen, 1983); competition in the labour market of corporate managers (Fama, 1980); product market competition (Hart, 1984) and the threat of a takeover (Jensen and Ruback, 1983).





enhances the scope for self-perpetuation and collusion at the SS level with other corporate controllers – in return for substantial and multiplying economic gains. We interpret the high concentration of PSSs as a tool by which entrenched managers, and owners in IBs, may exploit devout clientele; with the side effect of potentially adversely affecting firm performance. Following this thread, SSE is a control vehicle for managers and owners who find it easier to deal with a limited number of accommodating SSs so that they both signal to outsiders that they follow Shariah whilst also, potentially, pushing their agenda. There might be operational reasons for the owners' and managers' preference for sticking with '*reliable SSs*': they have more freedom in designing and getting approval for new products and projects. Thus, a contrary explanation for SSE and IB performance is that bank executives may choose entrenched SSs as they believe this will boost performance however this, in turn, casts doubt on the independence and due diligence of the SSB in the IBs' governance apparatus. That is, in any form and shape, SSE questions the integrity, credibility and prudence of the Shariah co-governance system.

To start with the mixed evidence available on the impact of SSB on IBs' performance (Mollah and Zaman, 2015 and Nawaz, 2019), we hypothesise that large SSBs will positively influence firm performance:

*H<sub>01</sub>: SSB size is positively linked to firm performance (FP).*

Following this, and in line with resource dependency theory and ethical and religious consideration of the role, we hypothesise that if the SSB is assigned a supervisory role then it also positively influences bank performance:

*H<sub>02</sub>: The SSB with supervisory role is positively linked to FP.*



With the known problem associated with entrenchment, we construe that SSE will have adverse implications for firm performance. We hypothesise that increased levels of SSE may adversely affect firm performance<sup>5</sup>:

*H<sub>03</sub>: SSE is negatively related to FP.*

Finally, we also expect that interaction of SSE and a supervisory role dummy will also bring performance losses for IBs due to the noted effects of entrenchment:

*H<sub>04</sub>: The SSE interacted with SSB – chair is negatively linked to FP.*

### 3. Data

We retrieve data from three different sources for the cross-section of IBs in the GCC region for the period of 2007–2017. The firm related and financial variables are obtained from Bankscope and Datastream. The rest of the variables are handpicked from published annual reports and/or relevant company/scholar websites. We list the full set of dependent variables, their construction procedures and details on data sources in Table 1. Panel A of Table 1 shows we measure IBs' performance using the book- and market-based measures; respectively return on assets (ROA) and Tobin's Q (TQ). Panel B onwards in Table 1, provide definitions and operationalisation procedures for all the independent variables. These variables are categorised as Shariah compliance-related variables, conventional governance specific variables and firm-specific control variables. Table A. I Appendix A provides a list of acronyms used in this study.

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Insert Table 1 about here

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<sup>5</sup> That is to supervise or advise board of directors in determining which projects, products and services are Shariah compliant. This essentially limits the pool of feasible investments available to IBs and restricts risk-taking more appropriately risk sharing, among other covenants, of the IBs. Ashraf et al. (2017) report that Islamic equity investors' sacrifice potential returns by holding constrained portfolios but do that by reducing risk of their holdings and this risk reduction depends on what screening standards are adopted i.e. book-value based or market-value based.



In the empirical part of the work, we assess the impact of SSE on ROA and TQ performance measures for 47 GCC IBs. However, not all IBs in our sample are publicly listed so when we use market-based approximations, for example, TQ as firm performance, the sample of IBs is reduced to 30 banks. The number of observations in the regressions when we use accounting (market) based measures are equal to or less than 482 (312).

### 3.1. Measurement of Shariah scholar entrenchment

Following Virk and Nawaz (2018), we compute two SSE measures after identifying 20 prominent SSs from 2007 to 2017. The first SSE measure approximates cross-sectional changes in SSE: it computes a ratio of the prominent 20 SSs relative to the size of SSB in the IB 'i' in year t:

$$SSE_{IB} = \frac{\text{No. of 20 prominent Shariah scholars (PSS) on the } SSB_{i,t}}{\text{size of } SSB_{i,t}} \quad (1)$$

The second measure approximates yearly changes in the SSE levels: a year-by-year (YBY) SSE measure is computed by dividing the sum of the SSB seats occupied by the 20 PSS in year t by the aggregate of all SSB seats in the cross-section of sample banks in that year:

$$SSE_{YBY} = \frac{\sum 20 PSS_t}{\sum SSB_t} \quad (2)$$

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 Insert Figure 1 about here  
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### 3.2 Summary stats

Table 2, Panel A presents descriptive statistics for the firm performance and risk variables. The mean performance of sample IBs is positive across both measures. The ROA and TQ have positive averages of 0.41 and 1.1, respectively, implying that IBs have maintained their market value as well as generating positive economic returns.



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Insert Table 2 about here  
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Panel B of Table 2 shows the summary statistics for Shariah and corporate governance variables. The mean SSB-size is 3.7; whereas SSB-role has an average value of 63.04%, depicting the times when SSB has a supervisory role. Interestingly, the 20 prominent Shariah scholars occupy approximately 50% of the SSB positions using either of the proposed measures to capture SSE. The distribution of  $SSE_{IB}$  is more dispersed than the distribution  $SSE_{YBY}$ : the standard deviation (minimum and maximum values) of the former is 0.33 (0 and 1), whereas the same for the latter measure are 0.13 (0.33 and 0.72). The larger picture shows us that SSE in the GCC banking sector is substantial and, as shown by the cross-sectional industry average,  $SSE_{YBY}$  can occupy 72% of all the SSB seats in GCC IBs. The larger dispersion of the  $SSE_{IB}$  displays the fact that for a minimum of two SSB, the SSE varies across 0 and 1 with a large average value of 51%. These trends remain unchanged across years, which offers further strong evidence for Shariah entrenchment across IBs in the GCC region.

Turning to the conventional corporate governance variables, the average board size is 8.98 with a maximum value of 15. On average, non-executive directors represent 77% of the board positions and 78% of the boards do not separate the roles of CEO and chairperson. This implies the CEO maintains a lot of control. The average size of the internal audit committee is 4.15 with an 80% independence ratio. Lastly, Panel C presents the descriptive statistics for bank-specific control variables. Overall, the continuous variables have positive average values, showing that, overall, GCC IBs are growing. The average score for the number of existing subsidiaries illustrates the IBs' business model complexity. Similarly, IBs maintain high audit quality with over 82% IBs audited by the Big4 and 68% of the sampled IBs have adopted IFRS.

#### 4. Method and empirical findings





To assess the relationship between Shariah compliance mechanisms undertaken in previous research, SSE and IBs' performance, we begin our analysis with the following model:

$$FP_{i,t} = \alpha_i + \beta_{SSB}SSB - size_{i,t} + \Gamma_j X_{i,j,t} + \varepsilon_{i,t}, \quad (3)$$

$FP_{i,t}$  represents IBs' performance, which is approximated using both book-based and market-based measures to correspond to earlier findings in the GCC Islamic banking literature. To estimate models, we employ pooled OLS regression approach.<sup>6</sup> We repeat different specifications of this model by including various features of SSB such as SSB-role and SSB-chair. The latter variable has not been previously examined and is a dummy variable that takes the value of 1 if the SSB chair is one of the 20 PSSs identified in our work. Across model specifications, the  $X_{i,j,t}$  matrix contains different combinations of control variables (firm-specific and governance specific),  $j$  control variables for  $i$  IBs, including firm-specific variables, and other independent variables listed in Table 1. All models include time and country fixed effects. These dummies are N-1 and T-1 column vectors that take the value of 1 for each country and each year only and are zero otherwise, where N=6 and T=11 are the number of countries and number of years in the sample period studied in our work, respectively.  $\Gamma_j$  is the parameter vector whose length is dependent on the number of control variables in the estimated specification.

As noted in section 3.1, we measure SSE in two different ways. One is bank-specific ( $SSE_{IB}$ ) and the other captures the yearly changes in the entrenchment level ( $SSE_{YBY}$ ) in the GCC Islamic banking industry. We add our SSE proxies to all the models to examine the impact of

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<sup>6</sup> The choice of pooled OLS approach is backed by the high r-squared values when we include SSE into the model specifications. For robustness, we also use panel-GMM approach and re-run all the model estimations. Estimations from the GMM approach are similar to the outputs reported in this work (these results are available upon request). These similarities are both in size and significance to the results in this work. The working of entrenched scholars also makes pooling of data a plausible choice when SSE is not country/panel-specific element in the dataset of our work rather is a wider macro-level phenomenon (Virk and Nawaz, 2018) in the GCC region.



SSE on IBs' performance. This scheme enables us to evaluate the mixed, and at times conflicting, nature of the evidence produced by conventional measures of Shariah governance such as SSB size and SSB-role. Specifically, when we account for SSE, our baseline model is:

$$FP_{i,t} = \alpha_i + \beta_{SSE}SSE_{i,t} + \Gamma_j X_{i,j,t} + \varepsilon_{i,t} \quad (4)$$

In addition to the Shariah board performance assessment, we also include variables that account for unitary board governance attributes such as the number of independent executives, size of the conventional board, CEO-power, size of Audit committee etc., see Panel C of Table 1 for the full list of these variables. We also note here that our study tests for a new variable in this category as well: we account for Audit committee power (AC-power). This variable computes the proportion of non-executives who are audit committee members to the total AC size. Thus, our next model includes several corporate governance-related firm variables and examines the robustness of our baseline regression as well as attempting to isolate independent and conditional effects of two-tiered corporate governance mechanisms in IBs:

$$FP_{i,t} = \alpha_i + \beta_{SSE}SSE_{i,t} + \Gamma_j X_{i,j,t} + c_j CG_{i,j,t} + \varepsilon_{i,t} \quad (5).$$

For completeness, we add different features of SSB to the model specifications in equation 5 to investigate if SSE is a significant aspect in the presence of other known Shariah governance (SG) variables. We estimate the following equation:

$$FP_{i,t} = \alpha_i + \beta_{SSE}SSE_{i,t} + \Gamma_j X_{i,j,t} + c_j CG_{i,j,t} + s_j SG_{i,j,t} + \varepsilon_{i,t} \quad (6).$$

#### 4.1. Replication of Prior Evidence for GCC IBs

Using a homogenous sample of GCC IBs, we replicate models estimated in Mollah and Zaman (2015) and Nawaz (2019) to find that SSB-size is inversely linked to both ROA (Panel A of Table 3) and TQ (Panel B of Table 3). This relation, however, is statistically insignificant most of the time; the only exception is in Model 2 using ROA as a performance measure. However,



this significance disappears once we estimate the full model using firm-specific variables and all the variables related to CG and SG. This result questions some findings of Mollah and Zaman (2015), however, it supports their results when it comes to the role of SSB: the SSB with a supervisory role positively influence IB performance. Nonetheless, the conflicting results generated by the SG variables do not provide a coherent relationship using book-based and market-based performance measures.

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 Insert Table 3 about here  
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However, when it comes to conventional CG variables, our results are consistent with Mollah et al. (2017): BSize, NED-ratio and CEO-power are negatively linked to the performance of GCC IBs. In particular, CEO-power negatively (positively) influences IBs' book-based (market-based) performance measure. These findings endorse that GCC IBs have weak governance and are managed by strong CEOs. The market-based findings, however, for CEO-power point to the contrary about our latter inference.

#### *4.2. Shariah entrenchment and Islamic banks' performance*

To account for the impact of SSE and its influence on the performance of GCC IBs, we add our SSE proxies and re-estimate all models. That is, we estimate model specifications as in Eq. (4). Using both performance measures, we present the results for four different specifications in Eqs. (4-6) that include different sets of control variables from Table 1. In this instance, we first use  $SSE_{YPY}$  as our main variable of interest to capture the SS entrenchment effect.

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 Insert Table 4 about here  
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Results reported in Table 4 show that  $SSE_{YBY}$  improves IBs' performance and is significant at the 1% level when we use ROA as the performance measure (across all specifications). The



same result is available across all specifications in panel B of Table 4, the positive relationship between Shariah entrenchment and market-based performance is significant at the 5% critical level. Our results show that the coefficient on SSB-size is sensitive to the choice of performance measure: this effect is only negative and significant with a book-based measure. The results using the market-based measure imply a positive yet insignificant influence. These results add to the earlier findings of Nawaz et al. (2021). However, the impact of the SSB-role that drives the main findings of Mollah and Zaman (2015) is consistent with our results whether we use a book- or market- performance measure. We do not find any impact from our dummy variable that captures if a PSS chairs the SSB across both the Panels of Table 4.

Other inferential variations when we account for Shariah entrenchment result in divergent impacts of BSize, CEO-power and the NED-ratio across measures of IB performance. Nonetheless, these results are consistent with prior evidence and the estimated effects from Table 3. The only variables (like  $SSE_{YBY}$ ), that have a consistent and stable effect on both performance measures, are SSB-role and firm complexity (Fcomplexity) (Table 4). We show that SSE is an important feature that adds to the explanatory power for variations in the performance of IBs: the Adj.  $R^2$  are 0.557 (ROA as dependent variable) and 0.243 (TQ as dependent variable). In the first case, the increase in explanatory power is approximately four-fold, relative to the ROA model reported in Table 3 (for the market-based performance measure the explanatory power of the model increases about 50%).

About the effects of bank-specific control variables, results in Table 4 show that bank size and return on equity relate negatively to ROA. However, the same relation is absent with TQ. Banks with strong capital produce higher financial returns but higher bank capital has the opposite effect on TQ. These results are consistent with earlier studies (for example, Mollah and Zaman, 2015). Firm complexity, measured by the total number of subsidiaries in GCC IBs, relates positively with both measures. These results are economically significant and robust across





specifications, suggesting that business heterogeneity increases both financial returns and market value of IBs.

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 Insert Table 5 about here  
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In Table 5, we repeat estimations in Table 4 using our other entrenchment proxy, namely,  $SSE_{IB}$ . Generally, the results are consistent with those we found after proxying entrenchment using  $SSE_{YBY}$ . Overall, these results show that SSE improves firm performance, and our results accumulate evidence against our main testable hypothesis, namely,  $H_{03}$ . We do not find evidence supporting  $H_{01}$ ; however, support for  $H_{02}$  is significant even after SSE is accounted for. Taken together, these results show that prior evidence has had an omitted variable problem and, after incorporating SSE, the model explanations substantially improve in terms of adjusted r-squared values with both book- and market-based performance measures.

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 Insert Table 6 about here  
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Finally, we examine the impact of the interaction of SSE and SSB-chair dummy to assess hypothesis four and the results using  $SSE_{YBY}$  are reported in Table 6.<sup>7</sup> These results show that entrenchment is positively linked to IB performance; however, we find negative estimates on the  $SSE_{YBY} \times SSB\text{-chair}$  using both performance measures. These coefficients are only significant using TQ. This result supports hypothesis four: for the noted person-specific adverse impact on firm performance, we find that when entrenched boards are chaired by one of the PSS, it results in performance losses for the GCC IBs.

## 5. Discussion on main results

<sup>7</sup> The results using  $SSE_{IB}$  are consistent what we have reported in Table 6 and available upon request.



Our results for conventional board independence negatively relate to performance across all models when performance is measured by ROA, which implies that a higher fraction of NEDs on boards dampens IBs' financial performance. Thus, consistent with Coles et al. (2008), we argue that there is an implicit potential cost when NEDs lack bank-specific knowledge and such outside directors do not positively contribute to banks' financial performance. In consideration of issues outlined in Hudaib and Haniffa (2009) and Sidani and Thornberry (2013), we conjecture that the larger proportion of NEDs on the board can be an outcome of widespread *'homophily'* and *'nepotism'* in the region and that the negative outcome of firm performance and NED-ratio captures these selection biases. This suggests the NED, instead of bringing independent, expert or wider social voices, may serve as a tool to pursue other socio-politico goals of the IBs' owners/managers. Nonetheless, when it comes to a market-based performance measure, the relationship between the NED-ratio and TQ is positive and statistically significant at the 10% level. This result may capture a market preference for the availability of diverse voices on the board as argued by Nawaz et al. (2021). The findings for the other governance measures, such as CEO-power, internal audit control etc., are consistent with prior findings in Mollah and Zaman (2015) and Nawaz (2019).

## 6. Conclusions

Using handpicked data on the concentration level of PSS in SSBs in the GCC IBs, we examine the impact of SSE on the firm performance of 47 GCC IBs. Our results show that SSE (of which prior research has not accounted for) is an important factor when examining the variation in the performance of IBs, whether measured by book-based or market-based performance indicators. Once entrenchment is accounted for, all other known dimensions of Shariah compliance mechanisms, such as SSB-size, either have no link with the performance of IBs or are negatively linked to IBs' performance.



Despite concerns about entrenchment on SSBs, however, the impact on firm performance is contrary to our expectations. Our results show that it positively affects the performance of GCC IBs, whether estimated by a book-based measure or a market-based measure. The adverse effect of SSE is only found when one of the PSS also chairs the SSB. Even though our results show a positive SSE-performance relationship, we argue that the effectiveness and due diligence of the incorporated Shariah compliance tools in IBs is questionable when we see how few SSs take up so many SSB seats across GCC IBs.

In sum, we conclude that our results raise more questions than answers about the role of Shariah compliance mechanisms adopted in IBs. We conclude that our finding of a positive SSE-performance relationship adds to the evidence in prior studies, together with the finding that SSE brings negative performance gains when entrenched SS chair the SSB. Taken together, these findings illustrate how the clandestine nature of financial intermediation and functioning of IBs, as well as weak governance procedures in GCC countries, make it hard to assess the role and impact of different SG dimensions on firm performance (Mollah and Zaman, 2015). Consequently, it is difficult to gauge how effective overall IB governance features are in relation to performance, risk-taking or Shariah governance in general. Arguably, there should be enhanced and directed testing on the effectiveness of SSB as a co-governance mechanism when they are inhabited by a few SSs.

For future research, first, our results, especially those documenting the negative impacts of SSE when a PSS chairs the SSB, requires further analysis. In the wake of SSE, we note that current SG mechanisms are questionable, and the tests undertaken in earlier research falls short in assessing the true effect of the work and efficiency of SSs/SSBs. SSBs supervise or advisory the board of directors in determining which projects, products and services are Shariah-compliant. This activity essentially should limit the pool of otherwise feasible investments available to IBs and limit/restrict risk-taking by the IBs. This further questions the viability of



the SSB/SSE-performance related testing approaches. Thus, there is a clear requirement in the SG literature to stipulate testing mechanisms that examine the efficiency and prudence of SSs/SSBs and the prevailing role of SSE. We recognise this as the main implication of our work to guide future research.

Second, from a policy perspective, IBs should be made to provide first-hand data on the working of SSs, and SSB functioning and productivity. In this respect, the lack of transparency in GCC countries hampers data availability in general related to how Shariah compliance is implemented in the businesses and decision-making processes of GCC IBs. This requires regulatory bodies to draft regulations on periodic declarations from IBs to provide the number of projects assessed/approved by the SSB, annual/quarterly frequency of SSB meetings and SSB meeting minutes should be made available for academic and professional scrutiny. Furthermore, given the large financial monitoring costs of maintaining SSB co-governance, namely, remuneration of SSs and other related administrative costs, the remuneration data for SS should also be made available to enhance governance standards and transparency. Making this information publicly available will help improve the trust, reliability and efficiency in the IB sector where clients look for investments consistent with the values of their Islamic faith and ethical provisions. Otherwise, continuation with the current SG framework will continue to blemish the functioning of the Islamic finance industry.





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Table 1: Variables and their approximation schemes

<i>Variable name</i>	<i>Acronym</i>	<i>Operationalization</i>	<i>Data sources</i>
<b>Performance measures:</b>			
Return on Assets	ROA	Net income available to stockholders/Total assets	Bankscope & DataStream
Tobin's Q	TQ	[Market capitalization + total liabilities]/Total assets	Bankscope & DataStream
<b>Shariah entrenchment:</b>			
Shariah supervisory board (SSB) size	SSB-size	Log of total number of members of SSB	Hand collected
SSB role	SSB-role	Dummy variable that takes the value of one if SSB assumes supervisory role, and zero otherwise	Hand collected
Top20 prominent Shariah scholars (PSS)	Shariah scholar Entrenchment (SSE)	Identification of twenty prominent Shariah scholars in the industry	Hand collected
SSE in SSB in IB $t$	$SSE_{t,IB}$	Ratio PSSs to the size of SSB in IB $j$ in year $t$	Hand collected
SSE in SSB in year $t$	$SSE_{t,IB}$	Ratio of the sum of all seats occupied by PSSs to the sum of all SSB seats in year $t$	Hand collected
Top20 SSB Chair	SSB-chair	Dummy variable that takes the value of one if prominent Shariah scholar chairs the SSB, and zero otherwise	Hand collected
<b>Governance-specific control variables:</b>			
Board-size	BSize	Log of total number of members of board	Hand collected
Board independence	NED-ratio	Proportion of non-executive directors (NED) to total board size	Hand collected
Role duality (CEO power)	CEO-power	Dummy variable equal to one if the CEO is also chairman of the board	Hand collected
Audit committee size	AC	Log of total number of members of internal audit committee	Hand collected
Audit committee independence	AC-independence ratio	Proportion of NED to total audit committee (AC) size	Hand collected
Audit committee power	AC-power	Proportion of non-executives who are audit committee members to total board size (in percentage)	Hand collected
<b>Firm-specific control variables:</b>			
Bank size	TA	Log of total assets	Bankscope database
Capital	Capital	Log of total capital	Bankscope database
Liabilities	Liabilities	Log of long term debt	Bankscope database
Level of risk	Leverage	Total debt/Total assets	Bankscope database
Asset growth	AG	Degree to which bank assets increase (decreased) in value over time	Bankscope & DataStream
Return on equity	ROE	Return on equity	Bankscope database
Firm Complexity	Fcomplexity	Log of total number of existing subsidiaries	Hand collected





Table 2: Summary statistics

<i>Stats</i>	<i>N</i>	<i>Mean</i>	<i>Std. Dev.</i>	<i>Min.</i>	<i>Max.</i>
<i>Panel A: firm performance and risk measures</i>					
ROA	464	0.4175	1.1649	-0.5761	6.1244
TQ	302	1.1024	0.7595	0.2850	6.0214
<i>Panel B: Shariah and corporate governance measures</i>					
SSB-size	472	3.6978	1.0592	2	6
SSB-role	472	0.6304	0.4832	0	1
$SSE_{IB}$	472	0.5102	0.3248	0	1
$SSE_{YBY}$	472	0.5272	0.1245	0.3333	0.7169
SSB-chair	472	0.720	0.450	0	1
BSize	472	8.9870	2.0108	5	15
NED-ratio	472	0.7703	0.2117	0.2857	1
CEO-power	472	0.7848	0.4114	0	1
AC	472	4.1522	1.3279	3	7
AC-independence ratio	472	0.7957	0.1913	0.6	1
AC-power	472	0.3794	0.1802	0.1538	1.1667
<i>Panel C: bank-specific control variables</i>					
TA	472	8.1520	1.9377	2.6391	11.1747
Liabilities	472	7.5882	2.7273	-1.6094	11.4318
Capital	472	14.5618	1.0318	12.2538	16.5533
Leverage	458	3.5544	0.9152	-1.1087	4.4708
AG	312	0.0720	0.1959	-0.5629	0.5454
ROE	484	5.0800	15.1892	-47.15	31.62
Fcomplexity	470	1.5938	1.1011	0	3.1021

*Notes:* see table 1 the definition of the variables definitions.



Table 3: Impact of Shariah governance features on firm performance

Variables	Panel A: Financial performance (ROA)				Panel B: Market performance (TQ)			
	Model 1	Model 2	Model 3	Model 4	Model 1	Model 2	Model 3	Model 4
SSB-size	-0.0793	-0.127*	-0.0538	-0.0534	-0.0495	-0.00585	-0.0267	-0.0203
SSB-role		0.168	0.265**	0.298***		0.0524	0.0932	0.0915
SSB-chair			-0.0769	-0.0961			0.162*	0.147
BSize			-0.0118	-0.0107			-0.0303	-0.0352
NED-ratio			-0.300	-0.272			-0.00176	-0.0124
CEO-power			-0.896***	-1.062***			0.149*	0.165*
ACS		0.0615		0.129**		0.0323		0.0291
AC-independence ratio		0.421		0.901**		-0.404		-0.438
TA		-0.124	-0.0921	-0.0658		-0.0363*	-0.0344*	-0.0163
Capital		-0.0235	-0.0685	-0.0686		-0.0446	-0.0579	-0.0642
Liabilities		-0.0277	-0.0445	-0.0546		0.185***	0.205***	0.210***
Leverage		0.0154	-0.00900	0.0270		0.205	0.104	0.119
AG		0.0582	0.108**	0.110**		0.135**	0.100**	0.121**
ROE						-0.219	-0.132	-0.196
Fcomplexity		0.00423	0.00642**	0.00557*		0.000777	0.00219	0.00150
Constant	0.535**	1.568	3.643***	2.309**	0.767***	0.930	0.933	0.923
Country effects	included	included	included	included	included	included	included	included
Time effects	included	included	included	included	included	included	included	included
Adj. R <sup>2</sup>	-0.002	0.041	0.101	0.123	0.011	0.160	0.157	0.164

Notes: Superscripts \*\*\*, \*\*, and \* indicate statistical significance at the 1%, 5% and 10% levels, respectively.



Table 4: Impact of industry-specific Shariah scholar entrenchment on firm performance

Variables	Panel A: Financial performance (ROA)				Panel B: Market performance (TO)			
	Model 1	Model 2	Model 3	Model 4	Model 1	Model 2	Model 3	Model 4
$SSE_{YBY}$	0.939***	0.927***	0.919***	0.922***	0.438**	0.446**	0.498**	0.459**
BSize	-	-0.00770	0.0246	-0.0121	-	0.0116	0.00421	0.0223
NED-ratio	-	-0.614**	-0.622**	-0.624**	-	0.356*	0.368*	0.344*
CEO-power	-	-0.858***	-0.854***	-0.871***	-	0.144	0.153*	0.155*
SSB-size	-0.131***	-	-0.0658*	-0.0722**	0.0267	-	0.0265	0.0302
SSB-role	0.0614	-	0.168**	0.176**	0.164*	-	0.154*	0.166*
SSB-chair	-0.00237	-	-0.0647	-0.0696	0.0929	-	0.127	0.109
ACS	0.0146	0.115	-	0.130	0.0311	0.0151	-	-0.0120
AC-independence ratio	-0.417*	0.209	-	0.253	-0.326	-0.411	-	-0.522
ACS-power	-0.261	-0.748	-	-0.805	0.308	0.431	-	0.657
TA	-0.201***	-0.148**	-0.156**	-0.145**	-0.0157	0.00945	-0.00514	0.00545
Capital	0.121***	0.0471	0.0526	0.0582*	-0.241**	-0.230**	-0.231**	-0.243**
Liabilities	0.0465	0.0211	0.0154	0.0175	0.411***	0.403***	0.399***	0.414***
Leverage	0.0133	0.0173	0.00873	0.00838	0.163	0.0651	-0.0708	0.0120
AG	-	-	-	-	-0.128	-0.110	-0.0604	-0.113
ROE	-0.00353*	-0.00512**	-0.00447**	-0.00489**	-0.00278	-0.00376	-0.00502	-0.00430
Fcomplexity	0.0763**	0.126***	0.134***	0.122***	0.115**	0.0959**	0.0571*	0.0848**
Constant	-0.185	0.915	1.132	0.907	0.608	-0.0932	-0.00448	-0.0890
Country effects	included	included	included	included	included	included	included	included
Time effects	included	included	included	included	included	included	included	included
Adj. $R^2$	0.492	0.553	0.556	0.557	0.239	0.239	0.239	0.243

Notes: Superscripts \*\*\*, \*\*, and \* indicate statistical significance at the 1%, 5% and 10% levels, respectively.



Table 5: Impact of Islamic bank specific Shariah scholar entrenchment on firm performance

Variables	Panel A: Financial performance (ROA)				Panel B: Market performance (TQ)			
	Model 1	Model 2	Model 3	Model 4	Model 1	Model 2	Model 3	Model 4
$SSE_{IB}$	0.564***	0.553***	0.551***	0.551***	0.230**	0.226**	0.276**	0.235**
BSize	-	-0.00440	0.0153	-0.00799	-	0.0295	-0.000695	0.0378
NED-ratio	-	-0.482*	-0.497*	-0.501*	-	0.291*	0.293*	0.272
CEO-power	-	-0.871***	-0.877***	-0.896***	-	0.158	0.168*	0.168*
SSB-size	-0.132***	-	-0.0670*	-0.0712*	0.0279	-	0.0241	0.0325
SSB-role	0.115	-	0.218**	0.228***	0.166*	-	0.154*	0.173*
SSB-chair	-0.0110	-	-0.0740	-0.0791	0.0139	-	0.0373	0.0308
ACS	-0.0148	0.0820	-	0.0953	-0.00909	-0.0463	-	-0.0753
AC-independence ratio	-0.527**	0.108	-	0.140	-0.521	-0.694	-	-0.826
ACS-power	0.00160	-0.452	-	-0.480	0.649	0.929	-	1.192
TA	-0.224***	-0.180**	-0.185**	-0.174**	-0.0186	0.00476	-0.00478	0.00186
Capital	0.137***	0.0674*	0.0747**	0.0781**	-0.218**	-0.208*	-0.203*	-0.227**
Liabilities	0.0602	0.0383	0.0322	0.0333	0.398***	0.384***	0.379***	0.401***
Leverage	0.0106	0.0183	0.00891	0.00966	0.161	0.0590	-0.0717	0.0139
AG	-	-	-	-	-0.157	-0.104	-0.0869	-0.128
ROE	-0.00383*	-0.00536**	-0.00463**	-0.00501**	-0.00299	-0.00383	-0.00484	-0.00426
Fcomplexity	0.0894***	0.136***	0.141***	0.133***	0.117**	0.0975**	0.0538*	0.0860**
Constant	-0.0293	0.941	1.102	0.904	0.846	0.215	0.102	0.299
Country effects	included	included	included	included	included	included	included	included
Time effects	included	included	included	included	included	included	included	included
Adj. $R^2$	0.469	0.527	0.533	0.533	0.229	0.232	0.225	0.234

Notes: Superscripts \*\*\*, \*\*, and \* indicate statistical significance at the 1%, 5% and 10% levels, respectively.





Table 6: Impact of Islamic bank specific Shariah scholar entrenchment on firm performance

Variables	Panel A: Financial performance (ROA)				Panel B: Market performance (TQ)			
	Model 1	Model 2	Model 3	Model 4	Model 1	Model 2	Model 3	Model 4
$SSE_{IB}$	0.569***	0.573***	0.560***	0.567***	0.638**	0.282*	0.663**	0.591**
$SSE_{YBY} \times SSB - chair$	-0.00889	-0.0316	-0.0146	-0.0255	-0.599*	-0.0771	-0.579*	-0.522*
BSize		-0.00442	0.0156	-0.00769		0.0267	-0.00229	0.0295
NED-ratio		-0.486*	-0.499*	-0.504*		0.291*	0.273	0.255
CEO-power		-0.876***	-0.877***	-0.897***		0.156	0.161*	0.163*
SSB-size	-0.132***		-0.0678*	-0.0728*	0.0228		0.0187	0.0264
SSB-role	0.115		0.219**	0.230***	0.216**		0.206**	0.217**
SSB-chair	-0.00445		-0.0632	-0.0605	0.232*		0.247*	0.218*
ACS	-0.0136	0.0859		0.0982	0.00118	-0.0399		-0.0542
AC-independence ratio	-0.523**	0.120		0.149	-0.478	-0.668		-0.735
ACS-power	-0.00165	-0.457		-0.485	0.558	0.882		1.010
TA	-0.224***	-0.178**	-0.185**	-0.174**	-0.0167	0.00582	-0.00481	0.00350
Capital	0.137***	0.0688*	0.0753**	0.0792**	-0.251**	-0.214*	-0.236**	-0.254**
Liabilities	0.0600	0.0376	0.0320	0.0329	0.416***	0.389***	0.399***	0.417***
Leverage	0.00995	0.0161	0.00761	0.00776	0.00135	0.000596	-0.000868	-1.95e-05
AG					-0.122	-0.106	-0.0548	-0.103
ROE	(0.403)	(0.543)	(0.255)	(0.226)	-0.00288	-0.00406	-0.00516	-0.00445
Fcomplexity	0.0765**	0.127***	0.135***	0.123***	0.116**	0.0963**	0.0584*	0.0861**
Constant	-0.214	0.870	1.112	0.862	0.642	-0.183	0.0345	-0.0631
Country effects	included	included	included	included	included	included	included	included
Time effects	included	included	included	included	included	included	included	included
Adj. $R^2$	0.468	0.526	0.532	0.532	0.234	0.229	0.230	0.237

Notes: Superscripts \*\*\*, \*\*, and \* indicate statistical significance at the 1%, 5% and 10% levels, respectively.



## Appendix A

Table A.I: List of acronyms

Acronym	Definition
IB	Islamic Bank
IFI	Islamic Finance Institutions
IIFS	International Islamic Financial Services
IFSB	Islamic Financial Services Board
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
GCC	Gulf Cooperation Council
SG	Religious/Shariah governance
SSB	Shariah Supervisory Board
SSs	Shariah Scholars
PSS	Prominent Shariah scholar
SSE	Shariah scholar entrenchment

## Author statement

### CRedit authorship contribution statement

**Nader Shahzad Virk:** Conceptualization, Methodology, Investigation, Writing – original draft, Software, Formal analysis, Writing – review & editing, Visualization. **Tasawar Nawaz:** Conceptualization, Methodology, Software, Formal analysis, Validation, Investigation, Data curation, Writing – original draft, Writing – review & editing. **Philip Molyneux:** Conceptualization, Writing – review & editing.

## Highlights

- Impact of enconcing of religious agency on the performance of GCC Islamic banks (IBs) is analysed.
- Analysis shows that high proportion of prominent religious scholars on Shariah supervisory boards (SSB) improves financial performance of GCC IBs.



- Prominent Shariah scholars are detrimental for performance when they assume SSB chair role.
- Shariah compliance mechanisms in the Islamic banking business model needs revisiting to mitigate embeddedness of Shariah scholars.

## **A Canary in a Coalmine! Religious agency and its impact on the performance of Islamic banks**

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### **Compliance with Ethical Standards:**

The manuscript fully comply with the ethical standards set by the journal.

### **Conflict of Interest:**

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<sup>8</sup> First author.



There is no conflict of interest with any individual or organisation.

Journal Pre-proofs

