



Corporate Governance and Risk Management in Islamic  
Banking: Integrating Western Principles with Islamic  
Finance

by  
Bchr Alatassi

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## Abstract

The dynamic landscape of global finance has witnessed the growth of Islamic banking, which is characterized by its unique adherence to Shari'ah principles and ethical underpinnings. This thesis critically examines the evolving corporate governance (CG) landscape within Islamic banking, focusing on the integration of Western governance frameworks with the ethical foundations of Shari'ah compliance. Through a comparative analysis of CG codes across diverse jurisdictions, including the United Kingdom, Germany, Saudi Arabia, and Malaysia, the research develops a global governance framework that harmonizes profit maximization with the ethical mandates of Islamic finance. By synthesizing Western governance principles—primarily agency theory and shareholder wealth maximization—with the stakeholder-centric model inherent in Islamic finance, this research proposes a governance paradigm that enhances both operational efficiency and ethical responsibility in Islamic banks.

The research is underpinned by a pragmatic and hermeneutic philosophical framework, acknowledging the complexities of governance across diverse cultural and regulatory environments. A mixed-methods approach—incorporating both qualitative and quantitative methodologies—offers a holistic analysis of corporate governance structures within Islamic financial institutions. The study is theoretically anchored in agency theory, stakeholder theory, and stewardship theory, which collectively provide insights into the balance between shareholder value maximization and broader ethical obligations in financial institutions.

Adopting an integrated thesis approach, this research comprises three peer-reviewed paper-style chapters, two of which have already been published. Each chapter addresses interrelated aspects of CG and risk management in Islamic banking. The findings provide critical insights into the sector's growth trajectory, the comparative effectiveness of governance structures, and the operational intricacies of Islamic banks. The study highlights the evolving interplay between Western governance frameworks and Shari'ah-compliant financial models, emphasizing the significance of Shari'ah supervisory boards as a distinctive governance feature of Islamic banking.

A core focus of this research is the role of corporate boards in shaping risk management strategies, specifically examining the impact of integrating Western CG elements on Shari'ah compliance in Gulf Cooperation Council (GCC) Islamic banks. The study evaluates key governance mechanisms such as board independence, risk oversight, and the function of

Shari'ah boards, assessing their implications for financial stability and compliance. A quantitative analysis employing Z-score methodology demonstrates that incorporating Western governance practices—alongside Islamic ethical tenets—can enhance financial stability while maintaining Shari'ah compliance.

Ultimately, this thesis advocates for a hybrid corporate governance model that synthesizes Western CG frameworks with Islamic governance principles, offering a robust governance structure tailored to the unique ethical and financial imperatives of Islamic banking. This study provides practical recommendations for policymakers, regulators, and banking professionals, contributing to the global discourse on corporate governance and risk management. By proposing a governance model that aligns financial stability with ethical integrity, this research lays a foundation for future policy developments in the Islamic finance sector.

## Contents

Copyright Statement	2
Abstract	3
List of Tables	9
Table of Figures	9
Declaration	10
Preface and Personal Statement	11
Acknowledgements	13
Chapter 1: Introduction	14
1.1 Background and rationale for the study	14
1.2 The integrated thesis format and its appropriateness for this research	15
1.2.1 Nature of integrated thesis format	16
1.2.2 Appropriateness for the research on Islamic banking	19
1.2.3 Advantages of the integrated thesis format in this research	19
1.2.4 Challenges and considerations	20
1.3 The significance of corporate governance in banks	21
1.4 Overview of the Islamic banking sector and its growth	21
1.4.1 Growth of the Islamic banking sector	22
1.4.2 Factors contributing to growth	22
1.4.3 Impact on economic growth	23
1.4.4 Challenges of Islamic banking	23
1.4.5 Summary	24
1.5 Objectives and scope of the thesis	24
1.5.1 Exploring corporate governance in Islamic banking	24
1.5.2 Integrating Western corporate governance principles	25
1.5.3 Examining risk management in Islamic banking	25
1.5.4 Scope of the thesis	25
1.5.5 Contribution to the field	26
1.6 Conclusion	26
1.7 Thesis Structure	27
Chapter 2: Literature Review	29
2.1 Silk Road of Philosophy: bridging Eastern and Western traditions	30
2.1.1 Introduction	30
2.1.2 Western philosophical foundations	31

2.1.3 The Greek influence on modern governance	31
2.1.4 The Greek influence on the foundations of governance thought	35
2.1.5 Philosophies: rationalism, empiricism and governance	36
2.1.6 Islamic philosophical traditions	38
2.1.7 Ethical convergence: integrating Islamic philosophical principles with Western governance models in Islamic banking	40
2.1.8 Summary	45
2.2 Review of existing literature on corporate governance in Islamic banking	46
2.4. Theoretical frameworks: agency, stakeholder and stewardship theories	49
2.4.1 Link between theoretical frameworks and philosophical perspectives	50
2.4.2 Shareholding vs stakeholding	52
2.4.3 Agency theory vs stewardship theory	53
2.4 Risk management in Islamic banking	55
2.5 Chapter conclusion	56
Chapter 3: Methodology	57
3.1 Research philosophy	57
3.2 Research approach	58
3.3 Research design	60
3.4 Research strategy	62
3.5 Chapter conclusion and chosen methodology in the context of an integrated thesis	66
Chapter 4: Paper 1—Best practice in bank corporate governance: the case of Islamic banks	68
4.1 Introduction	70
4.2 Literature review	73
4.2.1 The importance of corporate governance	73
4.2.2 Theoretical underpinning	74
4.2.3 The significance of corporate governance in banks	78
4.2.4 The case of Islamic banks	78
4.2.5 Enhanced shareholder activism	81
4.3 Proposed conceptual model of corporate governance in Islamic banks	82
4.4 Conclusion	86
Chapter 5: Paper 2—A comparative analysis of corporate governance and risk management: an evaluation of board responsibilities in Western and Islamic financial banks	87
5.1 Introduction	89
5.2 Literature review	92

5.2.1 Theoretical overview	92
5.2.2 Risk management	94
5.2.3 Summary	102
5.3 Methodology	102
5.3.1 Data Collection	103
5.3.2 Analysis process	104
5.4 Results and findings	105
5.4.1 Risk management guidelines in countries	105
5.4.2 Similarities and differences between CG and risk management guidelines in the four countries	108
5.4.3 Board–committee relationships	109
5.5 Conclusion, limitations and future research	111
Chapter 6: Paper 3—Exploring the complex impact of internal corporate governance mechanisms on risk management in GC's Islamic banks	113
6.1 Introduction	114
6.2.Literature review	118
6.2.1 Corporate governance in Islamic banks	118
6.2.2 Risk management in Islamic banks	119
6.2.3 Risk management framework and strategies	120
6.2.4 Relationship between internal corporate governance mechanisms and risk management in Islamic banks	121
6.2.5 Internal corporate governance mechanisms and hypothesis development:	123
6.2.6 Control variables	127
6.3 Methodology	129
6.3.1 Data collection and sampling	129
6.3.2 Variables and roles	129
6.4 Findings	133
6.4.1 Descriptive statistics	133
6.4.2 Box's test of equality of covariance matrices	135
6.4.3 d. First 1 canonical discriminant functions were used in the analysis.	136
6.2 Discussion and interpretation of the results	141
6.3 Conclusion, implications and future research	143
6.4 Implications for policymakers and practitioners	144
Chapter 7: Synthesis of papers, discussion and integration	145
7.1 Analysis of the interrelationship between the papers	146
7.1.1 Contribution of each paper	146

7.1.2 Interconnectedness and theoretical foundations	147
7.2 The papers' collective contribution to the field of Islamic banking and corporate governance	147
7.3 Discussion of findings in the context of the overall thesis objective	148
7.4 Integration of insights from paper-style chapters with the wider literature and research objectives	149
7.4.1 Ethical and philosophical underpinnings	150
7.5 Conclusion and integration with research objectives	151
Chapter 8: Conclusion and future work	156
8.1 Summary of key findings and their implications for Islamic banking and corporate governance	156
8.2 Directions for future research, considering the gaps identified in the study.	158
9. References	161
10. Appendices	190
Appendix 1 Steve consent	190
Appendix 2 Rekha consent	191
Appendix 3 Second paper analysis	192
Appendix 3.1 Board's responsibility toward risk in the West:	192
Appendix 3.2 Board's responsibility toward risk in the East/Islamic countries:	194
Appendix 3.3 Shari'ah governance	196



## List of Tables

Table 1: Comparison of risk management in CG codes in the UK, Germany, Saudi Arabia and Malaysia .....	106
Table 2: Key differences and similarities in risk management guidelines .....	108
Table 3: Board-committee relationship.....	110
Table 4: Variables used in the discriminant analysis .....	129
Table 5: Descriptive statistics for healthy and unhealthy organisations .....	132
Table 6: Box's test of equality of covariance matrices .....	133
Table 7: Summary of canonical discriminant functions eigenvalues.....	134
Table 8: Wilks' lambda score.....	134
Table 9: Standardized canonical discriminant function coefficients.....	135
Table 10: Structure matrix.....	136
Table 11: Canonical discriminant function coefficients.....	136
Table 12: Functions at group centroids.....	138
Table 13: Classification results <sup>a,c</sup> .....	138
Table 14: Summary of the key findings of the analysis .....	139

## Table of Figures

Figure 1 Integrated thesis structure showing links between papers and key objectives.....	17
Figure 2 Link between theories of corporate governance and the integrated framework for Islamic banking (Theoretical Framework).....	52
Figure 3 The integrated theoretical framework of Shari'ah governance. Source: (Obid and Nasysary 2014, p.314) .....	55
Figure 4 Deductive and inductive research approaches (Source: Farquhar 2012, p.24).....	59
Figure 5 Abductive research approach (Source: author based on Farquhar 2012) .....	60
Figure 6 Diagram of the <i>UK Stewardship Code</i> 2012.....	83
Figure 7 Conceptual model of Islamic banks' corporate governance .....	85
Figure 8 Relationship between the independent, control and dependent variables used to analyse risk management performance (Conceptual model) .....	129

## Declaration

I hereby declare that the content of this thesis is based predominantly on my original research and contributions. This thesis contains no material that has been accepted for the award of any other degree or diploma in any institution or university. All sources of information, including quotations and citations, have been duly acknowledged in accordance with academic standards.

Furthermore, I confirm that this thesis has not been previously or simultaneously submitted, either in part or in full, for any other qualification at any university or institution. Where the work is co-authored, as indicated in the specified papers within this thesis, I have contributed more than 90% of the research and writing which aligns with the Bournemouth University research code of conduct. The co-authorship details and the extent of my contributions are clearly outlined and documented at the start of the relevant chapters.

The papers included in this thesis align with the overall research objectives and complement my individual research efforts. Each co-authored paper has been included with the explicit consent of the co-authors, who have verified my significant contribution as the first and main author of these papers and added to the appendices.

This declaration affirms my adherence to the principles of academic integrity and the ethical conduct of research.

## Preface and Personal Statement

This thesis—a culmination of years of research and exploration into the realm of CG in Islamic banking—is more than an academic pursuit: it is a journey that intertwines my personal and professional experiences across two continents.

As an immigrant from Syria, my academic journey in the UK has been a transformative experience, shaped significantly by my Master's degree in Finance and Risk Management at Bournemouth University. The study of CG, particularly under the tutelage of Professor Steve Letza, was a revelation, opening my eyes to the governance gaps in the Middle East and igniting a passion for this field.

The journey to this thesis has been a rollercoaster of challenges and milestones, marked by significant discussions and insights. My first meeting with Professor Letza, exploring the potential of PhD research, resonates profoundly with me as a pivotal moment that set the stage for this extensive work. Furthermore, it was during this period that my understanding of the critical role of CG in economic finance, especially in the rapidly growing GCC area where I previously worked, was solidified.

As I stand on the threshold of completing my PhD, my aspirations extend beyond the realm of academia. I am driven by a deep-seated desire to contribute to the field of CG in the Middle East where I came from. Moreover, my goal is to aid in nurturing young researchers and students in finance and business, guiding them in applying best practices in CG. Also, I aim to influence policy makers in that region to see Islamic finance playing a key role in the world economy with best practice applied in CG. This endeavour is not only a tribute to my roots but also an expression of my gratitude towards the UK, which I now consider my home. The opportunities this country has provided me, from becoming a citizen with a fresh start to a career as a Sales Director for a listed company, have been instrumental in shaping my journey.

My future aspirations include bridging the gap between theory and practice. By leveraging my experience in business, I aim to apply the academic insights gained through this thesis in practical scenarios, contributing to both the academic field and the industry.

Finally, this thesis represents not just a scholarly accomplishment but a personal commitment to using knowledge as a tool for improvement and development in both the East and West.

In essence, this thesis reflects my journey across cultures, academic disciplines, and professional experiences and it encapsulates my aspirations to contribute meaningfully to the fields of CG and Islamic banking, driven by a blend of personal motivation and academic curiosity.

## Acknowledgements

This thesis represents not just my efforts, but the support and guidance of many who have been instrumental in its completion.

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Moreover, I am grateful to the Business School at Bournemouth University for providing an environment conducive to research and intellectual growth. The resources and support offered by the institution have been fundamental in facilitating my academic pursuits.

On a personal note, I owe a debt of gratitude to my family, whose unwavering support and encouragement have been my constant source of strength. Especially, to my mother, who has been my main supporter and motivator, your belief in me has been the cornerstone of my resilience and perseverance. To my wife and the rest of my family, your patience, understanding and love have been the bedrock of my personal and academic journey.

Furthermore, I would also like to express my gratitude to my colleagues, including Dr. Rekha Pillai, whose collaboration and discussion around CG have enriched my research experience.

Finally, I would like to acknowledge the general support and companionship of my peers and friends, whose shared experiences and insights have contributed to a stimulating and enriching research environment.

## Chapter 1: Introduction

### 1.1 Background and rationale for the study

The advent and expansion of Islamic banking, marked by its adherence to the principles of Shari'ah law, represents a pivotal shift in the global financial landscape. This distinct form of banking, which eschews interest (Riba) and speculative activities (Gharar), has gained substantial traction globally. Islamic banks are now a prominent feature in over 75 countries, managing assets that run into trillions of dollars (Warde 2000; Iqbal and Mirakhor 2007). This growth trajectory has positioned Islamic banking as a significant player in the global financial system, offering an alternative to conventional banking that aligns with ethical and religious principles. However, the rapid expansion of Islamic banking has not been without its challenges and one critical area of concern is corporate governance (CG)—the mechanisms, processes and relations used to control and direct corporations. In the context of Islamic banking, CG takes on additional layers of complexity due to the need for compliance with Shari'ah law.

Conventional CG models, developed primarily in Western contexts, focus largely on maximizing shareholder wealth and managing the relationship between shareholders and management. Therefore, these models often employ frameworks and theories like agency theory to guide governance practices (Jensen and Meckling 1976; Mallin 2013). While effective in a Western context, these models may not be entirely suitable for Islamic banking, which operates on a different set of principles and ethical considerations.

Islamic banking is not just a financial model but also a socio-economic system that emphasizes risk-sharing, social justice and asset-backed financing (Ahmed and Chapra 2002). Moreover, this approach to banking reflects a broader set of objectives beyond profit maximization, including social and ethical considerations that are deeply rooted in Islamic law. As such, Islamic banks are not only accountable to their shareholders but also to a wider set of stakeholders, including depositors, employees and the communities in which they operate. Therefore, they take a broader theoretical approach and use key theories, such as stakeholder and stewardships theories, to complement their belief that the corporation has wider responsibilities than just to shareholders (Davis et al. 1997).

The rationale for this study arose from the observed gap in the application of CG in Islamic banking compared with conventional banking. The central hypothesis of this research is that integrating Western CG principles with Islamic banking practices could enhance the

effectiveness and robustness of governance structures within Islamic banks, while still maintaining compliance with Shari'ah principles. This integration has the potential to ensure the long-term sustainability and ethical operations of Islamic banks, aligning them with global best practices in governance while respecting their unique Shari'ah-compliant nature (Safieddine 2009; Farag et al. 2018).

The study aimed to bridge the gap in CG practices between Islamic and Western banking systems. Furthermore, it sought to explore whether the integration of Western CG principles with those inherent in Islamic banking could lead to more effective governance structures. This exploration is timely and pertinent, given the significant growth of Islamic banking and its increasing interaction with global financial markets.

In pursuing this objective, the study analysed existing governance structures in Islamic banks, compared them with those in Western banks and proposed ways in which elements from Western CG could be integrated into Islamic banking practices. This included examining aspects such as board structures, risk management practices and compliance mechanisms within the framework of Shari'ah compliance.

The overarching aim was to propose a model of CG for Islamic banks that balanced the need for effective governance with the requirements of Shari'ah law. However, this model would potentially benefit not just Islamic banks but also contribute to the broader discourse on CG in diverse banking systems. In addition, the study's findings could provide valuable insights for policymakers, regulators and practitioners in the field of Islamic banking.

In summary, this research endeavour is positioned at the intersection of finance, governance and ethics and seeks to contribute to the evolving narrative of CG in Islamic banking. It aims to offer a nuanced understanding of how Islamic banks can navigate the complexities of CG while upholding their Shari'ah-compliant ethos, thereby contributing to the stability and integrity of the global financial system.

## **1.2 The integrated thesis format and its appropriateness for this research**

The integrated thesis format offers a unique and flexible approach to academic research that is particularly well-suited for exploratory and multi-dimensional studies like the current investigation into CG and risk management in Islamic banking. This format combines traditional thesis elements with paper-style chapters, creating a comprehensive and in-depth

research narrative. Such a structure allows for the incorporation of diverse methodologies, perspectives and detailed analyses within a cohesive framework.

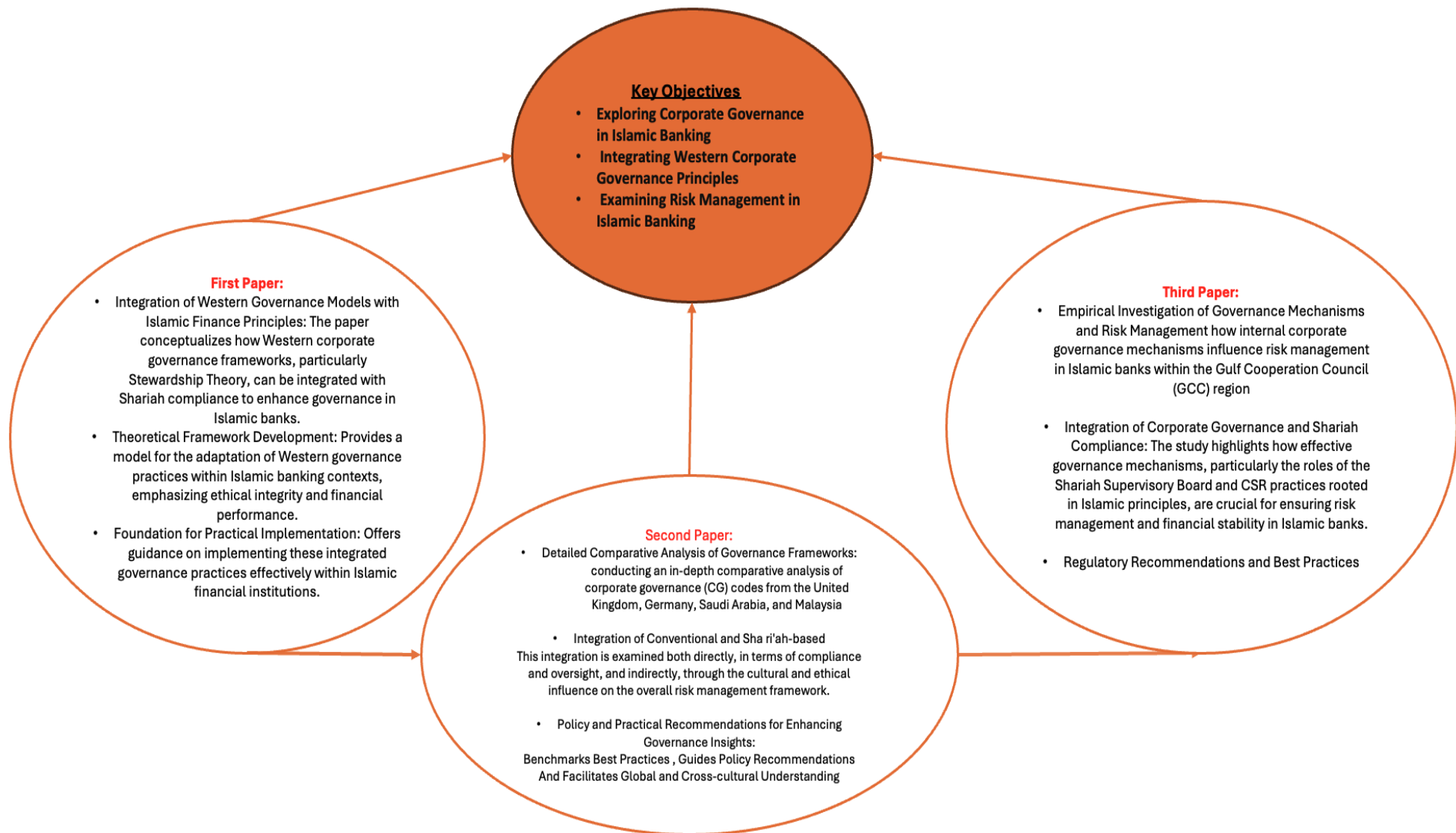
### 1.2.1 Nature of integrated thesis format

The integrated thesis format diverges from the traditional monograph thesis by allowing the inclusion of standalone papers within the broader narrative of the thesis (Thomson and Kamler 2012). Each paper-style chapter in an integrated thesis is based on a journal article that focuses on a specific aspect of the research topic, complete with its introduction, methodology, findings and conclusions. This format is particularly conducive to research that spans multiple facets of a complex topic, because it allows for a more nuanced and detailed exploration of each aspect. Once the work is ready for or has been published, sections of the thesis that standalone can be presented in the academic and public domain more rapidly.

This thesis explores the interplay between corporate governance and risk management within the unique context of Islamic banking, guided by three interconnected research papers. These studies collectively address the conceptual and practical gaps in integrating Western corporate governance principles with Islamic finance, culminating in a comprehensive governance framework tailored to the ethical and financial requirements of Islamic banks. By synthesizing these studies, the thesis provides a cohesive and structured analysis on integration, substantiation, and avoidance of duplication. To explicitly illustrate how these papers contribute to the thesis objectives, a conceptual diagram has been developed, mapping the linkages between the three research papers and their cumulative impact on the final conclusions (Figure 1).

The first paper establishes the theoretical foundation, conceptualizing how Western corporate governance models, particularly stewardship theory, can be adapted to align with Islamic finance principles. It argues that for corporate governance in Islamic banking to be effective, it must integrate Shari'ah compliance as a central tenet. This study develops a governance model that balances ethical integrity and financial performance, ensuring that corporate oversight mechanisms are both accountable and compliant with Islamic ethical mandates. The conclusions reached in this paper serve as the foundational premise for the subsequent research, providing the necessary conceptual baseline for exploring how ethical governance frameworks in Islamic finance serve as a mechanism for risk mitigation.





**Figure 1 Integrated thesis structure showing links between papers and key objectives**

Building on this theoretical framework, the second paper presents a comparative analysis of corporate governance codes across the United Kingdom, Germany, Saudi Arabia, and Malaysia. This comparative lens enables a nuanced understanding of how different cultural, ethical, and regulatory dimensions influence governance structures. The study examines the convergence and divergence between Western and Shari'ah-based governance frameworks, analysing their integration both directly (through compliance and regulatory oversight) and indirectly (through ethical and cultural influences). By contextualizing global best practices within Islamic governance models, the conclusions from this paper provide concrete policy recommendations, ensuring that governance in Islamic banks is both globally informed and locally contextualized. These findings feed directly into the empirical validation conducted in the third paper, ensuring that governance adaptations are tested against real-world financial and risk management data.

The third paper empirically evaluates internal corporate governance mechanisms and their impact on risk management in Islamic banking, focusing on the Gulf Cooperation Council (GCC) region. This study provides empirical validation for the theoretical framework established in the first paper and the comparative insights derived in the second paper. Specifically, the study highlights the critical role of Shari'ah Supervisory Boards (SSBs) and Corporate Social Responsibility (CSR) frameworks in ensuring financial stability and ethical governance. By emphasizing the integration of governance and risk management, the findings illustrate how corporate governance mechanisms can mitigate financial and operational risks while ensuring compliance with Islamic financial principles. The conclusions of this study confirm the need for a governance model that blends Western regulatory mechanisms with Islamic ethical imperatives, thereby substantiating the broader thesis argument that an integrated governance framework enhances risk management in Islamic banking.

Through a progressive research design, each paper logically builds upon the previous one, creating a clear and methodologically coherent trajectory towards the final thesis conclusions. The first paper conceptualizes the framework, the second paper tests its applicability through comparative analysis, and the third paper validates it empirically. This sequential structure ensures that conclusions are substantiated through a systematic exploration of theory, comparative analysis, and empirical testing.

The integration of these three research strands underscores a central argument—that the harmonization of Western corporate governance models with Islamic finance is both feasible and necessary for effective risk management in Islamic banking. The findings across all three papers converge on the assertion that corporate governance frameworks must be tailored to incorporate Shari’ah compliance, ethical accountability, and localized regulatory adaptations. The final synthesis of the thesis demonstrates that this governance model not only addresses existing governance challenges but also presents a viable risk management strategy that aligns with the ethical imperatives of Islamic finance.

Therefore, in the context of this research, the integrated thesis format enabled a comprehensive academic examination of CG in Islamic banking, while publishing standalone chapters on different dimensions such as board structure, risk management practices, Shari’ah compliance and the integration of Western CG principles. This approach not only provided depth to each aspect but also allowed for a broader understanding of how these aspects interconnect within the larger framework of Islamic banking.

### 1.2.2 Appropriateness for the research on Islamic banking

Islamic banking, with its unique blend of financial practices and ethical considerations rooted in Islamic law, presents a rich and complex field of study. The integrated thesis format was particularly well-suited for this research for several reasons:

- a. **Multidimensionality:** Islamic banking encompasses various dimensions, including finance, law and ethics. The integrated thesis format allowed for an in-depth exploration of these dimensions individually, while also illustrating their interconnectedness.
- b. **Comparative analysis:** The research involved comparing Western and Islamic banking governance models. The format facilitated this comparison by allowing each model to be explored in separate, detailed chapters before synthesizing the findings in the overarching narrative of the thesis.
- c. **Flexibility in methodology:** This research required a blend of methodologies, including qualitative analysis, quantitative analysis and comparative approaches. The integrated thesis format provided the flexibility to employ these varied methodologies effectively within each paper-style chapter (Tight 2012).

### 1.2.3 Advantages of the integrated thesis format in this research

- **Depth and breadth:** The format allowed for both depth and breadth in the

research. Each paper-style chapter could deeply analyse a specific aspect of CG in Islamic banking, while the overall thesis structure brought these aspects together to provide a comprehensive overview.

- **Publication potential:** Each paper-style chapter is structured like a journal article and the material from all three chapters have been submitted to relevant journals and conferences, facilitating the rapid publication of this research (the first two papers are published and accepted, whilst the third one submitted to a conference). This aspect of the integrated thesis format not only enhances the visibility and impact of the research but also contributes to the academic discourse in the field (Murray 2013).
- **Enhanced critical analysis:** The integrated format necessitates a critical reflection on how each paper-style chapter contributes to the overall research objectives. Therefore, this enhances the analytical depth of the thesis, ensuring a cohesive and coherent research narrative (Paltridge and Starfield 2019).

#### 1.2.4 Challenges and considerations

While the integrated thesis format offers numerous advantages, it also presents specific challenges:

- **Cohesion:** Ensuring cohesion and a clear overarching narrative can be challenging when integrating distinct paper-style chapters and it requires careful planning and structuring of the thesis to ensure that each chapter contributes meaningfully to the overall research objectives (Thomson and Kamler 2016). The additional chapters in this thesis (Introduction, Literature Review, Methods, Synthesis and Conclusions) set the research context for the paper-style chapters.

**Duplication:** There is a risk of duplication of content, particularly in the literature review and methodology sections across different chapters. Careful editing and structuring are required to avoid unnecessary repetitions while maintaining the comprehensiveness of each chapter (Aitchison et al. 2012). Maintaining the integrity of the papers as submitted or published was important but the styles were adjusted to match the overall thesis.

In conclusion, the integrated thesis format was found to be appropriate for this research on CG and risk management in Islamic banking. It offered the flexibility, depth and breadth required to explore this multifaceted topic comprehensively. With careful planning and structuring, this integrated thesis can effectively address the complexities of Islamic banking

and make a significant contribution to the field.

### **1.3 The significance of corporate governance in banks**

Financial institutions in general and banks in particular, have caught the attention of scholars and governments over the last three decades due to their influence on the progression of economies (John et al. 2016). Moreover, the CG of banks has also been a focus for policy makers and academics due to the significant role of banks in society (Macey and O'Hara 2003; Levine 2004; Walker 2009; Dermine 2013; de Haan and Vlahu 2016; John et al. 2016).

Archer and Karim (2007b) argue that CG in all banks, irrespective of specific nuances such as Islamic or Western, should be the subject of particular attention and require a unique governance structure due to three main factors. First, banks are more 'opaque' than other corporations, which causes more complex agency problems; second, the banking sector faces heavy regulation; and third, there is government ownership of many banks.

Extending the work of Archer and Karim (2007a), John et al. (2016) claim that banks suffer from a more complex agency problem than non-financial firms due to the significance of debtholders and the divergence between shareholders' interests and debtholders' interests. Furthermore, John et al. (2016) also state that banks are unique and therefore should be treated with a higher level of attention. The uniqueness of the banks may be attributed to many elements. First, for most banks the leverage ratio measured as the ratio of debt to equity, is very high (often 90%), while in the non-financial sector the leverage ratio rarely exceeds 30%. Second, there is conflict between shareholder and debtholder interests, as mentioned earlier. Third, banks are key players in society and potentially could have a larger impact on a wider range of stakeholders than non-financial firms, as exemplified in the 2007–2008 banking crisis. Finally, banks have a complex and an opaque asset structure which might necessitate a more complex governance mechanism.

### **1.4 Overview of the Islamic banking sector and its growth**

Islamic banking, also known as Shari'ah-compliant or participatory banking, has seen an exponential growth trajectory, emerging as a significant player in the global financial landscape. This overview delves into the growth patterns of the Islamic banking sector,

examining its impact on the global economy and identifying the driving forces behind its expansion.

#### 1.4.1 Growth of the Islamic banking sector

Islamic banking has experienced an impressive growth rate, averaging between 10%–15% annually (Mosteanu 2019). This rapid expansion is not confined to Muslim-majority countries but has occurred globally, reflecting the rising popularity and acceptance of Islamic finance principles. The industry's annual growth rate highlights its prominence in global finance (Belal et al. 2014). Therefore, the scholarly focus on Islamic banking efficiency has also intensified, with an annual growth rate of 12.5% in related literature since 2008 (Ikra et al. 2021), indicating a burgeoning academic interest in exploring Islamic banking practices and their efficiencies.

#### 1.4.2 Factors contributing to growth

Several key factors have contributed to the expansion of the Islamic banking sector:

- **Economic development:** There is a positive correlation between Islamic finance and economic growth in various countries (Riaz et al. 2022). This relationship suggests that Islamic banking plays a vital role in the financial development of these regions.
- **Expansion of halal industry:** El-Gamal (2006) defines halal in finance as activities and practices that are permissible under Islamic law, emphasizing the importance of adhering to Shari'ah principles that forbid interest, excessive uncertainty and investments in prohibited sectors. The growth of halal industry, encompassing sectors such as tourism, trade and commerce, adheres to Shari'ah rules and significantly propels the growth Islamic finance (Mishrif and Akkas 2018). This expansion leads to increased global franchising opportunities in Islamic finance (Oseni 2016) which will increase the attention on how these corporations will be managed and controlled.
- **Ethical reporting and identity:** The ethical reporting and identity of Islamic banks significantly influences their reputation and contributes to growth (Haniffa and Hudaib 2007; Belal et al. 2014). Furthermore, these ethical practices differentiate Islamic banks from their conventional counterparts and attract a broader customer base from both Muslims and non-Muslims customers.

#### 1.4.3 Impact on economic growth

Islamic banking positively impacts economic growth. Research indicates that Islamic bank financing can boost economic development, which in turn further increases the scope for Islamic bank financing (Afandi and Amin 2019). Moreover, the Islamic banking sector's financing in areas such as tourism has been instrumental in increasing local income and attracting halal tourists (Muhammad 2019). However, the impact of Islamic banking on economic growth in the industrial sector is less pronounced and still at an early stage (Pertiwi et al. 2021).

#### 1.4.4 Challenges of Islamic banking

Despite its growth, Islamic banking faces several challenges and several research gaps have been identified:

- **Religiosity and adoption:** The role of religiosity in the adoption of Islamic banking services is a critical area for further exploration (Yasin and Hati 2017).
- **Gender diversity and financial performance:** Research into the relationship between gender diversity in Islamic banking governance and its financial performance remains an underexplored area (Jabari and Muhamad 2021).
- **Interest rate impact:** The effect of interest rates on Islamic versus conventional banks presents an intriguing avenue for future research (Ergeç and Arslan 2013).
- **Ethical reporting and corporate social responsibility:** The practices of ethical reporting and CSR in Islamic banking need deeper investigation (Belal et al. 2014; Zainuldin and Lui 2021).
- **Trends in CSR and banking:** Understanding current trends and future research progression in CSR within the banking sector is crucial for researchers, bankers and regulators (Hassan et al. 2023).
- **Corporate Governance:** The impact of corporate governance on the operational and financial integrity of Islamic banks is an essential but less explored domain. Studies addressing how corporate governance mechanisms influence the risk management, transparency, and ethical decision-making in Islamic banks are particularly needed. This gap is vital for ensuring the sustainability and credibility of Islamic banking in the competitive global market (Daly and Frikha 2015)

### 1.4.5 Summary

The Islamic banking sector's remarkable growth signifies its increasing importance in the global financial system. Its positive impact on economic growth, commitment to ethical practices and forays into new industries highlight its potential for continued development. However, to sustain and further this growth trajectory, it is essential to address existing challenges and venture into new research domains. As Islamic banking continues to evolve, it remains a critical area of study for academics, practitioners and policymakers alike.

The challenge of corporate governance in Islamic banking is a significant gap that needs to be addressed. Effective corporate governance mechanisms are crucial for enhancing the operational and financial integrity of Islamic banks. They play a vital role in risk management, ensuring transparency, and guiding ethical decision-making processes. As the Islamic banking sector continues to evolve and expand globally, addressing this challenge becomes increasingly important for sustaining growth, competitiveness, and maintaining the trust of stakeholders. Moreover, improved corporate governance in Islamic banks can contribute to the overall stability and resilience of the financial system, aligning it more closely with the ethical and moral principles that underpin Islamic finance. Therefore, filling this research gap is not only essential for academic knowledge but also has practical implications for policymakers, regulators, and practitioners in the Islamic banking industry.

## 1.5 Objectives and scope of the thesis

### 1.5.1 Exploring corporate governance in Islamic banking

Islamic banking, while experiencing significant growth globally, presents unique challenges in CG. Traditional CG models have been primarily developed within the context of Western banking systems and may not be directly applicable to Islamic banks, which operate under a different set of principles and ethical considerations. This thesis aimed to:

- **Analyse current governance structures in Islamic banks**, focusing on their effectiveness, compliance with Shari'ah principles and their impact on operational efficiency. Also, exploring the applicability of adapting some of these ethical, asset based practices in the west.
- **Evaluate Western governance models** to determine their applicability and adaptation within the Islamic banking framework.



### 1.5.2 Integrating Western corporate governance principles

Considering the expansion of Islamic banking into global markets, it is crucial to explore how Western CG principles can be integrated into Islamic banking practices. This integration can enhance governance structures and ensure that Islamic banks can compete effectively in the global financial market. This thesis sought to:

- **Identify best practices** from Western CG models that could be integrated into Islamic banking.
- **Assess the integration impact on** the operational effectiveness, risk management and Shari'ah compliance of Islamic banks.

### 1.5.3 Examining risk management in Islamic banking

Risk management in Islamic banking is inherently different due to the prohibition of interest and the requirement for asset-backed financing. This thesis:

- **Explored risk management practices** to investigate how they are conducted in Islamic banks and compare them with conventional banks.
- **Analysed the effectiveness of risk management** in terms of how effectively Islamic banks manage risks, including credit, market and operational risks, within the constraints of Shari'ah compliance.

### 1.5.4 Scope of the thesis

The scope of this thesis encompassed several key areas:

- **Geographical focus:** While Islamic banking is prominent in the Middle East and Southeast Asia, this thesis will also consider Islamic banking practices in Western countries where it is emerging as a significant player.
- **Sectoral focus:** The focus will be on fully-fledged Islamic banks and not Islamic windows of conventional banks to ensure a clear understanding of purely Islamic banking practices.
- **Comparative analysis:** A comparative analysis between Islamic and Western banking governance models will be conducted to identify potential areas for integration.

### 1.5.5 Contribution to the field

This thesis makes a significant contribution to the field of Islamic banking and finance by:

- **Bridging knowledge gaps:** Addressing the gap in knowledge regarding the integration of Western CG practices in Islamic banking. The first paper (chapter 4) has already been published and cited, the second paper (chapter 5) has been accepted for publication, and the third paper has been submitted to the British Academy of Management conference 2024 which reflect part of that contribution.
- **Informing policy and practice:** Providing insights that could inform policy-making and best practices in Islamic banking governance.

## 1.6 Conclusion

Chapter 1 of this thesis laid a robust foundation for the exploration of CG and risk management within the Islamic banking sector. It set the stage by elucidating the background and rationale for the study and underscoring the pivotal shift that Islamic banking has brought to the global financial landscape. The chapter highlighted the unique attributes of Islamic banking, particularly its adherence to Shari'ah law, which differentiates it from conventional banking practices.

The chapter comprehensively discussed the expansion of Islamic banking, which is now a significant entity in over 75 countries and manages assets worth trillions of dollars. This growth, while indicative of the sector's success and appeal, has also brought to the fore challenges that are unique to Islamic banking, especially in the domain of CG. Therefore, the discussion emphasized that conventional CG models, although effective in Western contexts, may not fully align with the operational nuances and ethical considerations inherent in Islamic banking.

Chapter 1 posited the central hypothesis of the research, specifically that the integration of Western CG principles with Islamic banking practices could potentially enhance the governance structures within Islamic banks. This integration should maintain Shari'ah compliance while simultaneously aligning Islamic banks with global best practices in governance. It also outlined the objectives of this research, namely, to explore CG within Islamic banking, assess the potential for integrating Western governance models and examine risk management practices within this unique banking framework. The chapter established the scope of the thesis, focusing on fully-fledged Islamic banks and their governance

structures, and identified the need for a comparative analysis between Islamic and Western banking governance models.

The chapter justified the appropriateness of the integrated thesis format for this research, a format that allows for a nuanced exploration of the multifaceted and complex nature of Islamic banking. The benefits of this format, such as its ability to provide depth and breadth in research and its suitability for handling multidimensional subjects like Islamic banking, were highlighted.

In summary, the study is well-positioned to contribute significantly to the field of Islamic banking and finance. By addressing the integration of Western CG practices in Islamic banking, this research not only aimed to bridge knowledge gaps but also to inform policy-making and best practices in the field. The chapter sets a precedent for a research journey that is as challenging as it is rewarding, paving the way for a deeper understanding and advancement of CG in the context of Islamic banking.

## **1.7 Thesis Structure**

As identified above, this thesis follows an integrated format, blending three paper-style chapters with traditional academic discourse. Chapter 1 introduces the research question and objectives, while Chapter 2 presents a literature review of key topics and strands of research. Chapter 3 details the methodology used in the thesis to meet each objective.

Chapter 4—the first paper, published in the journal *Economics and Business Review*—focuses on the growth trajectory of Islamic banks and the embryonic stage of their CG, providing a conceptual model that synergizes Islamic finance principles with Western governance standards. This paper extends the discussion beyond financial metrics, emphasizing the broader societal and ethical responsibilities incumbent upon Islamic banks.

Chapter 5—the second paper, accepted for publication in *Economics and Business Review*—shifts the lens to a comparative analysis of risk management policies across the UK, Germany, Saudi Arabia and Malaysia. The analysis scrutinizes the role of boards in directing risk management strategies within both Western and Islamic banking systems. Furthermore, the paper illuminates the ultimate responsibility of boards for risk management, underscoring the need to integrate Western governance elements with Islamic principles to forge a robust governance structure.

Chapter 6—the third paper, submitted to the British Academy of Management conference and pending journal submission—examines the unique challenges and operational intricacies

inherent in Islamic banking in the GCC region. It explores the complex impact of internal corporate governance mechanisms on risk management in GCC's Islamic banks highlights the integration of Western CG elements into Islamic banking systems and their impact on Shari'ah compliance and operational efficiency. Further, this paper critically reflects on the methodologies employed, including quantitative analysis to explore the efficacy of such integrative practices in Islamic banks.

Chapter 7 then synthesizes insights from these papers and argues for a blended approach to CG in Islamic banking. It argues that incorporating Western governance models, characterized by their focus on shareholder wealth maximization and agency theory, with the ethical, stewardship and stakeholder-centric approach intrinsic to Islamic finance, can enhance the operational effectiveness of Islamic banks in particular and banking system in general. The synthesis not only bridges theoretical perspectives but also addresses practical governance challenges, offering a model that aligns with both financial stability and ethical mandates.

In Chapter 8, the thesis discusses the implications of this integrative approach for policymakers and practitioners in Islamic finance. It emphasizes the need for adaptive governance frameworks that can respond to the unique risks and ethical considerations in Islamic banking, while also drawing on the strengths of Western CG models. Thus, the research contributes to a nuanced understanding of CG in Islamic banking, proposing a pathway for future research to explore the impact of technological advancements, cultural factors and external governance mechanisms in the domain.

## Chapter 2: Literature Review

This chapter embarks on a scholarly journey along the ‘Silk Road of Philosophy,’ a path that bridges Eastern and Western traditions to deepen our understanding of CG in Islamic banking. It thoroughly explores the philosophical underpinnings that have shaped governance globally, laying a special emphasis on the confluence of Eastern Islamic principles with Western governance models.

The chapter begins by navigating the Western philosophical foundations that have influenced modern governance structures. It delves into the Greek influence on governance, examining the foundational thoughts originating from this ancient civilization. By exploring Greek philosophy’s contributions, particularly in rationalism and empiricism, the chapter provides a historical context to the principles that underpin contemporary governance models.

Because each paper in this thesis focused on the literature related to its research objectives and questions, a key aspect of the current chapter is the exploration of the ethical convergence between Islamic philosophical principles and Western governance models. The chapter aims to illustrate how Islamic banking, with its unique ethical and Shari’ah-compliant framework, can integrate aspects of Western governance to enhance its operational effectiveness and global appeal. The discussion extends to the blending of rationalistic and empirical approaches in governance with the moral and ethical dimensions emphasized in Islamic philosophy.

Then, the review continues with an analysis of existing literature on CG in Islamic banking, including a comparative analysis of Western and Islamic banking governance models that highlights the similarities and differences and the potential for integration. Theoretical frameworks, such as agency theory, stakeholder theory and stewardship theory, are critically examined to understand their applicability and adaptation within the context of Islamic banking.

Finally, an important aspect of this chapter is the focus on risk management in Islamic banking with a review of the literature on how Islamic banks manage risks, particularly in light of their unique operational principles and compliance with Shari’ah law. This section underscores the distinct risk management challenges and strategies employed by Islamic banks compared with their conventional counterparts.

In summary, this chapter aims to establish a comprehensive theoretical foundation for the thesis. Also, it seeks to illustrate the rich tapestry of philosophical thought that has influenced CG, drawing upon diverse traditions and schools of thought. Finally, the chapter sets the stage for a deeper exploration of how these philosophical insights can be practically applied to enhance governance structures in Islamic banking, contributing significantly to the field of Islamic finance and banking governance.

## **2.1 Silk Road of Philosophy: bridging Eastern and Western traditions**

### **2.1.1 Introduction**

The nexus between philosophy and CG has been a subject of rigorous scholarly interrogation, revealing that the principles guiding corporate conduct are deeply entrenched in philosophical thought (Solomon and Martin 2004). This chapter aims to elucidate the philosophical foundations that underpin CG with a special focus on Islamic banking. Corporate governance—a term that has gained substantial traction since the latter half of the twentieth century—refers to the systems, processes and policies by which corporations are directed and controlled (Tricker 2012). The significance of this inquiry lies in the premise that CG does not operate in isolation; rather, it is an embodiment of the ethical and moral philosophies that have evolved over centuries.

In the context of Islamic banking, the philosophical underpinnings are particularly salient, given that Islamic finance is not only a financial system but also a manifestation of an ethical framework derived from Shari’ah, or Islamic law (El-Gamal 2006). Shari’ah principles are rooted in the Qur’an and the Hadith and they encapsulate a comprehensive life ethic that includes guidance on economic transactions and financial behaviours (Ayub 2007). However, Islamic banking is not merely about compliance with religious edicts; it is about the actualization of a financial paradigm that upholds equity, justice and social welfare—values that are central to Islamic philosophy (Khan 2010).

The interconnection between Islamic philosophical thought and CG is evident in the concept of stewardship, which is ingrained in Islamic financial ethics. This stewardship is premised on the belief that humans are trustees on Earth—a concept that fundamentally shapes the governance structures in Islamic financial institutions (Choudhury and Alam 2013). The governance model in Islamic banking, consequently, is oriented towards risk-sharing, the prohibition of speculation and the promotion of socio-economic justice, which distinguishes it from its conventional counterparts (Chapra et al. 2008).

An exploration of Western philosophical contributions to CG is also indispensable. From Aristotle's advocacy for moderation to Kant's imperative of duty and the utilitarian principles of Mill, Western philosophy has contributed to the development of CG frameworks that prioritize transparency, accountability and ethical responsibility (Boatright 1994). These frameworks have been instrumental in shaping governance policies that align with the broader goals of corporate responsibility and sustainability.

Given the global landscape of finance, an understanding of how Eastern and Western philosophical doctrines can coalesce to inform governance in Islamic banking is both timely and necessary. This chapter will navigate these philosophical landscapes, drawing parallels and identifying the confluence between them. The aim is to construct a coherent narrative that not only highlights the unique features of CG in Islamic banking but also positions it within the broader spectrum of global financial governance practices.

The exploration of these philosophical dimensions is not merely an academic exercise but is also of practical import. As the world of finance becomes increasingly interconnected, the adaptation of diverse governance philosophies has the potential to foster more inclusive and ethically robust financial systems. This chapter, therefore, serves as a crucible for understanding the philosophical synergies that can contribute to the evolution of CG in the dynamic field of Islamic banking.

### 2.1.2 Western philosophical foundations

Philosophy, at its core, is the critical examination of the fundamental nature of knowledge, reality and existence. The discipline of philosophy has profoundly influenced the development of CG by providing ethical frameworks, justifications for organizational structures and by influencing the conceptual underpinnings of economic systems (Solomon 2013). Therefore, when considering the term 'corporate governance', one must reflect on the philosophical traditions that have shaped its evolution, particularly the moral responsibilities of those governing and the rights of those affected by corporate actions (Crane and Matten 2007).

### 2.1.3 The Greek influence on modern governance

The contributions of Socrates, Plato, and Aristotle to philosophical thought, particularly within the frameworks of rationalism and empiricism, are foundational to Western intellectual traditions. These classical thinkers not only shaped their immediate intellectual environment but also laid the groundwork for later Islamic and Enlightenment-era

philosophy, influencing key figures such as Al-Farabi, Avicenna, Averroes, Kant, and Locke. A granular analysis of these thinkers is necessary to contextualize their impact, particularly in relation to Islamic philosophy and governance structures.

Socrates, who is widely regarded as the father of Western rationalist thought, emphasized dialectical reasoning as the foundation of intellectual and ethical inquiry. His Socratic method—systematic questioning—became integral to later Platonic idealism and Aristotelian empiricism (Brickhouse and Smith 2004). Socrates himself left no written records; instead, his ideas were primarily documented by Plato and Xenophon. His focus on self-examination and ethical responsibility is particularly relevant to Islamic moral philosophy, which similarly prioritizes self-reflection and just action (Fakhry 2004). The principle of *ma'rifa* (knowledge through self-awareness) in Islamic philosophy echoes Socratic dialectics, suggesting an implicit but profound interconnection between Greek rationalism and early Islamic epistemology (Nasr 2002). Furthermore, Socratic ethics, which emphasize the necessity of virtue in governance, resonate with the Islamic concept of *Adl wa Ihsan* (justice and benevolence), which underpins Islamic political and legal thought (Hourani 1985).

Plato advanced Socratic principles through his theory of Forms, which posited that true knowledge derives from understanding abstract, non-material realities beyond sensory experience (Plato 1997). This idealist framework significantly influenced Islamic philosophy, particularly through the works of Al-Farabi and Avicenna, who integrated Platonic metaphysics into Islamic theology (Goodman 1992). Al-Farabi's concept of the "Perfect State" in his work *Al-Madina al-Fadila* is heavily Platonic, resembling the governance model outlined in Plato's *Republic* (Walbridge, 2001). Furthermore, Avicenna's adaptation of Platonic dualism—separating the intellect from the material body—laid the foundation for later theological debates within Islamic philosophy and Sufism (Gutas 2001; Adamson 2016). The fusion of Plato's idealism with Islamic metaphysics highlights the ways in which early Islamic scholars critically engaged with Greek philosophical traditions, modifying them to align with the ethical and theological principles of Shari'ah.

Aristotle, though a student of Plato, diverged from his mentor's rationalist outlook by championing empirical observation and logical deduction as the primary sources of knowledge. His influence on Islamic thought was even more pronounced than Plato's, as seen in the works of Averroes (Ibn Rushd), who sought to reconcile Aristotelian philosophy with Islamic theology and jurisprudence (Davidson 1992). Averroes' commentaries on Aristotle's *Metaphysics* and *Nicomachean Ethics* were instrumental in preserving and expanding



Aristotelian logic within Islamic and later European Scholastic traditions (Butterworth 2001). His insistence on empirical rationality later influenced European thinkers such as Thomas Aquinas, who incorporated Aristotelian reasoning into Christian theology (Hyman and Walsh 1983).

Aristotle's governance theories, particularly his classification of governments into monarchies, oligarchies, and democracies, had a profound impact on Islamic political philosophy. His view that political authority must be based on virtue and rational governance aligns with the governance models proposed by Al-Mawardi in his *Al-Ahkam al-Sultaniyya* (Black 2011). The Aristotelian influence on Islamic governance structures, particularly in relation to Shari'ah-compliant leadership, suggests that Greek rationalism was not merely received but actively transformed within Islamic scholarship. Furthermore, Aristotle's ethical framework, which ties morality to human flourishing, mirrors the Islamic philosophical approach that views ethics as essential for personal and societal well-being (Hourani 1985). His notion of *eudaimonia* (human flourishing) closely parallels the Islamic concept of *falah*, which describes success in both worldly and spiritual domains.

Xenophon, a contemporary of Plato and Aristotle, documented an alternative perspective on Socratic ethics and leadership. His work *Memorabilia* provides a practical rather than abstract portrayal of Socrates, focusing on his views on virtue, leadership, and governance.

Xenophon's pragmatic approach resonates with the Islamic concept of governance (*siyasa shar'iyyah*), which emphasizes moral responsibility and ethical rulership (Crone 2004). His emphasis on virtue-based leadership has parallels with Islamic governance models, particularly the Caliphate system, where moral integrity is a prerequisite for legitimate rule (Rosenthal 1968). Xenophon's influence extends into later medieval governance theories, which sought to balance power with ethical considerations, a theme deeply embedded in Islamic political jurisprudence.

The profound influence of Greek philosophy on modern governance is a testament to the enduring relevance of ancient wisdom in contemporary society. The principles laid down by Greek thinkers have not only shaped Western thought but have also provided a common language for intercultural dialogue and intellectual exchange. As articulated by Rovella et al. (2019), the seeds of political, scientific, technological and philosophic knowledge were sown during the epoch of Ancient Greece, with its cultural heritage still resonating in today's governance practices.

Westermann (2019) notes that post-Cartesian discourse has struggled to grapple with the concept of interrelation—a challenge that ancient Greek philosophy had begun to address. This struggle reflects the dualistic nature of Western thought, which often separates the material from the spiritual, the individual from the collective. However, Greek philosophy, with its emphasis on the polis and the communal life, serves as a precursor to the modern pursuit of harmonizing these dualities within the structures of governance and ethics.

The ethical crises and leadership challenges highlighted by Knights and O'Leary (2006) can be seen as a modern manifestation of the ancient Greek exploration of virtue and the good life. These crises necessitate a return to the foundational principles of ethics and collaborative leadership. Such principles are rooted in the Aristotelian virtue ethics, which Ford and Richardson (2012) emphasize as crucial for ethical decision-making in the context of CG.

Moreover, the empirical literature on ethical decision-making also reveals the significance of gender differences in ethical attitudes, as shown by Emerson et al. (2007). These differences underscore the need for inclusive governance structures that reflect diverse perspectives, resonating with the Greek ideal of a balanced and harmonious society.

The ethical failures of corporations like Enron, analysed by Kulik (2005), demonstrate the consequences of a governance devoid of virtue ethics. They are a stark reminder of the importance of integrating ethical considerations into the agency theory that often underpins CG. The performative aspects of such corporate failures, as explored by Boje et al. (2004), highlight the need for governance systems that are transparent and aligned with ethical principles.

The importance of ethical perceptions shaped by education and culture, as investigated by Lopez et al. (2005), suggests that the incorporation of Greek philosophical tenets into business and governance education could foster a more ethically grounded leadership. This approach could help mitigate the risk of financial distress in companies, as shown by Frémeaux et al. (2021), by promoting a governance structure that values ethical integrity and accountability. The philosophical foundations laid by Aristotle are evident in modern scientific and philosophical thought, as discussed by Protin (2021). This lineage of thought extends through key Western figures like Newton and Kant, showcasing the Greek influence on the evolution of Western scientific and philosophical paradigms.

The reception of Western philosophy in non-Western contexts, such as its interpretation and adaptation in Chinese philosophy, offers a unique perspective on the global impact of Greek

thought. Littlejohn (2015) discusses the cross-cultural engagement with Western philosophical ideas, highlighting the global nature of philosophical discourse and its implications for governance.

The philosophical harmony between Western and Islamic thought, as evidenced in the works of Fakhry (1972, 1994), Al-Jabri (1999) and Adamson and Taylor (2004), who trace the influence of Greek philosophy on Islamic thought, particularly through the translations of philosophical texts and the works of key figures such as Al-Kindi, Al-Farabi, Avicenna, and Averroes, reaffirms the universal relevance of Greek philosophy. These studies demonstrate how the philosophical foundations laid by the Greeks continue to foster dialogue and integration across diverse cultural and intellectual traditions, underscoring the potential for a governance model that is both globally informed and ethically grounded.

In summary, the Greek influence on modern governance is woven through the annals of history, culture and philosophy. It challenges contemporary leaders to look beyond the immediate and the material and to consider the broader ethical implications of their decisions. As we navigate the complexities of the modern world, the wisdom of the ancients serves as a guiding light, illuminating the path toward a more virtuous, balanced and interconnected global society.

#### 2.1.4 The Greek influence on the foundations of governance thought

The discourse on governance is deeply indebted to the philosophical legacies of ancient Greece, where the foundational concepts of ethics, politics and civic responsibility were first articulated in a systematic manner. The seminal works of Socrates, Plato and Aristotle have not only shaped the trajectory of Western philosophy but have also profoundly influenced the principles and practice of governance in contemporary times.

Socrates, as captured in the dialogues of Plato, relentlessly pursued the essence of virtues such as justice and the greater ethical imperatives of human conduct. His method of inquiry, known as the Socratic method, is predicated on the belief that through persistent questioning, one can distil wisdom and truth (Vlastos 1994). This philosophical approach underscores the importance of critical scrutiny and ethical reflection, paralleling the modern call for transparency and ethical integrity in governance. The robust tapestry of governance thought is deeply woven into the philosophical legacies of ancient Greece, a legacy that was extensively discussed by Shorey (1920). They delved into the evolution of political theory, spotlighting Plato and his predecessors and highlighting how their ruminations on society and governance have echoed through the ages.

The creative underpinnings of governance, as informed by the philosophical roots of Western thought, are extensively explored by Niu and Sternberg (2006), who juxtapose Western and Eastern conceptions of creativity, revealing a web of cross-cultural philosophical influences that continue to shape modern governance.

The Socratic method, known for its critical questioning, is not just a relic but a living practice with practical applications in cognitive restructuring, as studied by Froján-Parga et al. (2010). This illustrates the enduring relevance of Socratic dialogue in contemporary therapeutic and educational settings. Wellman (1976) offers a more in-depth image of Socrates, as viewed through Xenophon's writings, presenting a multifaceted portrait of the philosopher's methods and their interpretations across different narratives and historical contexts.

The renegotiation of ethics across disciplines, as discussed by Adamson et al. (1998), provides a broad vista into the interplay of ethical thought in literature, philosophy and theory, underlining the intersectionality of ancient ethics and its modern adaptations across various strands of intellectual inquiry. The philosophical milieu of ancient Greece also intersected with the social fabric, as Hamouda (2019) notes, with comedy serving as a vehicle for philosophical discourse, thereby integrating philosophical thought into the very sinews of societal interaction and reflection. Pentaraki (2012), in considering the class implications of governance in the wake of disasters, provides a practical perspective on how ancient philosophical considerations of justice and equity find their expression in modern policy-making and its societal impacts.

In drawing these various strands together, the Greek philosophical tradition, as embodied by Socrates, Plato and Aristotle, remains a cornerstone of governance thought. Their insights into ethics, politics and civic responsibility transcend the centuries, offering guiding principles for contemporary governance that seeks to balance diverse stakeholder interests and pursue the common good.

### 2.1.5 Philosophies: rationalism, empiricism and governance

The Enlightenment era, characterized by a focus on reason and empirical evidence, also significantly influenced governance structures and practices. Immanuel Kant and John Locke emerge as pivotal figures in the evolution of rationalism and empiricism. Kant sought to bridge the divide between empirical observation and innate rational structures, arguing in *Critique of Pure Reason* that all knowledge begins with experience but is shaped by a priori categories of understanding (Kant 1998; Guyer 2006). His emphasis on universal reason and

autonomy has influenced modern ethical and political philosophy, particularly in theories of justice and moral law (Rawls 1971). Locke, by contrast, firmly positioned himself within empiricism, asserting in *An Essay Concerning Human Understanding* that the human mind is a blank slate (*tabula rasa*), shaped entirely by experience and observation (Locke 1980; Yolton 1990). Locke's theories on natural rights, governance, and individual liberty were foundational for modern Western legal and economic systems and had indirect parallels with Islamic economic principles, such as contract-based trade and property rights (Baqir al-Sadr 1982). His work influenced later discussions on Shari'ah-compliant governance, particularly in relation to Islamic contract law (*fiqh al-mu'amalat*) and the ethical dimensions of business (Vogel and Hayes 1998).

Locke emphasized the importance of individual rights and the social contract in his "Second Treatise of Civil Government" (Locke 2015). His ideas, including the separation of powers and the right to revolt against repressive governments, continue to shape modern governance (Griffith 1997). This period also saw the emergence of a new approach to governance, termed the juridical government, which aimed to reform conduct and produce new forms of habitual behaviour (Tully and Skinner 1993). The Enlightenment's influence on governance extended beyond England, with the founding of the College of William and Mary and the creation of Williamsburg in the American colonies reflecting the era's emphasis on education and rational governance (Patton 1970). The debates between rationalism and traditionalism during this period further underscored the transformative impact of the Enlightenment on governance (Parry 1963). Despite the challenges and limitations of the Enlightenment's influence, its emphasis on reason and individual rights continues to shape modern governance structures and practices (Hufton 1977). René Descartes, with his foundational assertion '*Cogito, ergo sum*,' heralded an age where logic and reason became the bedrock of governance. His rationalist philosophy, emphasizing the pre-eminence of clear and distinct ideas, aligns with the transparency and analytical rigor demanded in CG today. Bhagat and Bolton's (2008) exploration of the nexus between CG and firm performance reflects this, underscoring the pivotal role of clear governance structures in shaping corporate outcomes.

Yet, as Lodge and Wegrich Feiock (2007) articulate, the rationality that Descartes espoused encounters paradoxes in the real world, where the bounded rationality of decision-makers often complicates the application of rational governance tools. This interplay between ideal governance structures and the human elements within them is also reflected in Gibson Kaul and Ventikos's (2015) study on the influence of Enlightenment philosophy on the

enterprising nurse, highlighting the era's enduring impact on professional identities and ethics.

In the empirical camp, John Locke's reflections on property rights and the social contract profoundly shaped modern concepts of corporate ownership and stakeholder rights, as highlighted by Tyson and Oldroyd (2019), who discuss the impact of ownership structures on corporate reputation. Dam and Scholtens (2012) further illustrate the significance of governance frameworks in their examination of state ownership and audit findings, demonstrating the intricate dance between ownership, governance and accountability.

The Enlightenment's advocacy for individual rights and the birth of civil society has lent itself to modern governance, where corporate accountability and the social responsibilities of business are increasingly foregrounded. Esmark and Yuan's (2022) exploration of liberal governmentality's limits further expands on the challenges of governance in contemporary settings, echoing the Enlightenment's quest for a balanced society where individual freedoms are harmonized with collective well-being. In summary, the Enlightenment's dual legacies of rationalism and empiricism are woven into the fabric of modern governance, advocating structures and decision-making processes that are at once logical, evidence-based and attuned to the social and ethical dimensions of corporate behaviour.

### 2.1.6 Islamic philosophical traditions

The first Muslim philosopher is widely acknowledged to be Abu Yusuf Ya'qub Al-Kindi, who lived between approximately 800 and 870 AD. Al-Kindi, an Arab by ethnicity, made significant contributions to the field of philosophy, mathematics, physics, astronomy, and medicine, as well as playing a crucial role in translating and expanding upon the works of ancient Greek thinkers, including Aristotle and Plato. He worked under the patronage of two influential Abbasid caliphs, namely Al-Mamun and Al-Mu'tasim, in the renowned House of Wisdom (Bayt al-Hikma) in Baghdad, a leading institution where scholars from various disciplines collaborated to translate, preserve, and expand knowledge inherited from Greek, Persian, and Indian traditions (Adamson 2007).

Al-Kindi's engagement with Greek philosophy, particularly the works of Plato and Aristotle, is notable for its influence on his attempts to reconcile philosophical teachings with Islamic theology. His efforts were part of a broader intellectual movement in which later Islamic philosophers, such as Al-Farabi and Avicenna (Ibn Sina), engaged with and expanded upon Greek philosophical works, thereby integrating Greek philosophical traditions into Islamic thought. This translation and interpretation movement shaped Islamic epistemology, ethics, and metaphysics, significantly impacting medieval Islamic and European Scholastic philosophy (Gutas 2001).

Within the realm of philosophy, Al-Kindi is particularly significant for his efforts to present Greek philosophical teachings as an integral part of Islamic intellectual discourse. His writings explore complex themes, such as the concept of the absolute oneness of God (Tawhid), the Qur'an's perspective on the creation of the world, and its insights into the resurrection of the body. Additionally, Al-Kindi engaged deeply with Aristotle's logical methods, adapting them to Islamic theology, particularly in discussions on causality, existence, and divine attributes (Nasr 1976).

One of the key areas where Al-Kindi's thought intersects with Islamic economic principles is his treatment of Riba (usury), a practice explicitly prohibited in Islamic law. While Al-Kindi did not extensively write on economic matters, his ethical and philosophical approach to justice inherently opposes exploitative financial transactions, such as those found in usurious practices. His belief in the harmonious relationship between reason and divine revelation led to an understanding that economic justice and fairness are essential for social stability, a theme further explored by later Islamic philosophers such as Al-Farabi and Al-Ghazali (Al-Ghazali, 2011). This ethical stance aligns with the Islamic prohibition of Riba, which is grounded in the principle that wealth accumulation must be balanced with social responsibility (Chapra, 2000).

Al-Kindi's contributions also serve as an intellectual bridge between Western philosophy and Islamic governance structures. His engagement with Plato and Aristotle influenced the development of Islamic political thought, particularly in relation to statecraft, governance, and economic justice. Plato's concept of the ideal state, as articulated in *The Republic*, resonated with Al-Farabi's model of governance, which emphasized divinely guided leadership and moral virtue as essential for political legitimacy (Mahdi, 2001). Meanwhile, Aristotle's empirical approach to governance and economics was later incorporated into Islamic legal discourse, shaping discussions surrounding contract law, wealth distribution, and market ethics (Rosenthal, 1968).

The Neoplatonic school of thought, particularly Plotinus' concept of emanation, was another significant influence on Al-Kindi. His metaphysical inquiries into the nature of existence and divine causality were rooted in Neoplatonic cosmology, which proposed that all things emanate from a single divine source (Gutas, 2001). This philosophical framework played a crucial role in shaping later Islamic economic thought, where the unity of divine justice necessitated an economic system that prohibited exploitative financial practices, including Riba and unethical trade practices (Nasr, 2006).

Al-Kindi's translation efforts also contributed significantly to the transmission of Greek and Islamic thought into medieval Europe, influencing Scholastic philosophers such as Thomas Aquinas and shaping early modern European thought on governance and economics (Leaman 2002). His work played a critical role in bridging the gap between Greek rationalism, Islamic legal theory, and later

Western economic thought, illustrating the global interconnectedness of economic and philosophical traditions.

#### 2.1.7 Ethical convergence: integrating Islamic philosophical principles with Western governance models in Islamic banking

The interaction between Western philosophical traditions and Islamic thought is particularly significant. Islamic scholars such as Al-Farabi, Avicenna, and Averroes not only engaged with Aristotelian and Platonic philosophy but also synthesized Greek rationalism with Islamic theological and ethical principles. The transmission of these ideas into medieval Europe, particularly through the Latin translations of Aristotle and his Islamic commentators, played a crucial role in shaping Scholasticism and pre-Enlightenment thought (Adamson 2016; Gutas 2001). This intellectual exchange underscores the global interconnectedness of philosophical traditions, demonstrating that the development of Western rationalism and empiricism was not an isolated phenomenon but part of a broader cross-cultural dialogue.

Locke's Second Treatise of Government (1689) presents a labour-based theory of property, arguing that ownership is derived from individual labour investment and that natural rights to property exist independently of governmental authority (Locke, 1690). This Enlightenment perspective laid the foundation for Western capitalist economic models, where private ownership and market autonomy are regarded as fundamental principles (Tully, 1980). However, Islamic economic philosophy—while recognizing individual property rights—places greater emphasis on wealth redistribution and social welfare, as outlined in Shari'ah provisions such as zakat (charitable tax), waqf (endowments), and trade ethics (Chapra, 2000).

The contrast between Locke's liberalism and Islamic economic justice is particularly relevant in contemporary discussions on Islamic finance and banking. While Locke's theory aligns with free-market principles, Islamic scholars such as Ibn Khaldun (d. 1406) and Abu Yusuf (d. 798) emphasized that economic justice necessitates ethical constraints on wealth accumulation and market behaviour (Baqir al-Sadr 1982). This intellectual divergence between capitalist property rights and Islamic ethical economy highlights the necessity of further exploring the philosophical foundations of capitalism and its relation to Islamic economic justice.

In the contemporary landscape of Islamic finance, the philosophical underpinnings of Islamic banking serve not only as a foundation for ethical financial transactions but also as a guide for CG. The intricate tapestry of Islamic philosophy, with its emphasis on justice, stewardship and social welfare, resonates through the structure and operations of Islamic banks, offering a unique perspective that contrasts with yet complements Western CG models.



Islamic philosophy, as introduced by Zekkari (2021), is characterized by key principles that govern both personal conduct and business ethics. These principles, which are deeply rooted in the Qur'an and Sunnah, emphasize justice (Adalah), benevolence (Ihsan) and stewardship (Khilafah), and form a framework within which Islamic finance operates. The integration of these principles into CG is not just theoretical but practical, because they dictate policies and practices that align with the ethical and moral compass of Islamic law (Shari'ah).

The historical evolution of Islamic philosophy, detailed by Kukkonen et al. (2005), shows a rich tradition of intellectual engagement with Western philosophies. The works of Islamic scholars during the Golden Age of Islam influenced and were influenced by Greek philosophies—particularly Aristotelian ethics—which bear similarities to Islamic concepts of the virtuous life. This cross-pollination of ideas created a foundation for a governance system in Islamic banking that is both distinct from and reflective of universal ethical considerations. Abu-Tapanjeh (2009) highlights that CG in Islamic banking is underpinned by the concept of Tawhid (Oneness of God), which transcends the material aspect of transactions to include spiritual accountability. Islamic banks, therefore, operate under a dual accountability system: to their stakeholders and to a higher moral authority. This dual accountability promotes transparency and fairness and discourages excessive risk-taking. It aligns with the Maqasid al-Shari'ah, which aims to protect and preserve public interest.

This ownership structure in Islamic finance, as discussed by Chang et al. (2016), also influences governance practices. Unlike conventional banking where the maximization of shareholder value might be the singular goal, Islamic banking broadens the scope to include the welfare of all stakeholders, including customers, employees and the broader community, reflecting the Islamic principle of social justice and equity. Choudhury and Alam (2013) further elaborate that CG in Islamic banking is not just about compliance with regulations but about ensuring that all business practices adhere to Islamic ethical norms. This includes the prohibition of interest (Riba), engaging in socially responsible investments and ensuring that products and services contribute positively to society.

The role of the Shari'ah supervisory board, as analysed by Mohammed and Muhammed (2017), is unique to Islamic banking and serves as an internal governance mechanism that oversees the adherence to Islamic laws and principles. This board, comprising scholars who are knowledgeable in Islamic finance and law, plays a crucial role in ensuring that a bank's operations do not deviate from its religious and ethical foundations. In exploring the epistemological foundations of Islamic CG, Alnasser and Muhammed (2012) point out that

knowledge in Islamic philosophy is not confined to the empirical or rational but includes revealed knowledge as a legitimate source. This epistemology shapes the governance structure of Islamic banks, where decision-making is guided by Shari'ah principles.

The influence of Islamic philosophy is embedded in Muslim transactions and extends beyond finance into other areas of life, as evidenced by the study of Halabi and Kazi 2006).

Similarly, the CG disclosure practices in Indonesian Islamic banks, investigated by Firdaus et al. (2020), show a commitment to transparency and ethical reporting that is informed by Islamic values. The distinctive CG model of Islamic banking is deeply intertwined with Islamic philosophy. It provides a comprehensive ethical framework that not only dictates financial transactions but also shapes the overall approach to governance, resonating with the principles of justice, transparency and social responsibility. As Islamic banking continues to grow globally, its governance model offers a viable alternative that bridges the gap between traditional financial models and a values-based economic system.

Building on the ethical framework established, Islamic banking's CG system inherently promotes a balance between profitability and social responsibility. The governance structures are designed to ensure that financial activities align with the broader goals of societal development and welfare, which are core to Islamic teachings. This balance is reflective of the concept of Maslahah, which refers to the public interest or common good. Islamic banks are thus mandated to consider the impact of their decisions on society at large, a principle that closely mirrors the stakeholder theory in contemporary CG discourse. As Mohammed and Muhammed (2017) highlight, the role of the Shari'ah supervisory board is critical in maintaining this balance, ensuring that all banking activities serve the Maslahah and adhere to the principles of Shari'ah, thus functioning within the ethical boundaries set by Islamic jurisprudence.

The principle of mutual risk and profit-sharing in Islamic finance, which stands in stark contrast to the interest-based transactions of conventional banking, is another manifestation of the ethical governance in Islamic banking. This system encourages a more equitable distribution of wealth and reduces the burden of financial risk on any single party. It is a practical application of the Islamic ethical principle of sharing in the burden and benefits of financial transactions, as elaborated by Choudhury and Alam (2013).

Furthermore, the concept of Gharar, which refers to uncertainty or deception, is prohibited in Islamic banking. This prohibition is not just a legal requirement but a governance measure that ensures transparency and honesty in financial dealings, as explored by Abu-Tapanjeh

(2009). The avoidance of Gharar, along with the prohibition of speculative transactions (Maisir), creates a stable and trust-based financial environment that is conducive to long-term investment and economic stability.

The role of Islamic finance in societal development is further emphasized by its commitment to Zakat, the Islamic practice of almsgiving. As part of their corporate social responsibility, Islamic banks allocate a portion of their profits to charitable activities and social development projects. This practice not only serves the community but also reinforces the ethical underpinnings of Islamic governance, because it ensures that the financial success of the banks contributes to the welfare of the less fortunate, as detailed by Alnasser and Muhammed (2012).

In the context of global financial practices, the governance model of Islamic banking offers insights into an alternative approach that is not only profitable but also ethically grounded and socially responsible. The principles of Islamic philosophy, when applied to CG, create a model that is resilient, equitable and sustainable. As the intersection of Islamic and Western CG continues to evolve, the potential for a synergetic relationship that leverages the strengths of both systems becomes increasingly evident.

The synthesis of the philosophical underpinnings with practical governance mechanisms positions Islamic banks as not only financial institutions but also as beacons of ethical business practices. This unique blend of ethics and economics exemplifies how ancient philosophical wisdom can inform modern business practices, offering a pathway to a more equitable and ethical global financial system. In the realm of CG within Islamic banking, contemporary philosophical dialogues are not merely academic; they are vital to the evolution and application of financial practices that are both ethically sound and economically viable.

At the forefront of these dialogues are the works of scholars like Muhammad Baqir as-Sadr and Tariq Ramadan, whose intellectual contributions have significantly shaped the moral and ethical landscape of Islamic economics and governance. Muhammad Baqir Al-Sadr's seminal work, '*Iqtisaduna*' (Our Economics) published in 1982, constitutes a cornerstone in the field of Islamic economics. Al-Sadr's critique of both capitalist and socialist systems led him to propose an alternative economic model based on the principles of Islamic jurisprudence, which emphasized social justice, economic equity and the welfare of all members of society. His vision was not only to establish an economic system that aligned with Islamic teachings but also to create one that ensured equitable distribution of wealth and resources (Al-Sadr 1982).

Tariq Ramadan, a contemporary Islamic thinker and philosopher, has been influential in articulating the ethical frameworks of Islamic finance in the modern context. His book '*Western Muslims and the Future of Islam*,' published in 2004, explored the challenges and opportunities for Muslims in the West, advocating for a dialogue between different cultures and philosophical traditions. Ramadan argued for a contextualized understanding of Islamic principles, one that was responsive to the complexities of contemporary life while remaining faithful to the ethical imperatives of Islam (Ramadan 2004).

The ongoing dialogue among contemporary scholars continues to expand the philosophical underpinnings of Islamic banking and finance. Their work underscores the potential for a financial system that not only adheres to Shari'ah law but also contributes to the overall well-being of society. These contributions echo the ethical considerations that have been at the heart of Islamic philosophy since its inception, emphasizing the importance of justice, transparency and the avoidance of exploitation.

The conclusion of this intellectual journey brings us to the metaphor of 'the Silk Road'. This ancient network of trade routes symbolizes the rich exchange of goods, ideas and philosophies between the East and West. In much the same way, the confluence of Islamic and Western philosophies in the sphere of CG has fostered an environment where principles of Islamic finance can interact with, and be enriched by, Western concepts of CG and vice versa. The Silk Road of Philosophy represents a pathway through which ethical principles and economic practices can traverse geographical and cultural boundaries. It is a route marked by the exchange of scholarly thought and practical wisdom, leading to CG models that are not only financially sound but also socially responsible and ethically robust.

In the context of Islamic banking, this philosophical exchange has profound implications. It suggests that the values and principles espoused by Islamic finance can contribute to the global financial landscape, offering alternative perspectives on wealth distribution, risk-sharing and ethical investment. At the same time, it acknowledges the influence of Western governance models, with their emphasis on accountability, transparency and stakeholder engagement. This fusion of ideas forms a dynamic and adaptive framework for CG in Islamic banking. It is a framework that is capable of addressing contemporary economic challenges while remaining grounded in the rich tradition of Islamic philosophy. As Islamic banking continues to grow and integrate into the global financial system, the Silk Road of Philosophy remains a testament to the enduring power of intellectual exchange and the potential for a more equitable and sustainable financial future.

### 2.1.8 Summary

This research delved into the dynamic interplay between Eastern and Western philosophies within the sphere of CG, particularly in Islamic banking. This interaction is not a mere historical footnote but an active, evolving process shaping contemporary Islamic financial practices and principles. Therefore, scholars, practitioners and policymakers are currently weaving a rich mosaic of ideas into a governance model that balances moral and ethical considerations with economic growth and profitability. Central to this discourse are the contributions of scholars such as as-Sadr and Ramadan. Their work offers a contemporary perspective on the complexities of Islamic finance and governance, grounded in a continuum of thought that can be traced back to classical Islamic scholars. These early scholars not only engaged with but also expanded upon Greek and other non-Islamic philosophies, highlighting the historical depth of this intellectual tradition.

The blend of Islamic financial principles with modern CG requires a nuanced approach. Islamic banks are challenged to adhere to the unchanging principles of Shari'ah while adapting to the evolving realities of the global financial landscape. This equilibrium is pivotal in ensuring compliance with Islamic law and responding adeptly to market complexities. In practical terms, this philosophical dialogue is manifested in the governance structures of Islamic banking. Therefore, elements such as the Shari'ah supervisory board and Islamic financial instruments like Sukuk (Islamic bonds) are not only regulatory mechanisms but also imbue ethical considerations into decision-making processes and prioritize social and economic justice.

The Islamic banking governance model, which emphasizes risk-sharing and eschews speculative transactions, emerges as a robust alternative to traditional finance's debt-centric approaches. This is especially pertinent in the context of global financial crises, where the downsides of excessive speculation and leverage have been starkly revealed. As Islamic banking's influence and prevalence grow, its governance models offer profound insights into aligning finance with the greater good. These models challenge us to reimagine the roles and practices of financial institutions, steering them towards a pathway that is ethically grounded, socially responsible and economically viable. The Silk Road of Philosophy represents more than an historical allusion; it symbolizes the ongoing intellectual journey that shapes our understanding and application of CG within Islamic banking. This journey, enriched by the ongoing exchange of knowledge between Eastern and Western traditions, heralds the emergence of a more equitable and just financial world.

In conclusion, traversing the philosophical path outlines above reveals that the ethical and moral imperatives of Islamic finance that serve as a guide through the intricacies of modern governance. The interplay between Islamic and Western philosophies not only enriches our viewpoints but also charts a course towards a financial system that values sustainability, resilience, equity and justice. It is through this philosophical exchange that Islamic banking can meaningfully contribute to a global economy that cherishes collective well-being alongside wealth.

## **2.2 Review of existing literature on corporate governance in Islamic banking**

Beyond the philosophical aspect of the research, corporate governance in the banking sector has been researched almost exclusively in terms of conventional, Western banking systems. Despite the rapid growth of Islamic finance over the last two decades, the research into CG in Islamic banks is still at an early stage (Abdel Karim and Archer 2007; Obid and Naysary 2014; Mollah and Zaman 2015). Therefore, this research reviews the underpinning rules and regulations of Islamic Banks' CG with the aim of building a bridge between theory and practice.

Interest in CG has increased rapidly over the last two decades driven by catastrophic scandals around the world such as Enron in the US, Royal Bank of Scotland in the UK, Parmalat in Italy, China Aviation oil and many others (Letza et al. 2008; Mallin 2013). There is a perceived universal need for robust and effective governance structures in order to protect all stakeholders from such collapses. Cadbury (2002) argues that CG is a key driver in the world's economic and political strategies due to the significant growth of international businesses. Supporting his contention are several studies that conclude that countries with developed CG structures attract more investors (Wint and William 2002 : Tun et al 2012). Moreover, CG plays a key role not only in protecting the interests of existing shareholders but also in attracting potential investors. Thus, corporations need a robust and transparent internal governance structure and a sound regulatory environment in order to sustain and compete in international markets (Cadbury 2002; Abu-Tapanjeh 2009; Mallin 2013).

The importance of CG in Islamic banking is underscored by its unique ethical and moral dimensions (Alam 2017). Many studies have researched CG in Islamic banking from multiple angles. This is particularly evident in the role of the Shari'ah supervisory board, which plays a crucial role in ensuring compliance with Islamic principles (Muhamad and Sulong 2019). The significance of the Shari'ah supervisory board and

the board of directors in Islamic banks also is underscored because they have a substantial influence on customer satisfaction (Kumar 2009; Bukhari 2013).

Furthermore, effective CG in Islamic financial institutions is also essential for maintaining stakeholder interests and promoting growth (Elasrag 2014). Islamic banks were found to exhibit higher profitability and more prudent risk management during financial crises, with CG mechanisms playing a significant role (Chazi et al. 2018). However, the need for a solid governance model in Islamic financial institutions is emphasized, with a focus on fairness, accountability and transparency (Hasan 2010).

There has been a surge in scholarly attention concerning CG in Islamic banking, which now encompasses a more extensive range of subjects that emphasize the importance of compliance with Shari'ah principles and the role of Islamic CG in ensuring ethical and responsible banking practices. El-Halaby and Hussainey (2016) explored the determinants of compliance with Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) standards by Islamic banks, highlighting the significance of adhering to financial and governance standards. Additionally, Hamza (2013) contributed to the literature by examining Shari'ah governance in Islamic banks and the effectiveness of supervision models, emphasizing the need for robust governance structures to ensure adherence to Shari'ah principles. Najib and Rini (2019) focused on the influence of Shari'ah compliance and Islamic CG on fraud in Islamic banks, underscoring the importance of ethical governance in preventing fraudulent activities. Similarly, Issa et al. (2022) highlighted the impact of Islamic banking CG on green banking, emphasizing the role of governance principles in promoting sustainable and environmentally responsible banking practices. Moreover, Salahuddin (2022) emphasized the influence of Islamic CG and intellectual capital on the Islamicity Performance Index, highlighting the role of governance and capital in achieving the ethical and Shari'ah-compliant goals of Islamic banks. Franzoni and Allali (2023) analysed the role of CG in protecting participatory depositors, emphasizing the unique stakeholder dynamics in Islamic banking governance. Many studies have focused on customer satisfaction in the dual banking sector, providing insights into the perception of Islamic banking among customers (Migdad 2017; Lone and Bhat 2019).

Overall, the literature underscores the significance of Islamic CG and Shari'ah compliance in ensuring ethical, responsible and sustainable banking practices within the

Islamic banking sector. These studies provide valuable insights into the unique governance challenges and opportunities within Islamic banking, emphasizing the need for robust governance frameworks aligned with Shari'ah principles.

### **2.3 Comparative analysis of Western and Islamic banking governance**

Western banking governance, which is rooted in capitalist economics, primarily emphasizes shareholder value maximization. Therefore, the governance structure typically includes a board of directors with a significant focus on protecting shareholders' interests. Frameworks like the Sarbanes-Oxley Act and the Basel Accords guide these systems, emphasizing transparency, accountability and risk management (Mallin 2016). Moreover, the Western model often adopts a shareholder-centric approach, aligning with Friedman's (1970) theory on corporate responsibility that focuses solely on profit maximization. In contrast, Islamic banking governance integrates financial practices with ethical and religious principles derived from Shari'ah law. Thus, its model emphasizes risk-sharing, prohibits interest (Riba) and engages in socially responsible investments. Furthermore, the Shari'ah supervisory board (SSB), which is considered a unique feature of Islamic banks, ensures Shari'ah compliance of all banking activities (Chapra and Ahmed 2002). Governance in Islamic banking aligns with stakeholder theory, considering the interests of various stakeholders including depositors, the community and the environment (Freeman 1984). The fundamental difference lies in the ethical underpinning of Islamic banking, which mandates adherence to Islamic principles, in contrast to the profit-centric approach of Western banking. Moreover, Islamic banks' SSBs play a crucial role in governance, unlike Western banks where such a religious-ethical oversight body is absent (Nomran and Haron 2019). However, both systems share commonalities in striving for good governance practices, such as transparency, accountability and effective risk management.

In terms of performance and stability, studies suggest that Islamic banks showed resilience during financial crises, which was attributed to their risk-sharing model and ethical investment practices, compared with their Western counterparts which faced significant challenges during economic downturns (Khan and Bhatti 2008).

In summary, while Western and Islamic banking governance systems have distinct foundational principles and operational frameworks, both aim towards effective governance, financial stability and ethical practices.



## **2.4. Theoretical frameworks: agency, stakeholder and stewardship theories**

‘Corporate governance’ as a term—along with its daily usage in both press and academic literature—is a relatively new phenomenon from the last three decades (Mallin 2013).

However, the main theories which participate in evolving and shaping the contemporary CG models have a longer history (Clarke 2004; Mallin 2013). Mallin (2013) highlighted that CG theories are influenced by different aspects including finance, economics, accounting, law and organizational behaviour. According to Mallin (2013) choosing the appropriate theory in CG is affected by various aspects such as the corporations’ culture, activities, time frame and ownership structure, and notably in which country/countries the corporation operates.

Two theories dominate the literature on CG, principal/agent theory and stakeholder theory.

These theories are often presented by their supporters as the fundamental model underpinning CG. This has resulted in the debate on CG being polarised into two camps, each claiming superiority. The shareholding theory camp has an emphasis on principal/agent theory and stakeholder theory camp has an emphasis on a wider range of interested parties, such as customers, employees, suppliers, lenders, society and shareholders (Jensen 2001; Letza et al. 2004; Mallin 2013). The debate presents a seemingly natural division between the two—either one or the other—with apparently no opportunity for consideration of a merger.

However, an alternative view is presented by Letza and Sun (2004a). They suggest that instead of a clear-cut stable boundary between the two theories—where a static and entitative conception is presented—in the real world of boardrooms, decisions will be made and policies agreed based on a dynamic analysis of the constantly changing organisational environment where both the shareholder and stakeholder perspectives are constantly being debated and considered. Consequently, the perceived theoretical division between shareholders and stakeholders exists only in theory and not in practice. Letza and Sun (2004a) proposed a processual approach to the understanding of CG where both the shareholder theory and the stakeholder theory are seen as relevant and applied in practice when circumstances dictate. Thus, there is no ‘one best fit’ theory for all countries and corporations.

In addition to the agent and stakeholder theories mentioned above, there is the new contribution of stewardship which suggests that managers, acting as stewards of the company, are motivated to act in the best interests of their shareholders or owners, prioritizing long-term value over personal gain. This perspective contrasts with agent theory, emphasizing alignment of interests through incentives, and is particularly relevant in the context of Islamic banking, where ethical and moral governance practices are integral to its

operations. These three are the most commonly used theories in CG in both Islamic and conventional banks (Obid and Naysary 2014). Indeed, most scholars associate the concept of CG with agency theory, stakeholder theory and stewardship theory (Jensen and Meckling 1976; Davis et al. 1997; Jensen 2001; Clarke 2004; Letza et al. 2004; Nordberg 2011; Mallin 2013). It should be noted that multiple theories are deliberated in the literature that go well beyond the three main ones, including class hegemony, managerial hegemony, transaction cost theory, institutional theory and prospect theory (Mallin 2013; Cuevas-Rodriguez et al. 2012).

#### 2.4.1 Link between theoretical frameworks and philosophical perspectives

Incorporating various philosophical perspectives provides a deeper foundation for understanding the dominant theoretical frameworks in CG, particularly agency theory, stakeholder theory, and stewardship theory. These philosophical perspectives shape CG models by providing a moral and ethical lens through which the actions of directors, shareholders, and stakeholders are evaluated. Howell and Letza (2000) highlight that corporate governance theories are not purely mechanistic models but rather derive their intellectual legitimacy from classical Western philosophy. Similarly, Howell and Sorour (2016) emphasize that governance frameworks are shaped by underlying philosophical assumptions about human nature, power structures, and ethical obligations. This recognition allows for a more contextualized and philosophically enriched approach to governance models.

Agency theory, one of the most influential frameworks in CG, is fundamentally rooted in Machiavellian political thought and utilitarian rationalism. Howell and Sorour (2016) argue that agency theory reflects an inherently individualistic worldview, where directors (agents) act out of self-interest, potentially leading to conflicts with shareholders (principals). This assumption aligns with Machiavelli's concept of *virtù*, which emphasizes pragmatic leadership that prioritizes power, control, and strategic decision-making over ethical considerations (Machiavelli 1532). Within corporate governance, this manifests in the reliance on financial incentives, monitoring mechanisms, and contractual safeguards to align managers' behaviour with shareholder interests (Howell and Letza 2000). Howell and Sorour (2016) critique this approach, arguing that agency theory reduces governance to a contractual relationship while neglecting broader ethical and social considerations. They highlight that the dominance of shareholder-centric governance—influenced by this Machiavellian logic—has led to short-term profit maximization at the expense of corporate social responsibility.

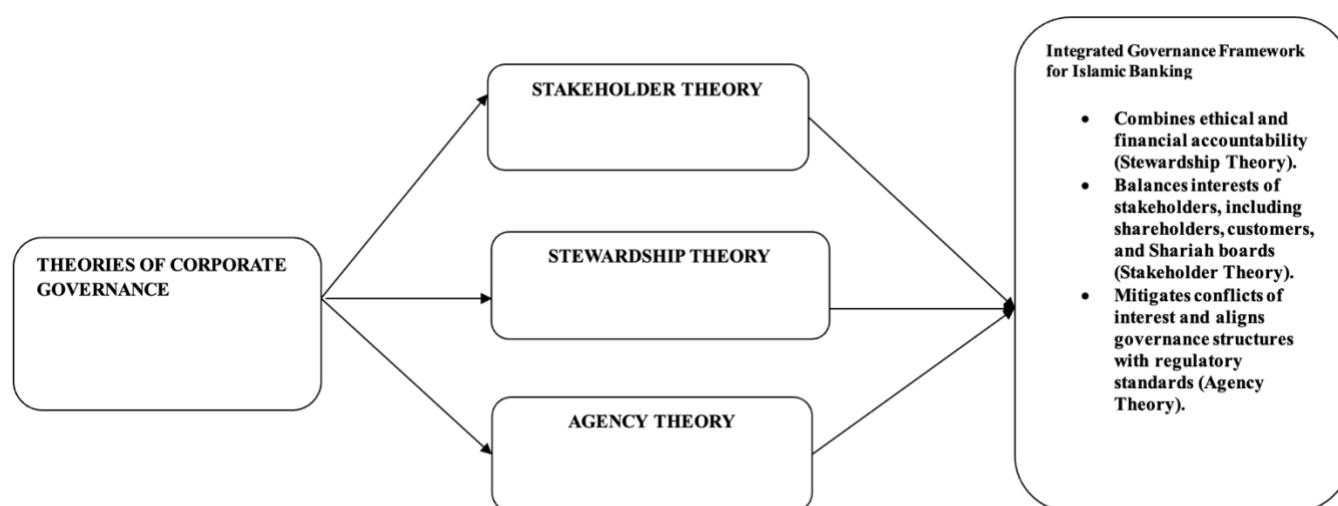
In contrast, stakeholder theory finds its philosophical grounding in Kantian deontological ethics, particularly his categorical imperative, which posits that moral actions should be guided by universal principles and treat individuals as ends rather than means (Kant 1785). Howell and Sorour (2016) stress that stakeholder theory challenges the reductionist assumptions of agency theory, advocating for a governance model that recognizes the moral obligations that corporations owe to all affected stakeholders. According to Howell and Letza (2000), stakeholder theory incorporates a broader spectrum of ethical considerations, ensuring that employees, suppliers, customers, and society at large are actively accounted for in corporate decision-making. Howell and Sorour (2016) build on this by asserting that modern stakeholder governance necessitates a paradigm shift, where businesses are evaluated not just by financial performance but by their long-term contributions to social and environmental sustainability. This reflects a Kantian perspective, where corporate leaders prioritize ethical duties over narrow economic incentives.

Stewardship theory, on the other hand, draws from Aristotelian virtue ethics, particularly the concept of arete (excellence) and the importance of moral character in governance. Howell and Sorour (2016) argue that stewardship theory fundamentally rejects the self-interest assumptions of agency theory, instead proposing that corporate managers act as responsible stewards who seek the long-term well-being of both the organization and its stakeholders. Aristotle's philosophy maintains that virtue is cultivated through habituation, meaning that leaders must develop ethical character over time through governance structures that reward trust, accountability, and collaboration (Aristotle 350 BCE). Howell and Letza (2000) highlight that stewardship theory aligns with the idea that ethical governance leads to corporate flourishing, because it fosters an organizational culture based on long-term value creation rather than short-term financial gains. Howell and Sorour (2016) reinforce this perspective, emphasizing that effective governance is not just about regulatory compliance but about fostering a corporate ethos rooted in moral integrity.

Expanding on these theories, Letza and Sun (2004b) introduce a processual understanding of corporate governance, challenging the binary distinction between shareholder and stakeholder models. Howell and Sorour (2016) support this view, contending that corporate governance should not be viewed as a static, one-size-fits-all model but as a continuously evolving practice that reflects the socio-economic and political context in which it operates. This aligns with the philosophical idea that governance is inherently dynamic, adapting to changes in corporate culture, industry norms, and regulatory frameworks.

Thus, the dominant corporate governance theories—agency theory, stakeholder theory, and stewardship theory—are deeply embedded in Western philosophical traditions. Howell and Letza

(2000) argue that recognizing these philosophical underpinnings allows for a more nuanced and ethically conscious approach to governance. Howell and Sorour (2016) further emphasize that corporate governance should not be reduced to economic efficiency alone but should be assessed in terms of ethical legitimacy, social responsibility, and long-term sustainability. Engaging with these philosophical perspectives ensures that governance frameworks move beyond simplistic models of profit maximization, embracing a more comprehensive and morally grounded understanding of corporate decision-making (Figure 2).



**Figure 2 Link between theories of corporate governance and the integrated framework for Islamic banking (Theoretical Framework)**

#### 2.4.2 Shareholding vs stakeholding

One of the major dilemmas in CG is identifying the purpose behind corporations and whose benefit they should be serving. The debate in the CG literature is often polarised into the shareholding and stakeholding models (Letza et al. 2004).

Friedman (1970;2007) claimed that all of a business's activities and managers' decisions should focus on generating maximum profits and maximising shareholders' value. Davis et al. (1997) argued that both agents and principals aim to maximise their own utility based on the assumption of the 'homo-economics' model of humanity, where directors are opportunistic and self-serving. The main objective of the agency theory is to reduce the agency cost arising from the divergence in principal-agent interests. Therefore, agency theorists provide several governance mechanisms which can be applied to achieve that goal,

including financial incentive schemes aimed at aligning principal and agent interests or a governance structure aimed at controlling the agent.

Freeman (2010) argued that maximising the owner's wealth could only be achieved by taking into consideration all stakeholders' interests. Jensen's (2001) concept was that of enlightened value maximisation which adopted the classic stakeholder theory principle as long as it participated in creating long-term value maximisation not just short-term profits. Jensen (2001, p.13) claimed that as

*'firms should pay attention to all their constituencies, the theory is unassailable. Taken this far stakeholder theory is completely consistent with value maximization or value-seeking behaviour, which implies that managers must pay attention to all constituencies that can affect the value of the firm'.*

Mallin (2013), however, describes stakeholder theory as the 'juxtapositions' to the agency theory that focus on a wider range of people who are affected in the decision-making process including employees, suppliers, customers, lenders and governments. Furthermore, CG mechanisms, including monitoring processes and board construction, might differ based on the country of operation. For instance, the so-called Anglo-Saxon model of CG emphasises maximising the shareholders wealth whereas other models, such as the German and Japanese models, tend to take a long-term strategic view and embrace a broader prospective.

Many scholars in Islamic finance claim that Islamic banks should adopt a 'societal model' that acknowledges the rights and needs of substantial stakeholders including depositors, investment account holders and employees (Grais and Pellegrini 2006; Archer and Karim 2007a; Iqbal and Mirakhor 2007; Bhatti and Bhatti 2010; Obid and Naysary 2014).

#### 2.4.3 Agency theory vs stewardship theory

Corporations are the spine of all advanced economies in the world. Most of these corporations evolved from small trading entities and enable their stockholders to trade in regional markets and, in some cases, to multibillion dollar corporations trading in global financial markets. As these corporations grew, for most, the entrepreneurial founders transferred the running of the business to professionals, giving rise to separation between ownership and management. Governing firms require a professional level of monitoring of all fundamental components including strategy, human forces, marketing, financial accounting and structure to assure their stakeholders that all mechanisms are in harmony (Nordberg 2011).

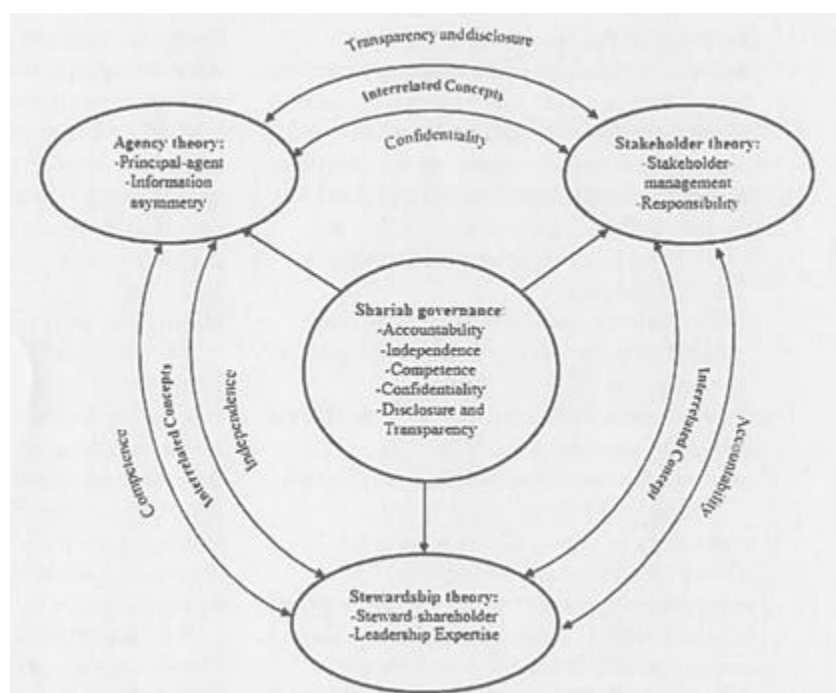
Agency theory is a key factor in shaping corporate structure and business policies. Agency theory was founded on the assumption that directors (agents) and owners (principals) are both attempting to maximise their own utility, often referred to as 'slack'. In its original form, agency theory adopted a simplistic approach of two actors, namely, an agent and a principal (Jensen and Meckling 1976; Davis et al. 1997). Davis et al. (1997) argued that there was a perceived need for a new theory which was able to explain the complex nature of organisational behaviour. This theory also should aim to explore the affairs in corporations taking into consideration non-economic factors.

Stewardship theory was introduced as a revolutionary concept that was able to explain relationships based on other non-economic behavioural assumptions (Donaldson and Davis 1991; Davis et al. 1997). Rather than management being seen as utility maximisers, as proposed in agency theory, stewardship theory views management as stewards. Unlike agency theory, which requires either incentives or monitoring mechanisms to ensure harmony, stewardship theory suggests introducing an element of trust of the agent to deliver harmony. Davis et al. (1997) states that stewardship theory and agency theory complement each other and there is no one best way of thinking and, therefore, there is no one perfect theory. However, reconciliation is required to differentiate between both theories and be able to determine which one best suits the organisation's circumstances to achieve the best outcome for major stakeholders.

The agency problem has been recognized in the literature of Islamic finance by many scholars such as Safieddine (2009) and Obid and Naysary (2014). Safieddine (2009) argued that Islamic banks suffered from a more complex agency problem accrued from the separation of not only management and ownership but also from the separation between cash flow and control. Therefore, any attempt to develop a CG model for Islamic banks should take into consideration this agency problem and adapt accordingly. In contrast, a few scholars such as Bhatti and Bhatti (2009) and Obid and Naysary (2014) argued that CG in Islamic banks should be more based on the stewardship theory because all the parties of the bank are viewed as stewards and perform their duties in the spirit of partnership in line with Islamic beliefs.

Obid and Naysary (2014) presented what they call development of an integrated theoretical framework of Shari'ah governance. This theoretical framework represents the relationships between the three main theories deliberated in Islamic banking from their prospective. Obid and Naysary (2014) discussed these relationships and how they might lead to a better

governance performance from a theoretical standpoint without linking them to practice and what happens inside Islamic banks. Nonetheless, this framework enhanced the idea of ‘one-size does not fit all’ from a theoretical perspective and also supported the adaption of the three main theories underpinning this research and its proposed model. Their framework is presented in Figure 3.



**Figure 3 The integrated theoretical framework of Shari’ah governance. Source: (Obid and Nasysary 2014, p.314)**

## 2.4 Risk management in Islamic banking

Risk management is a vital aspect of the financial industry, including Islamic banking (Alam and Tang 2012). Risk management involves the identification, analysis and mitigation of potential risks that could impact the financial stability and profitability of Islamic banks (Darwish 2015). Given the nature of Islamic banking, which is based on principles derived from Islamic law, there are unique risks that need to be addressed to ensure compliance with Shari’ah standards (Hasan and Dridi 2010; Hussain and Al-Ajmi 2012; Djayusman 2017). Hassan (2009) noted a gap between theoretical studies and practical risk management applications in Islamic banking, while Baldwin (2016) emphasized the need for robust risk assessment tools, tailored to Islamic finance’s unique risks. Comparative studies by Bashir and Azeez (2022) and Zakarneh et al. (2022) revealed differences in risk management between Islamic and conventional banks, especially in liquidity, operational risk and

contractual risk transfer. Masood et al. (2017) and Febianto (2012) highlight specific risks such as Mudaraba investment account risk and Shari'ah incompliance risk. Rehman et al. (2018) and Khaliq et al. (2017) provided empirical insights into risk management practices, advocating policy recommendations and methodological advancements. Abdullah et al. (2011) and Masood et al. (2012) focused on operational and credit risk in Islamic banks, suggesting adaptations for risk measurement and management, while Tabash et al. (2014) and Warsame (2016) compare financial performance and credit risk management in Islamic and conventional banks. Rhanoui and Belkhoutout (2019) and Noor et al. (2013) highlighted the need for ongoing research due to the sector's growth and evolving nature.

## **2.5 Chapter conclusion**

This chapter of this thesis reviewed the literature and synthesized key themes and findings, addressing gaps in the literature and elucidating the thesis's contributions and directions for future research. It explored the interplay between Western CG models and Islamic banking principles, focusing on ethical and moral dimensions, the role of Shari'ah supervisory boards and the distinctive challenges in Islamic finance. Furthermore, the review identified significant gaps in the empirical application of governance theories and risk management practices in Islamic banking. This thesis aims to bridge these gaps through comparative analysis and empirical research, contributing substantially to advancing the field. The thesis focused on validating the effectiveness of Western governance models in Islamic banking and exploring their global impact, with a particular emphasis on robust risk management strategies and the integration of ethical considerations into CG frameworks. This chapter sets the stage for a deeper understanding of CG in Islamic banking, highlighting its unique characteristics and the potential for successful integration of Western models.



## Chapter 3: Methodology

This chapter defines the research philosophy, strategy, methodology and methods underpinning this study, which were crucial in informing and guiding the data collection, analysis and development of a theoretical framework. It articulates the foundational approaches of the different strategies applied in each paper and examines various methodological perspectives. The research aims, which were refined throughout the thesis development, are reiterated, followed by an exposition of the data collection processes. The chapter culminates with an in-depth discussion of the analytical approach employed in evaluating the empirical data and, thus, framing the study's theoretical contributions.

### 3.1 Research philosophy

Philosophy in research, as described by Waite and Hawker (2009), is a system of beliefs arising from the study of fundamental knowledge, reality and existence. The research philosophy of this thesis, which was deeply influenced by the ideas of Creswell (2013), Howell (2013) and Smith (2015), embraced a more holistic understanding of the interplay between theoretical constructs and the practical realms of CG in Islamic banking. This philosophical grounding shapes the research's ontological, epistemological and axiological stances which, in turn, direct the methodology.

Ontologically, this research aligned with the concept of multiple realities (Creswell 2013; Farquhar 2012). By recognizing the pluralistic nature of CG within Islamic banking, the study acknowledged varied interpretations and perspectives. Therefore, the ontological stance supported the thesis's goal of integrating Western governance models into Islamic banking, considering diverse viewpoints and contexts.

Recognizing the multiplicity of realities (Farquhar 2012; Creswell 2013) and the subjective construction of knowledge (Klein 1998; Collis and Hussey 2014), this study adopted an interpretivist stance. This epistemological standpoint is consistent with the views of Collis and Hussey (2014) because it is integral to understanding the subjective nature of CG in Islamic banking, where social constructs and individual perceptions play a critical role. The interpretivist stance is aligned with the thesis's aim to explore and propose a contemporary governance model, evaluating its applicability and effectiveness across different Islamic banking contexts worldwide.

Axiologically, the research recognized the influence of the researcher's values and beliefs, as highlighted by Farquhar (2012). The qualitative methodology of this study, in alignment with the interpretivist paradigm, sought to gain a deeper understanding of CG challenges and innovations in Islamic banking. This approach enabled a nuanced exploration of how Western governance principles can be effectively integrated within the Islamic banking framework.

The methodological approach of this research, grounded in a pragmatic philosophy (Johnson and Onwuegbuzie 2004), used a mixed-methods strategy. This strategy was pivotal in addressing the complex interplay between Western CG principles and Islamic banking practices. Furthermore, it allowed for an in-depth analysis that incorporated both theoretical frameworks and empirical realities, as advocated by Bryman (2016) and Teddlie and Tashakkori (2009). The mixed-methods approach facilitated an exploration that was both versatile and comprehensive, ensuring a thorough understanding of the topic.

The research philosophy acknowledges the evolving nature of knowledge and the role of the researcher in shaping the inquiry. As Lincoln and Guba (2016) suggest, the researcher's positionality significantly influences the interpretation of data and the construction of knowledge. This consideration is particularly relevant in a study that traverses cultural and contextual boundaries, as is the case in the comparison of Western and Islamic banking governance models.

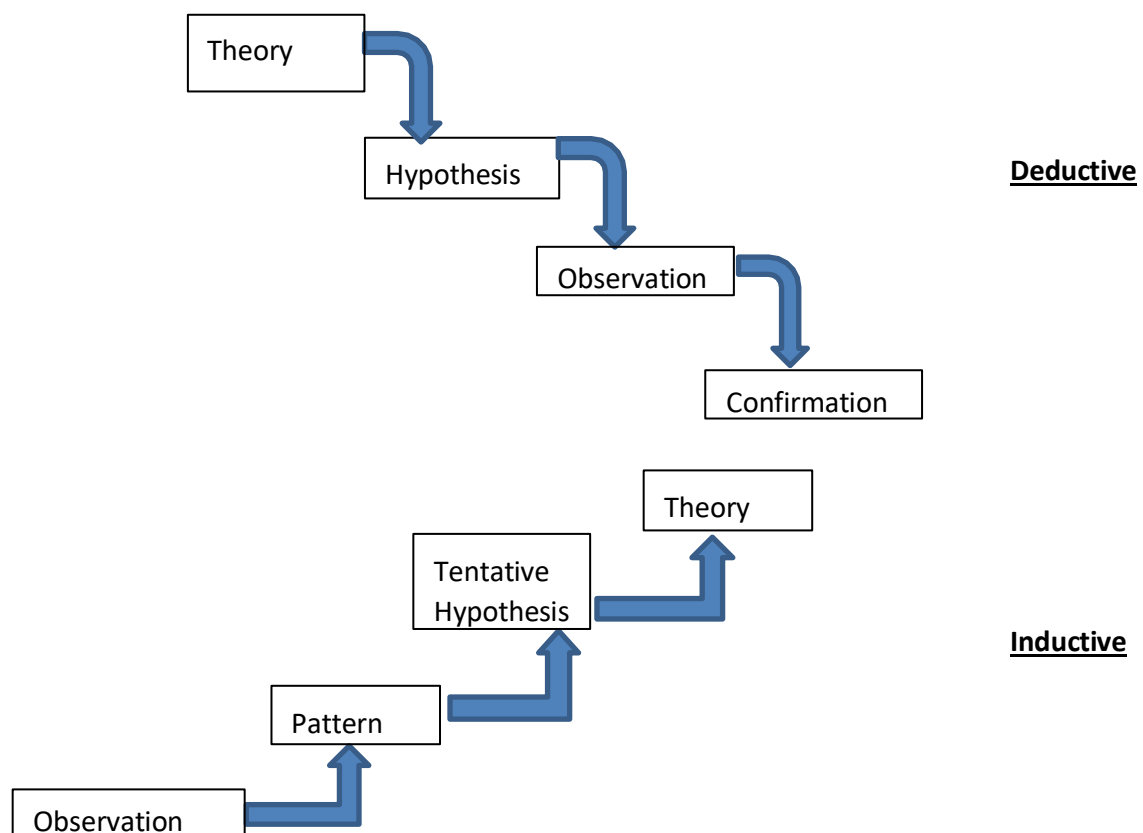
In summary, the research philosophy of this thesis set the stage for a methodologically robust and philosophically grounded investigation. Also, it established the framework for an in-depth exploration of CG in Islamic banking, underpinned by an appreciation of diverse realities, subjective knowledge construction and the impact of the researcher's values. This philosophical foundation not only guided the research journey but also ensured that the study's findings were reflective of the complex and dynamic nature of CG in the context of Islamic banking.

### **3.2 Research approach**

Easterby-Smith et al. (2012) argue that it is important for researchers to choose an appropriate approach to the theory because this choice will help researchers to make an informed decision about the research design. Furthermore, it will enable researchers to apply appropriate strategies that work toward the purpose of their conducted study. Understanding the different type of approaches and research traditions will enable researchers to overcome

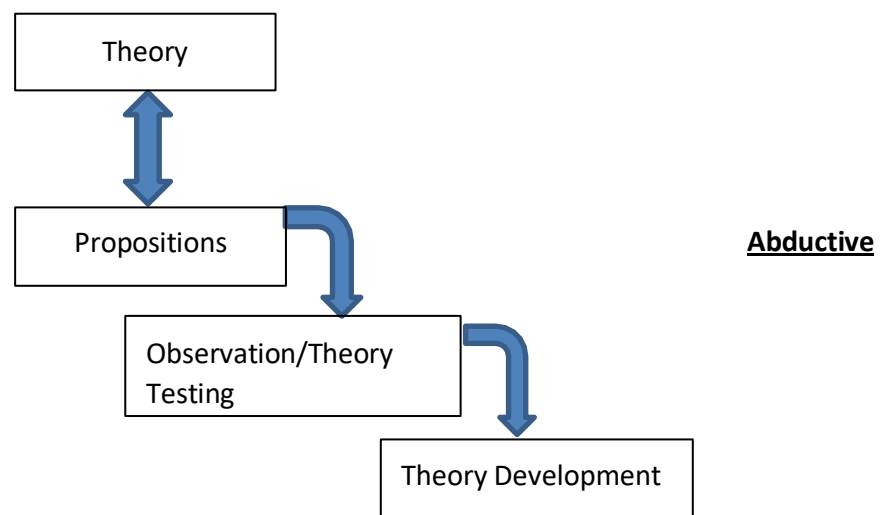
research constraints such as access to data by choosing a suitable research design among a few options.

Although the research approach is commonly divided in the academic literature into two main camps—deductive and inductive approaches—there is a third and innovative research approach which was identified in recent academic literature called the abductive approach (Hammersley 2005; Thomas 2010; Farquhar 2012; Saunders et al. 2016). The deductive approach is mainly used in scientific research by positivist researchers where a theory or conceptual framework is developed and then tested (Johnstone et al. 2004; Farquhar 2012; Collis and Hussey 2013; Saunders et al. 2016). In other words, the deductive approach is based on developing the finding through a logical reasoning and it aims to develop hypotheses from theory then design the research strategy to test these hypotheses. In contrast, the inductive approach is slightly more common in qualitative research where researcher aims to develop a theory from the gathered data (Eisenhardt 1989b; Farquhar 2012; Collis and Hussey 2013; Saunders et al. 2016). This approach follows a ground-up logic rather than developing hypotheses from theory and then testing them. Figure 4 compares and contrasts these two main research approaches.



**Figure 4 Deductive and inductive research approaches (Source: Farquhar 2012, p.24)**

The third research approach is the abductive approach. This approach was developed on the basis that in research it is difficult to distinguish between the inductive and deductive approaches. Therefore, a fusion between both is not unheard of and might be applicable in many cases (Lee and Lings 2008). The advantage of this pragmatic approach is the ability to switch between deduction and induction by relying on abductive reasoning, as well as recognizing the disadvantages of purely deductive or inductive reasoning and avoiding them during the research process (Farquhar 2012). Indeed, Thomas (2021) argues that conducting research is not a matter of only choosing between the inductive and deductive logics, but it is a matter of choosing the most appropriate approach that is able to explain the studied phenomena. Figure 5 demonstrates the research process using abductive logic.



**Figure 5 Abductive research approach (Source: author based on Farquhar 2012)**

For the purpose of this research, abduction reasoning was adopted because the research did not exclusively test theory through data analysis nor did it purely using observations to reach a theory. The study used a literature review drawing on the previous research in CG theory in the west (deductive). However, there was far less theory and literature in the context of CG in Islamic banking (inductive), which led to an abductive approach enabling the researcher to modify an existing theory (Saunders et al. 2016).

### 3.3 Research design

Research design, according to Creswell (2013, p.5) is '*the entire process of research, from conceptualizing a problem to writing a research questions and onto data collection, analysis, interpretation and report writing*'. Collis and Hussey (2013) divided research into four

categories based on its purpose which were: exploratory, descriptive, analytical and predictive. They described analytical research as an analysis of the correlation between two or more variables and the effect of this correlation. In contrast, predictive research goes beyond only analysing phenomena to providing a forecast of how the studied variables interact in response to the changes to the studied phenomena. Furthermore, Collis and Hussey (2009) distinguish between the exploratory studies which are often used when there are no or very few prior studies able to provide evidence or a logical explanation of the studied phenomena. In contrast, descriptive studies are conducted to describe phenomena as they exist and usually go further than exploratory studies by examining the studied phenomena. Thus, descriptive approaches are used to gather more information on the characteristics of a specific research problem.

The research design for this thesis, in alignment with its research philosophy, used a mixed-methods approach, as recommended by Creswell (2014) and Tashakkori and Teddlie (2009). This approach is particularly suitable for exploratory research and, according to Collis and Hussey (2013), is utilized when limited information is available on the subject. The thesis aimed to explore CG within Islamic banking, a field that has been less examined within the broader scope of Western CG systems.

The research design was structured to provide a comprehensive overview of CG in Islamic banks, examining both the theoretical frameworks and practical applications. This involved a detailed analysis of various financial reports, guidelines and comparative studies, aiming to bridge the gap between theory and practice in Islamic banking governance. In line with the mixed-methods strategy, the research used both qualitative and quantitative methods.

Qualitative methods, underpinned by an interpretivist epistemology, enabled a detailed exploration of governance models and practices in Islamic banks, while quantitative methods complemented this by providing empirical data to support or refute the theoretical constructs explored in the study. Therefore, this methodological pluralism ensured a balanced approach to the research, allowing for a thorough investigation of the subject. Furthermore, the research design incorporated a dynamic perspective on CG in Islamic banking, acknowledging the evolving nature of this field. This dynamic approach, as outlined by authors such as Johnson and Onwuegbuzie (2004), provided the flexibility to adapt the research methods as new information and insights emerged during the study.

In summary, the research design of this thesis was methodologically robust and philosophically aligned with the study's objectives. It combined the strengths of both qualitative and quantitative methods within a mixed-methods framework, guided by an interpretivist stance. Hence, this design ensured a comprehensive exploration of CG in Islamic banking, capturing both the theoretical nuances and practical realities of the field.

### **3.4 Research strategy**

This study is grounded in a pragmatic ontological and epistemological framework, reflecting a context-driven, pluralistic, and action-oriented approach to inquiry. Pragmatism, as described by Howell (2013), rejects rigid ontological distinctions such as realism versus relativism and instead asserts that reality is fluid and shaped by human interactions, social structures, and evolving contexts. This study aligns with this view by recognizing that CG in Islamic banking is not a fixed entity but a continuously evolving system that adapts to socio-cultural, economic, and religious imperatives.

Ontologically, this research assumes that governance frameworks in Islamic banking emerge from practical realities rather than being imposed as universal models, which resonates with Dewey's (1938) argument that reality is dynamic and constantly reconstructed through human experience. Howell (2013) supports this pragmatic stance, arguing that ontology in research should not be a static claim about reality but rather an adaptive construct that responds to contextual needs. This study, therefore, acknowledges that corporate governance structures in Islamic banking are contingent upon both Western economic influences and Islamic ethical values, shaping a hybrid governance model unique to this financial system.

Epistemologically, pragmatism promotes fallibilism, the idea that knowledge is provisional and continuously revised based on new empirical insights and theoretical refinements (Howell, 2015). This stance aligns with the abductive reasoning adopted in this study, which allows for a continuous interplay between theoretical frameworks and empirical data. Howell (2013) highlights that abduction enables researchers to move beyond mere description, facilitating the refinement of conceptual models based on real-world observations. This methodological flexibility is crucial for understanding how governance practices in Islamic banking are iteratively adapted to maintain both financial efficiency and Shari'ah compliance.

A hermeneutic approach is integrated to enhance the interpretivist dimension of this research, ensuring that corporate governance structures are analysed within their socio-

historical and ethical contexts. Howell (2013) discusses hermeneutics as a bridge between subjective meaning and structured analysis, emphasizing that understanding is co-constructed between the researcher and the subject of inquiry. This study applies Dilthey's (1976) and Gadamer's (2004) hermeneutic principles, arguing that corporate governance in Islamic banking must be understood as a practice embedded in cultural traditions, ethical commitments, and evolving regulatory frameworks. As Howell (2013) notes, hermeneutics rejects the idea of objective, detached observation, advocating instead for a reflective and historically aware analysis of social structures.

The hermeneutic circle is particularly relevant in this context, ensuring that individual governance practices are not examined in isolation but as part of a broader ethical and regulatory system. Howell (2013) expands on this by explaining that the hermeneutic process involves an ongoing dialogue between the researcher's preconceptions and the evolving meaning of the subject matter. This is crucial for studying Islamic banking governance, where Western governance theories are continuously interpreted and modified to align with Islamic ethical mandates.

Pragmatism also provides an integrative foundation for understanding the three dominant governance theories—agency, stakeholder, and stewardship theories—within the context of Islamic banking. Howell and Sorour (2016) argue that agency theory is rooted in a contractual, self-interest-driven model of governance, which pragmatism challenges by emphasizing adaptability and ethical accountability. Instead of assuming that directors (agents) will always act in their own interest, as traditional agency theory suggests, this study follows a pragmatic abductive approach to explore how agency conflicts in Islamic banking are mitigated through ethical accountability structures, Shari'ah compliance, and fiduciary obligations.

Stakeholder theory, which aligns with Kantian deontological ethics, extends beyond shareholder interests to incorporate ethical obligations toward employees, customers, suppliers, and society (Freeman 1984). Howell and Letza (2000) emphasize that stakeholder theory represents a paradigmatic shift in governance thinking, aligning with pragmatism's emphasis on situational decision-making rather than rigid theoretical prescriptions. Howell (2013) further reinforces this by noting that pragmatism encourages governance models that prioritize both ethical responsibility and business sustainability, rather than focusing solely on profit maximization. This study applies this logic to corporate governance in Islamic

banking, where governance must balance financial performance with religious and ethical imperatives.

Stewardship theory, which assumes that corporate leaders act as responsible stewards rather than opportunistic agents, is deeply connected to Aristotelian virtue ethics and the Islamic concept of amanah (trust) (Donaldson and Davis 1991). Howell and Sorour (2016) argue that pragmatism supports stewardship-oriented governance models, which rely on trust, ethical leadership, and long-term relational accountability rather than contractual mechanisms alone. Howell (2013) further supports this by explaining that pragmatic governance structures should be adaptable and built on ethical leadership rather than imposed external controls. This reinforces the study's assertion that stewardship theory provides a more holistic governance model for Islamic banking, aligning with Islamic ethical principles and stakeholder-oriented governance.

The research strategy is also pragmatically driven, supporting a mixed-methods approach that integrates both qualitative and quantitative methodologies. Howell (2013) describes pragmatism as a methodological enabler, allowing researchers to blend interpretive and empirical approaches based on the demands of the research problem. The qualitative component of this study employs hermeneutics to analyse governance practices within their cultural and religious contexts, drawing from Gadamer's (2004) and Ricoeur's (1987) perspectives on interpretive meaning-making. Howell (2013) argues that hermeneutic inquiry is particularly effective for analysing governance models that are context-dependent and socially constructed, reinforcing the study's approach to understanding corporate governance in Islamic banking as a dynamic and evolving structure.

The quantitative component complements this by providing empirical validation, assessing governance effectiveness through financial performance, risk management, and compliance metrics. Pragmatism enables the seamless integration of these two methodological strands, ensuring that the research remains contextually relevant and theoretically robust (Howell and Sorour 2016). Howell (2013) further supports this by asserting that pragmatism allows researchers to prioritize research utility over methodological purity, making it well-suited for studies that explore governance as a practice-driven phenomenon.

This study's methodological framework is firmly rooted in pragmatism and hermeneutics, ensuring a flexible and interpretive approach to corporate governance research. Howell (2013) emphasizes that pragmatism allows for the reconciliation of diverse theoretical



perspectives, providing a framework that is adaptive rather than dogmatic. Hermeneutics enriches this study's interpretivist orientation, ensuring that governance practices are analysed not only as regulatory frameworks but as ethical and socio-cultural constructs.

Gillham (2000) discussed both quantitative and qualitative research in depth and concluded that quantitative research is more numbers-focused and requires some kind of measurement; it is also mainly adopted by positivist theorists. In contrast, qualitative research seeks a deeper understanding to the study and provides a meaning to what is happening. Moreover, Gillham (2000) argue that qualitative research is the best fit when the researcher is aiming to 'get under the skin' of any corporation or group of individuals by exploring what happening from the inside. Therefore, a qualitative study is ideal when the researcher conducting research where the process leads to results. Creswell (2013) stated that there was perceived need to identify the qualitative study approach in order to provide a sound and coherent research.

Creswell (2013) also compared and contrasted the five main qualitative strategies that are deliberated in the literature: narrative research, phenomenology, grounded theory, ethnography and case study. Narrative research, according to Creswell (2013), is more focused on individuals to explore their lives by drawing upon the humanities including psychology, history and sociology. In contrast, grounded theory aims to develop theory grounded in data from the field by studying a process, an action, or interaction within a group. Phenomenological studies focus on understanding the essence of an experience by studying several individuals who have shared an experience, while ethnographic studies focus on studying a culture-sharing group using primary observations and interviews. The final qualitative approach in Creswell's book is the case study strategy which focuses on developing an in-depth description and analysis of the case/cases using multiple sources of primary and secondary data such as interviews, observation and documents.

The research strategy for this integrated thesis was crafted to align with the unique demands of each constituent paper. The first paper (Chapter 4), which focusing on stewardship theory in Islamic banking, adopted a qualitative philosophy with an exploratory lens. This approach was pivotal for conceptualizing and discussing a tailored CG framework that bridged the gap between Islamic and Western banking systems.

The second paper (Chapter 5), which conducted a comparative analysis of risk management in CG codes across four countries, used a methodology that critically examined these codes. This comparative approach, which was rooted in both positivist and interpretivist paradigms,

allowed for a nuanced exploration of CG, risk management and Shari'ah governance within Western and Islamic banking systems.

The third paper (Chapter 6), which was distinct in its methodology, utilized a panel data approach to analyse Islamic banks within the Gulf Cooperation Council (GCC) geographic region. This quantitative method was instrumental in assessing risk management performance and highlighting the dynamics of various governance mechanisms.

Despite the diversity in methodologies, each strategy was meticulously chosen to align with the overarching interpretivist philosophy and the acknowledgment of multiple realities. This approach ensured a comprehensive and coherent exploration of CG in the context of Islamic banking, encompassing both theoretical and empirical dimensions.

### **3.5 Chapter conclusion and chosen methodology in the context of an integrated thesis**

This chapter plays a crucial role in defining the research philosophy, approach and design that underpinned the entire study as part of the integrated thesis format. It serves as a compass, guiding the research process from the conceptualization of the problem to the development of the research questions, data collection, analysis and, ultimately, the formulation of a theoretical framework and it provides a solid foundation for informed decision-making throughout the research journey.

The research philosophy adopted in this thesis was strongly influenced by the works of scholars such as Howell (2013), Creswell (2013) and Smith (2015). It embraced a holistic understanding of how theoretical constructs intersected with the practical dimensions of CG in Islamic banking. At its core, this philosophy recognized the multiplicity of realities, as articulated by Farquhar (2012) and Creswell (2013), and acknowledged the subjective nature of knowledge construction, following the insights of Collis and Hussey (2014) and Klein (1998). The interpretivist stance was well-suited to the thesis's exploratory objective of devising a contemporary CG model applicable to Islamic banks worldwide. Furthermore, it accommodated the diversity of interpretations and perspectives within the field of Islamic banking, paving the way for the integration of Western governance models while considering the various viewpoints and contexts that influence CG.

Ontologically, the research aligned with the concept of multiple realities, recognizing the pluralistic nature of CG within Islamic banking. This acknowledgment of diverse interpretations and perspectives supported the thesis's goal of harmonizing Western governance models with Islamic banking.

Epistemologically, the research adopted an interpretivist approach, consistent with the views of Collis and Hussey (2014). The approach was essential for understanding the subjective nature of CG in Islamic banking, where social constructs and individual perceptions play a critical role. Also, it aligned well with the thesis's aim to explore and propose a contemporary governance model, evaluating its applicability across different Islamic banking contexts.

Axiologically, the research acknowledged the influence of the researcher's values and beliefs, as highlighted by Farquhar (2012). This recognition was crucial for the qualitative methodology, which sought a deeper understanding of CG challenges and innovations in Islamic banking. Moreover, it allowed for a nuanced exploration of how Western governance principles can effectively merge with the Islamic banking framework.

The methodological approach, which was grounded in a pragmatic philosophy, used a mixed-methods strategy. This strategy was essential for addressing the complex interplay between Western CG principles and Islamic banking practices. It allowed for an in-depth analysis that incorporated both theoretical frameworks and empirical realities, as advocated by Teddlie and Tashakkori (2009) and Bryman (2016). Furthermore, this mixed-methods approach ensured a versatile and comprehensive exploration of the research topic, capturing both theoretical nuances and practical insights.

The research philosophy acknowledged the evolving nature of knowledge and the role of the researcher in shaping the inquiry. As Lincoln and Guba (2016) suggest, the researcher's positionality significantly influence data interpretation and knowledge construction and this consideration was particularly relevant in a study that traversed cultural and contextual boundaries, such as the comparison of Western and Islamic banking governance models. The research philosophy served as the foundation for a methodologically robust and philosophically grounded investigation. It ensured that the study's findings reflected the complex and dynamic nature of CG in the context of Islamic banking.

## Chapter 4: Paper 1—Best practice in bank corporate governance: the case of Islamic banks

*This first paper-style chapter of the thesis contains an article titled ‘Best practice in bank corporate governance: the case of Islamic banks’ co-authored with my first supervisor, Steve Letza. In it, the authors propose a conceptual model tailored for CG in Islamic banks. It was published in ‘Economics and Business Review’ (2018), Volume 4, Issue 4. The paper was received on May 13, 2018 and accepted for publication on September 24, 2018, with its online publication occurring on November 22, 2018 (Alatassi and Letza 2018). The acknowledgement that I was a lead author and contributed more than 90% of the content of the paper is shown in Appendix 1. Minor modifications have been made to fit this published paper into the format of an integrated thesis. There may be some unavoidable repetition of information given earlier in the thesis.*

**Objective and methodology:** *The objective of this research was to devise a CG model that synergized the principles of Islamic finance with Western CG standards. It addressed the unique ethical and operational dimensions inherent in Islamic banking by employing a qualitative research approach. The paper utilized theoretical frameworks, notably the principal/agent theory, stakeholder theory and stewardship theory, to dissect and understand the intricacies of CG within the realm of Islamic financial institutions.*

**Findings:** *The authors found that Islamic banks, governed by Shari’ah law and emphasizing risk-sharing, economic development and social well-being, need a distinctive governance structure. The proposed model melds these Islamic principles with Western governance paradigms, focusing on the roles of investment account holders and Shari’ah supervisory boards in Islamic banks’ governance.*

**Contribution to research:** *This paper makes a pivotal contribution to the thesis by establishing a theoretical foundation for integrating Western governance standards into Islamic banking. It advances the thesis’s central theme of exploring the compatibility and potential synergies between Western and Islamic banking governance systems. The paper’s in-depth analysis of theoretical underpinnings significantly enriches the comparative study of Islamic and Western banking governance within the thesis. Since its publication, the paper has garnered attention in academic circles, as evidenced by its citation count of 14, which is a testament to its scholarly impact and recognition within the domain of CG in Islamic banking (Alatassi and Letza 2018).*

*In summary, this work provides an essential cornerstone for the thesis, offering both a theoretical lens and a practical framework for understanding and enhancing CG in Islamic banking, thus bridging a significant gap in the existing literature.*

**Citation:** *Alatassi, B. and Letza, S., 2018. Best practice in bank corporate governance: the case of Islamic banks. Economics and Business Review, 4 (4), 115-133.*

*<https://doi.org/10.18559/ebr.2018.4.7>*

## **Abstract:**

Islamic banks are growing rapidly with annual growth rates of 17.6% between 2009 to 2013 and 19.7% from 2014 to date. This level of growth is projected to continue into the future. Islamic banks now operate in more than 75 countries with a value of approximately \$920 trillion of bank assets. Islamic banks are increasingly being seen as good long-term value propositions and are serving both Muslim and non-Muslim customers across international markets. Despite the rapid growth in Islamic finance, the underpinning corporate governance rules and regulations are at an embryonic stage of development with little attention having been paid to them. The purpose of this paper is to help fill that gap by exploring a conceptual model of corporate governance for Islamic banks based on both Islamic finance principles while fused with elements of corporate governance standards from Western theories and codes, primarily the UK, and thereby ensure that good governance is in place in Islamic banks. The paper links the predominant corporate governance theories of Principal/Agent, Stakeholder and Stewardship with practice based corporate governance codes and explores the potential of applying stewardship theory to Islamic banks. Islamic principles emphasis is on real assets rather than debt as is the case in Western Banks and as a consequence this paper offers the conclusion that the more prudent approach to banking used by Islamic banks could be used as a model for Western banks and thereby deliver a more sustainable future and maintain confidence in banks and substitute for the need for taxpayer support, such as the guaranteed deposit scheme, which acts as a backstop under the Western approach.

## **4.1 Introduction**

In an article in the Guardian newspaper (4 Dec 2014) entitled '*Could Islamic finance save capitalism?*' Harris Irfan posed the question: where is there a place for ethics and morality in the global economy? He went on to question whether it is sufficient to rely on governments and central banks to tweak financial regulation at the margins or whether the global economy needs a root-and-branch reformation, effectively a revolution in capitalism. At around the same time, London became the first non-Muslim city to host the world Islamic economic forum at which David Cameron, the then prime minister of the UK, announced the intention to create a £200 m Islamic bond. Against this backdrop, it may be opportunistic for the UK to further

develop Islamic finance as part of a bigger post-Brexit strategy as post-Brexit UK becomes a reality.

Islamic banking is different from its Western counter parts primarily due to a difference in focus. Islamic banks focus on asset values, viewed as actualities, while Western banks are credit focused, essentially on future potentialities. Western banks attempt to assess future income streams when assessing whether to loan money, a case of potentialities rather than actualities. Islamic principles have been suggested as a solution to the failings in Western banking, failings which manifested themselves in the 2007–2008 banking crisis. Unpalatable as the idea of religion and dogma may seem at first sight to scientific focused eyes, leaving the religious aspects to one side and instead focusing on the principles and philosophy developed over hundreds of years in the Islamic tradition provides a reassuringly prudential approach to decision making which resonates well with sound economic thinking.

Modern banks began offering Shari'ah-compliant products in the mid-1970s. Since then Islamic banking has grown into a global industry with total assets of around \$920 trillion (Ernst and Young 2016). The spectacular growth in Islamic banks over the last 10 years, with annual growth rates averaging 17.6% between 2009 to 2013 and 19.7% from 2014 onwards (Ernst and Young 2015), suggests that Islamic banks have a value proposition that is attractive to the global investing community of both a Muslim and non-Muslim persuasion. To date, CG in the banking sector has been researched almost exclusively in terms of conventional, Western banking systems. Despite the rapid growth of Islamic finance over the last two decades, research into CG in Islamic banks is still at an early stage (Archer and Karim 2007a; Mollah and Zaman 2015).

The aim of this paper was to fill a gap in knowledge and understanding by exploring the idea of fusing principles of Islamic finance with elements of mature Western CG codes and the established theories underpinning CG in order to model existing CG practice in Islamic banking. The paper then proposes a conceptual model of best practice for future discussion amongst interested parties. The paper considers fully-fledged Islamic banks; it does not consider Islamic windows which have been developed by some Western banks as an extension to their conventional banking offerings.

This paper begins by considering both CG theorising in general, then examines Islamic finance, Shari'ah and other forms of Islamic legal and moral systems. The paper goes on to develop and

discuss a proposed conceptual framework which is intended to help in understanding the gaps between practice in Islamic and western banking systems and points towards the conditions needed for development of a code of best practice aimed specifically at Islamic banks.

Early in the development of European CG standards, Cadbury (1992, p.15) defined CG as

*‘... the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place’.*

While the literature on CG has widened considerably beyond this 25-year-old definition, in a narrow sense the above definition incorporates the mechanisms used internally within corporations to monitor managerial decisions and evaluate firms’ performance. In moving beyond the financial aspects in which Cadbury’s standards were set, it is helpful to consider contextual issues. Solomon (2013) says, for example, that CG is affected by the local culture and regulation. Consequently CG might differ from one country to another (Nordberg 2011; Solomon 2013). The cultural impact on CG is at the heart of this paper, along with the premise that one-size does not fit all.

Drawing on the above, Islamic financial institutions (IFIs) were outlined by Warde (2000, p.5) as

*‘those that are based, in their objectives and operations, on Koranic principles. They are thus set apart from “conventional” institutions, which have no such preoccupations’.*

In particular, Hosseini (2009, p.603) defines Islamic banks as ones in which

*‘..... depositors are treated as if they were shareholders of the bank. Consequently, depositors are not guaranteed the nominal value, or a predetermined rate of return, on their deposits. If the bank makes profits, then the shareholder ( depositor) would be entitled to receive a certain proportion of these profits. On the other hand, if the bank incurs loss the depositor is expected to share in these as well and receive a negative rate of return.’*

The Central Bank of Malaysia (2014, p.3) defines investment account holders (IAHs) as



*‘Investment Accounts such Islamic deposits on current account, deposit accounts, savings account or other similar accounts (e.g. general investment account and specific investment account) under any Shari’ah contract which is non-principal guaranteed’.*

Drawing upon the ideas above, this paper investigated the extent to which stewardship theory was appropriate for Islamic banks and, specifically, of relevance to IAHs.

The paper is structured as follows: first, it provides a literature review drawing on the received wisdom in CG in terms of the fundamental theories underpinning CG rules and principles and the significance of CG in Banks with a specific focus on Islamic banking. The review section concludes with the literature on active shareholding and its role in enhancing a stewardship culture. Second, the paper presents two models. Figure 6 provides a conceptual model based on the UK Stewardship Code published by the Financial Reporting Council, initially in 2010 in response to the collapse of major banks in the UK and then revised in 2012. To our knowledge, no other researchers have attempted to provide a diagrammatic presentation of this code. Figure 7 provides the main conceptual model introduced by this research. The model engages with the unique requirement of Islamic Banks’ governance in general and the case of IAHs in particular. It utilizes three leading theories of CG: agency theory, stakeholder theory and stewardship theory, the last of these being the distinguishing theory. Then, there is a discussion of the limitations of this research and recommendations for future research. The paper concludes with a summary of the main ideas and an elaboration of its potential significance for practice and policy. The principal contribution lies in examining the unique position that IAHs play in Islamic Banks.

## **4.2 Literature review**

### **4.2.1 The importance of corporate governance**

The interest in CG has increased rapidly over the last two decades driven by catastrophic scandals all around the world such as Enron in the US, Royal Bank of Scotland in the UK, Parmalat in Italy, China Aviation oil and many others (Letza et al. 2008; Mallin 2013). Therefore, there is a perceived universal need for robust and effective governance structures in order to protect all stakeholders from such collapses.

Cadbury (2002) argued that CG is a key driver in the world’s economic and political strategies due to the significant growth of international businesses. Supporting Sir Adrian Cadbury’s

contention are several research projects that conclude that countries with developed CG structures attract more investors. Moreover, CG plays a key role not only in protecting the interests of existing shareholders but also in attracting potential investors. Thus, corporations need a robust and transparent internal governance structure and a sound regulatory environment in order to sustain and compete in international markets (Cadbury 2002; Abu-Tapanjeh 2009; Mallin 2013).

#### 4.2.2 Theoretical underpinning

‘Corporate governance’ as a term and its daily usage in both press and academic literature is a relatively new phenomenon of the last three decades (Mallin 2013). However, the main theories which participated in evolving and shaping the contemporary CG models can be traced back to earlier years (Clarke 2004; Mallin 2013). Additionally, Mallin (2013) highlighted that CG theories were influenced by different aspects including finance, economics, accounting, law and organizational behaviour. According to Mallin (2013) choosing the appropriate theory in CG is affected by various aspects such as the corporations’ culture, activities, time frame and ownership structure and, notably, in which country/countries the corporation operates.

Two theories dominate the literature on CG: principal/agent theory and stakeholder theory. These theories are often presented by their relative supporters as the fundamental model underpinning CG. This has resulted in the debate on CG being polarised into two camps, the shareholding theory camp with an emphasis on principal/agent theory and the stakeholder theory camp emphasising a wider range of interested parties such as customers, employees, suppliers, lenders, society and shareholders (Jensen 2001; Letza et al. 2004 ; Mallin 2013), with each camp claiming superiority over the other. The debate presents a seemingly natural division between the two, either one or the other, with apparently no opportunity for consideration of a merge between the two. However, an alternative view is presented by Letza and Sun (2004a). They suggest that, instead of a clear-cut stable boundary between the two theories, where a static and entitative conception is presented, in the real world of boardrooms, decisions will be made and policies agreed based on a dynamic analysis of the constantly changing organisational environment where both the shareholder and stakeholder perspectives are constantly being debated and considered. Consequently, the perceived theoretical division between shareholders and stakeholders exists only in theory and not in practice. They proposed a processual approach to the understanding of CG where both the shareholder theory and the

stakeholder theory are seen as relevant and applied in practice when circumstances dictate their application. Thus, it is concluded that there is no ‘one best fit’ theory for all countries and corporations. Many scholars (such as Jensen and Meckling 1976 ; Davis et al. 1997; Jensen 2001; Clarke 2004; Letza et al. 2004; Mallin 2013; Nordberg 2010) associate the concept of CG with three main theories: agency theory, stakeholder theory and stewardship theory. It should be noted that the theories that are deliberated in the literature go well beyond these three and include class hegemony, managerial hegemony, transaction cost theory, institutional theory and prospect theory (Mallin 2013; Cuevas-Rodriguez et al. 2012). However, the three theories discussed above are the most commonly referred to when considering CG of both Islamic and conventional banks (Obid and Naysary 2014).

#### *4.2.2.1 Shareholding versus stakeholding*

One of the major dilemmas in CG is identifying the purpose behind corporations and whose benefit it should be serving. The debate in the CG literature is polarised into shareholding and stakeholding models (Letza et al. 2004).

Friedman (1970; 2007) claimed that all of a business’s activities and managers’ decisions should focus on generating maximum profits and maximising shareholders’ value. Furthermore, Davis et al. (1997) argued that both agents and principles aim to maximise their own utility based on the assumption of the ‘homo-economics’ model of humanity, where directors are opportunistic and self-serving. The main objective of agency theory is to reduce the agency cost arising from the divergence vis-à-vis principal–agent interests. Therefore, agency theorists provide several governance mechanisms which could be applied to achieve that goal, including financial incentive schemes aimed at aligning principal and agent interests or a governance structure aimed at controlling the agent.

In contrast, Freeman (2010) argued that maximising an owner’s wealth could only be achieved by taking into consideration all stakeholders’ interests. Furthermore, Jensen (2001, p.13) moved to an enlightened standpoint by claiming that because

*‘firms should pay attention to all their constituencies, the theory is unassailable. Taken this far stakeholder theory is completely consistent with value maximization or value-seeking behaviour, which implies that managers must pay attention to all constituencies that can affect the value of the firm.’*

Jensen (2001) introduced the enlightened value maximisation which adopts the classic stakeholder theory principle as long as it participates in creating long-term value maximisation not only short-term profits.

Mallin (2013) describes the stakeholder theory as the ‘juxtapositions’ to agency theory that focus on a wider range of people who are affected in the decision-making process including employees, suppliers, customers, lenders and governments. Furthermore, CG mechanisms including monitoring processes and board construction might differ based on the country of operation. For instance, the so-called Anglo-Saxon model of CG emphasises maximising the shareholders’ wealth whereas other models, such as the German and Japanese models, tend to take a long-term strategic view and embrace a broader prospective.

Many scholars in Islamic finance claim that Islamic banks should adopt a ‘societal model’ which acknowledges the rights and needs of substantial stakeholders including depositors, investment account holders and employees (Grais and Pellegrini 2006; Archer and Karim 2007b; Iqbal and Mirakhor 2007).

#### *4.2.2.2 Agency theory versus stewardship theory*

Corporations are the spine of all advanced economies in the world. Most of these corporations evolved from small trading entities to enabling their stockholders to trade in regional markets and, in some cases, to multibillion dollar corporations trading in global financial markets. As these corporations grew, for most, the entrepreneurial founders transferred the running of the business to professionals, giving rise to separation between ownership and management. Governing a firm requires a professional level of monitoring of all fundamental components including strategy, human forces, marketing, financial accounting and structure, as well as assuring their stakeholders that all mechanisms are in harmony (Nordberg 2010).

Agency theory is a key factor in shaping corporate structure and business policies. Agency theory was founded on the assumption that directors (agents) and owners (principals) are both attempting to maximise their own utility, often referred to as ‘slack’. In its original form, agency theory adopted a simplistic approach of two actors, namely, agent and principal (Jensen and Meckling 1976; Davis et al. 1997). However, Davis et al. (1997) argued that there was a perceived need for a new theory which was able to explain the complex nature of organisational

behaviour. Also, this theory should aim to explore the affairs in corporations taking into consideration non-economic factors.

Stewardship theory was introduced as a revolutionary concept that was able to explain relationships based on other non-economic behavioural assumptions (Donaldson and Davis 1991; Davis et al. 1997). Rather than management is being seen as utility maximisers as proposed in agency theory, stewardship theory views management as stewards. Also, unlike agency theory which requires either incentives or monitoring mechanism to ensure harmony, stewardship theory is capable of introducing an element of trust in the agent to deliver harmony. Davis et al. (1997) state that stewardship theory and agency theory complement each other and there is no one-best-way of thinking and, therefore, there is no perfect theory. However, reconciliation is required to differentiate between both theories and be able to determine which one best suits the organisation's circumstances to achieve the best outcome for major stakeholders.

The agency problem has been recognized in the literature of Islamic finance by many scholars such as Safieddine (2009) and Obid and Naysary (2014). Safieddine (2009) argued that Islamic banks suffer from a more complex agency problem accrued from the separation of not only management and ownership but also from the separation between cash flow and control. Therefore, any attempt to develop a CG model of Islamic banks should take into consideration the additional complexities of agency. Some scholars, including Bhatti and Bhatti (2009) and Obid and Naysary (2014), argue that CG in Islamic banks should be based on the stewardship theory because all the parties of the bank are viewed as stewards and perform their duties in the spirit of partnership in line with Islamic beliefs'.

Obid and Naysary (2014) present what they call a development of an integrated theoretical framework of Shari'ah governance. This theoretical framework represents the relationships between the three main theories deliberated in Islamic banking. Obid and Naysary (2014) go on to discuss these relationships from a theoretical stand and suggest how they might lead to a better governance performance. Obid and Naysary's (2014) ideas are not linked to practice nor do they discuss the internal mechanisms of Islamic banks. Nonetheless, this framework enhances the idea of 'one-size does not fit all' from a theoretical perspective and supports the adaption of the three main theories as discussed above.

#### 4.2.3 The significance of corporate governance in banks

Financial institutions in general and banks in particular have caught the attention of scholars and governments over the last three decades due to their major influence on an economy's progression (John et al. 2016). The CG of banks has also caught the attention of policy makers and academics due to the significant role of banks in society (Macey and O'Hara 2003 ; Levine 2004 ; Walker 2009; Dermine 2013; de Haan and Vlahu 2016; John et al. 2016).

Archer and Karim (2007b) argued that CG in all banks, irrespective of any specific nuance such as Islamic or Western, should be the subject of particular attention and require a unique governance structure due to three main factors. First, banks are more 'opaque' than other corporations, which causes more complex agency problems. Second, the heavy regulation facing the banking sector provides much greater externally imposed control than most sectors. Third, significant government ownership of many banks results in concentrated shareholding and consequently the conventional understanding of the principal/agent theory based on dispersed shareholding is of lesser significance.

Extending the work of Archer and Karim (2007b), John et al. (2016) claim that banks suffer from a more complex agency problem than non-financial firms due the significance of debtholders and divergence between shareholders' interests and debtholders' interests. John et al. (2016) state that banks are unique and, therefore, they should be treated with a higher level of attention. The uniqueness of the banks can be attributed to many elements. First, for most banks the leverage ratio, measured as the ratio of debt to equity, is very high, often 90%, while in the non-financial sector the leverage ratio rarely exceeds 30%. Second, there is a conflict between shareholder–debtholders as mentioned earlier. Third, banks are key players in society and potentially could have a larger impact on a wider range of stakeholders than non-financial firms. The 2007-2008 banking crisis is an example of this wider impact. Finally, as discussed above, banks have a complex and an opaque asset structure which might necessitate a more complex governance mechanism.

#### 4.2.4 The case of Islamic banks

Warde (2000) argues that the definition of an Islamic bank is much deeper than the popular view of 'interest-free' banks. It includes a wider variety of products and services that are compliant with fundamental Islamic principles. Warde (2000) and Iqbal and Mirakhor (2007)

highlight two main features in Islamic banking. First, Islamic banking is based on the risk-sharing model i.e. lenders and borrowers must participate not only in profits but also in losses. Second, Islamic banking pays major attention to economic development and seeks to develop the social well-being through specific investments and utilizing alms-giving known in Islam as ‘Zakat’. Zakat was defined as ‘*the compulsory giving of a set proportion of one’s wealth to charity*’ (BBC 2009), and it applies to both individual and institutions.

Despite the rapid growth of Islamic banks there is a gap in the literature on CG in Islamic banking (Abu-Tapanjeh 2009; Abdullah Saif Alnasser and Muhammed 2012; Muneeza and Hassan 2014; Mollah and Zaman 2015).

The governance structures in Islamic banks differ from their similar counterparts in the West. This divergence is largely attributed to the unique business model of Islamic banks because these institutions include unique items in their balance sheets such as alms-giving. Additionally, Islamic banks require a secondary board known as a Shari’ah supervisory board (SSB). The objective of the SSB is to assure all stakeholders that the banks’ activities and investments are in line with Shari’ah law (Abdullah Saif Alnasser and Muhammed 2012). Consequently, Islamic banks require a unique comprehensive governance structure enabling all additional elements unique to Islamic finance to be captured.

Archer and Karim (2007b) and Abdullah Saif Alnasser and Muhammed (2012) argue that a good governance structure requires aligning the interest of the banks’ management with its wide range of stakeholders, not only the bank’s shareholders. Additionally, there is a substantial need for a proper incentive scheme that allows a more effective supervisory mechanism to motivate managers to be more efficient in allocating banks’ resources. Finally, complying with Shari’ah rules and principles is essential to establish a relevant governance structure in order to avoid any reputational damage.

Islamic banks consist of two boards: the traditional board of directors and a Shari’ah board. As with the traditional role of non-executive directors, the role of the Shari’ah board fluctuates from advisory to supervisory depending on the regulations and codes of the countries in which they are operate. They provide an audit of the banks’ activities to make sure that they are compliance with Shari’ah principles.

The divergence in the governance structure is not limited to the difference between Islamic banks and their counterparts in the conventional markets but also between Islamic banks in different Muslim regions. For example, the study by Grassa and Matoussi (2014) found that board structure is affected by cultural, social and economic factors in GCC and Southeast Asia.

Grassa and Matoussi (2014) claim that CG in Islamic banks is required to be different from its conventional counterparts in three substantial areas; First, all Islamic banks must comply with Shari'ah law. Consequently, any non-compliance risks leading to reputational damage and financial losses. Second, the IAHs play a unique role in Islamic banks. Third, there is an argument by Claessens (2006 cited by Grassa and Matoussi 2014) that Islamic banks generally operate in less transparent systems and weaker regulated and monitored market.

All the above underpin the importance of having a unique governance structure for Islamic banks. As Chapra (1992, p.19) states, citing the famous Islamic philosopher Al-Ghazali (died 1111),

*‘The very objective of Shari’ah is to promote the welfare of the people. Which lies in safeguarding their faith, their life, their intellect, their posterity and their wealth. Whatever ensures the safeguarding of these five serves public interest and is desirable.’*

From the above quote we can see that Shari'ah emphasis is on society and the need to ensure a stewardship of the assets under management.

Drawing upon the ideas of leadership highlighted in the Islamic principles, stewardship theory is more applicable in Islamic banks rather than forming a governance structure based solely on the assumption that managers are self-serving and should be treated as agents. Moreover, Abdullah Saif Alnasser and Muhammed (2012) suggest any governance structure for Islamic banks should utilize stakeholder theory to insure the banks fulfil their purpose and achieve long-term success. Grais and Pellegrini (2006) claimed that the moral codes of Islam might enhance the ethical behaviour of managers in banks. Despite the strong moral principles, there is the ever present danger of the agency costs particularly, in the case of Islamic banking when you have a more complex agency problem caused by the existence of IAHs, who suffer from a lack of representation under a traditional governance structure (Safieddine 2009).



This paper adopted a theoretical stance aligned with the ideas presented by Davis et al. (1997) and Obid and Naysary (2014) that there is no one-best fit theory for all organisations and applicable under all circumstances. This paper embraces the idea of reconciling the different theories to recognize which will lead to a better governance structure that serves the best interest of major stakeholders. Nonetheless, this paper emphasises that CG in Islamic banks is affected not only by local cultures and regulations mentioned by Solomon (2013), but also by the ideas of leadership highlighted in the Islamic rules and philosophy. The focus on stewardship in this paper embraces the core dogma of Islam without neglecting the importance of stakeholder and agency theories.

#### 4.2.5 Enhanced shareholder activism

The debate on active shareholders, such as institutional shareholders, and their effect on the companies' governance, is not a new phenomenon. The debate has been ongoing for decades and can be traced back to the early 1990s (Cadbury committee 1992 cited by Banaga et al. 1995; Goranova and Ryan 2014; McNulty and Nordberg 2016; Armitage et al. 2017).

Archer and Karim (2007b) argue that CG adopted by western banks is not inconsistent with the requirement of Islamic principles. However, a number of additional features should be implemented over and above conventional models and theories of CG should be compliant with Islamic principles. Therefore, it is only rational to build upon the existing models and research on contemporary CG and implement the required features to suit the mechanisms and products of Islamic finance.

Goranova and Ryan (2014, p.1232) defined shareholder activism as

*'actions taken by shareholders with the explicit intention of influencing corporations' policies and practices, rather than as latent intentions implicit in ownership stakes or trading behavior'.*

As an example, the UK Stewardship Code (2012) argues that the investors' role must extend beyond just simply voting to include activities such as engaging, managing, strategies and CG. McNulty and Nordberg draw a useful distinction between the episodic and change-orientated activism identified by Goranova and Ryan (2014) and stewardship/engagement aimed at mutual understanding.

However, the Islamic Financial Services Act 2013 (IFSA), as cited by the Central Bank of Malaysia (2014, p.1), '*distinguishes investment account from Islamic deposit*'. These investments can be divided into three main types. 'Mudarabah' contracts are an equity-like instrument based on partnership principles including profit and loss sharing, where one party is providing capital and the other party is managing the asset (Minhat and Dzolkarnaini 2016). 'Musharakah' are equity partnerships combining the act of investment and management (Iqbal and Mirakhor 2007). Finally, 'Wakalah' is a contractual relationship between two parties, where one is acting as an agent to perform specific tasks for the other party either voluntarily or with associated fees (Central Bank of Malaysia 2014).

Drawing upon the above, it was concluded that IAHs could be treated as equity investors because they provide capital and participate in profits and losses. Moreover, IAHs should act alongside shareholders, actively and responsibly seeking to enhance the stewardship practice in their bank which consequently will be able to achieve long-term success and sustainable performance.

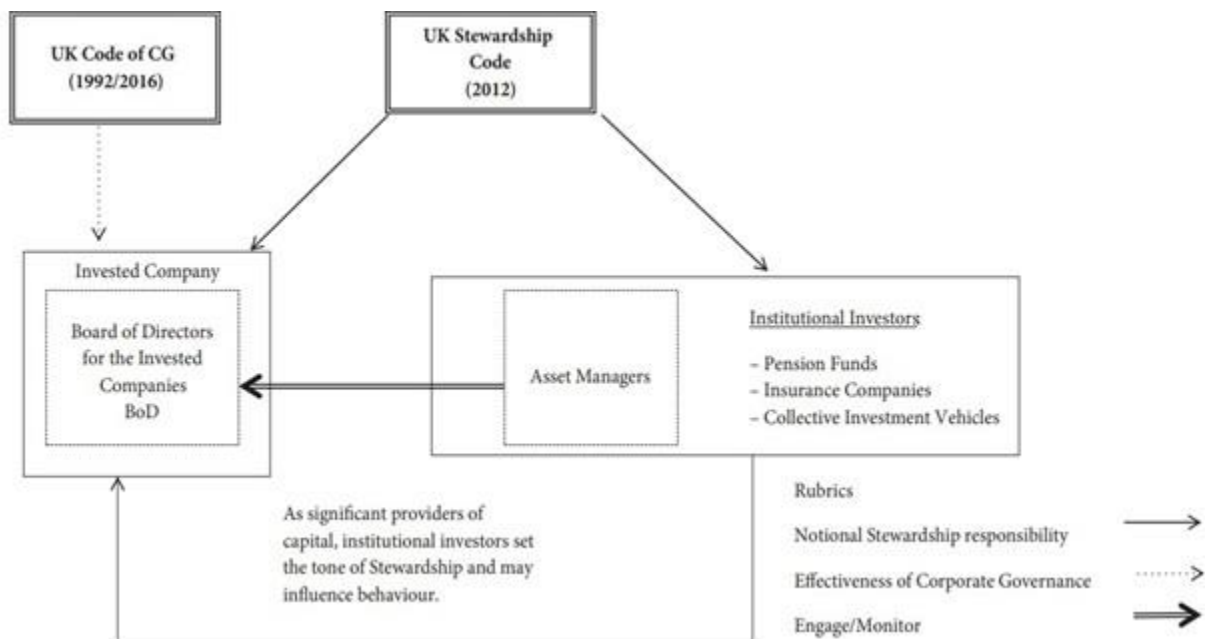
#### **4.3 Proposed conceptual model of corporate governance in Islamic banks**

This research aimed to incorporate the three main theories underpinning CG, and CG in Islamic banks specifically, into an overarching model. First, the model included principal/agent theory which is a key theory in CG and is seen as fundamental in CG in Islamic banks. The focus is on reducing agency costs (Jensen and Meckling 1976; Cuevas-Rodriguez et al. 2012). Second, this model used a governance structure taking primary stakeholders into consideration because most of the Islamic literature on Islamic finance argues that any Islamic corporation should be serving the public good and expanding its purpose beyond the financial needs of its shareholders in an attempt to fulfil the non-financial needs of its primary stakeholders based on moral and Islamic values (Chapra and Ahmed 2002; Grais and Pellegrini 2006; Abdullah Saif Alnasser and Muhammed 2012). Finally, stewardship theory acted as the pre-eminent element in the model, guiding directors in Islamic banks to both monitor and trust their managers by encouraging them to act as stewards and work for the best interest of their banks (Donaldson and Davis 1991; Davis et al. 1997; Cuevas-Rodriguez et al 2012).

In addition to the three theories identified above, the proposed conceptual model drew on three main codes of practice. First, we consulted the *UK Stewardship Code* published by the Financial Reporting Council (FRC 2012 ; 2020) which is considered as one of the most

substantial moves to engage shareholders as active owners (McNulty and Nordberg 2016). Second, we examined the ‘*Guiding principles on CG for institutions offering only Islamic financial services*’ published by the Islamic Financial Services Board (IFSB 2006) and deliberated by the literature of scholars such as Archer and Karim (2007b). Third, we drew on the ‘*Investment Account*’ policy published by the Central Bank of Malaysia (2014), which is a leading country in Islamic finance. This policy aimed to set the guiding principles on the treatment of IAHs, focusing on four main areas: (1) ensure compliance with Shari’ah principles; (2) establish a sound risk management structure to manage the assets of IAHs in order to safeguard the stakeholders’ interests including the IAHs; (3) set a minimum disclosure requirement enabling IAHs to make informed decisions that will boost the performance of the IFIs; and (4) ensure the sustainability of the Islamic financial system by supporting a robust risk management structure. The policy was divided into two types: standards that must be complied with ‘S’ or advisory guidance ‘G’.

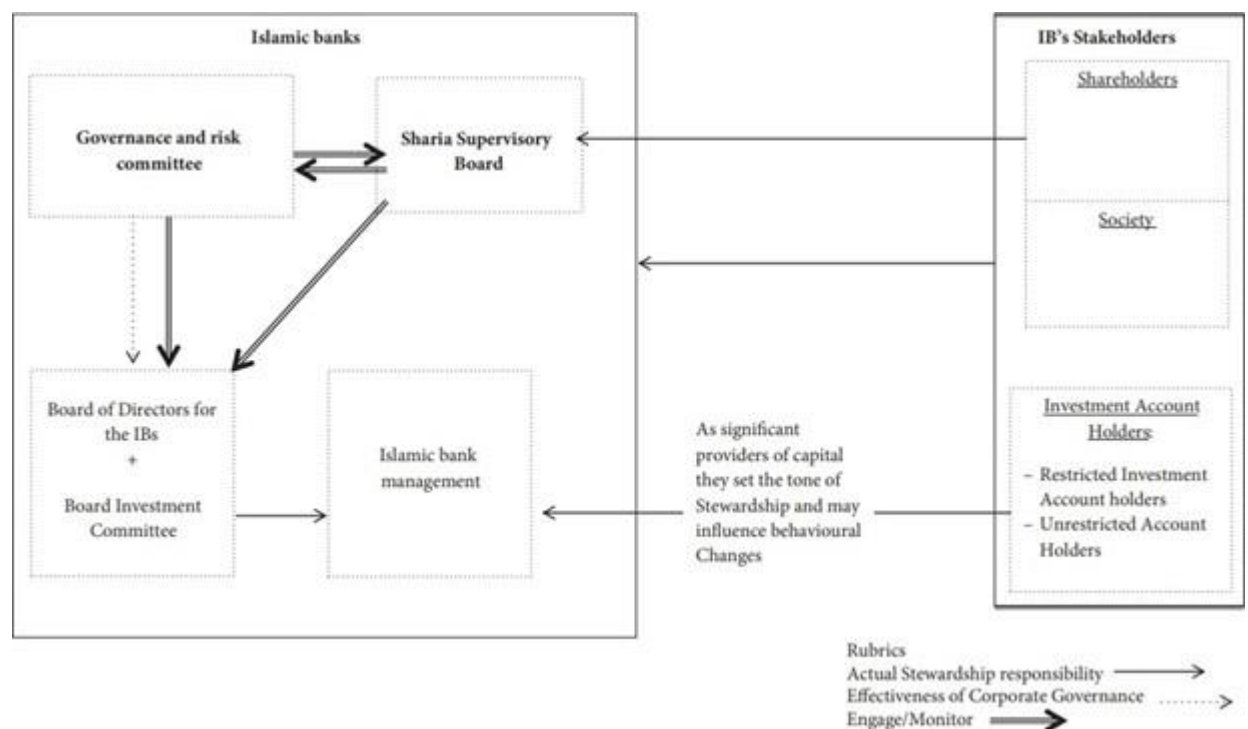
Figure 6 is a representation of the *UK Stewardship Code* (2012). In this representative model, the stewardship responsibility is shared between the board of directors and the institutional investors. Boards hold primary responsibility for stewardship practice by monitoring/trusting managers’ activities, while institutional investors are responsible for holding the board accountable for its stewardship responsibilities via the asset managers employed by the institutional investors. Consequently, the UK code of CG (FRC 2024) acts to enhance the effectiveness and efficiency of CG. This model is mainly concerned with institutional investors such as pension funds, insurance companies, investment trusts and collective investment vehicles that provide the capital to asset managers who manage the assets on behalf of the institutional investors. Consequently, these investment owners set the tone of stewardship and may influence a behaviour change and improve the corporate culture.



**Figure 6 Diagram of the UK Stewardship Code 2012**

Banaga et al. (1995) claimed that while there has been an ongoing discussion on the role of institutional investors for over two decades the reality remains a strategy of ‘exit’ i.e. the sale of shares in response to poor financial performance rather than active engagement in the governance of companies by institutional investors.

Figure 7 provides a representation of the proposed conceptual model for CG in Islamic banks. This model extends Figure 6, the stewardship model, by incorporating IAHs as unique to Islamic banks and considered one of the most substantial stakeholders (Archer and Karim 2007b). Their investment is crucial to Islamic banks and should be well protected. Moreover, Archer and Karim (2007) argue that IAHs are like ‘quasi-equity holders’, having no power on how the institution is governed. The IAHs have no protection and rely on the sympathy of policy makers and the Shari’ah board. Therefore, this conceptual model presents IAHs as a form of active shareholder/institutional investors with an entitlement to engage in a stewardship role in the Islamic bank.



**Figure 7 Conceptual model of Islamic banks' corporate governance**

Under the proposed model both the board and the IAHs engage in stewardship of the bank. However, due to the unique structure of Islamic banks, the board of directors shares the responsibility with the Shari'ah supervisory board which advises the board on all Shari'ah principles. The Governance Committee, suggested by the IFSB (2006) and shown in Figure 7, represents a parallel to the UK code. Furthermore, the IFSB (2006) suggests that the Governance Committee could consist of:

- i) A member of the audit committee
- ii) Shari'ah scholar
- iii) Non-executive director

The governance committee oversees and monitors the application of the governance framework in addition to providing the Islamic bank boards with reports and recommendations designed to enhance the accountability and the effectiveness of the board. Therefore, this Governance Committee is considered a key player in reducing agency costs. The Central Bank of Malaysia (2014) goes further by suggesting the formation of a risk management committee designed specifically to provide a more robust risk management for the IAHs. This paper suggests the amalgamation of both committees to form the governance and risk committee as

shown in Figure 7, which is responsible for providing a robust risk structure for IAHs. Finally, the model adopted the recommendation of the Central Bank of Malaysia (2014) that a board investment committee should be formed when the investment account constitutes a significant proportion of the total asset in the bank. Nonetheless, it is the board's responsibility to determine the significance of this investment.

#### **4.4 Conclusion**

This paper highlighted the unique position of CG in Islamic banks and proposed a model for further development that combined the fundamental philosophical principles of Islam with the theories and practical structures, codes and systems developed in the West. The IAHs were identified as significant stakeholders and were given a pivotal role in the proposed conceptual model. The proposed model combined the recommendations of both the Central Bank of Malaysia (2014) and the IFSB (2006) through the formation of a governance and risk management committee designed to enhance the efficiency and the accountability of the board of directors. These inclusions, together with the integration of an SSB, were designed to improve the CG in Islamic banks and provide assurance to all primary stakeholders that all the investments and activities are compliant with the Islamic principles.

On a final note, and in the light of the recent banking crisis, it may be of interest to Western governments and bank regulators to reflect on the founding principles of Islamic banks where the focus is on real assets, sustainability, wide stakeholder engagement with specific attention to society and the public good. These attributes have widespread appeal to global society, whether of Western or Eastern persuasion.

## Chapter 5: Paper 2—A comparative analysis of corporate governance and risk management: an evaluation of board responsibilities in Western and Islamic financial banks

*Chapter 5 of this thesis presents a significant extension of the overarching research on CG in Islamic banking. Titled ‘A comparative analysis of corporate governance and risk management: an evaluation of board responsibilities in Western and Islamic financial banks’ and co-authored with Dr. Rekha Pillai, this paper has been accepted for publication in the same journal of the first paper, ‘Economics and Business Review’. This submission reflects a strategic effort to ensure continued impact and synergy within the academic community, reinforcing the ongoing dialogue initiated by the first paper. I was lead author on this paper, and contributed over 90% of the content, as documented in Appendix 2 and signed by Dr Rekha.*

*Minor modifications have been made to fit this submitted paper into the style of the overall thesis. There may be some unavoidable repetition of information given earlier in the thesis.*

**Introduction and context:** *This chapter builds upon the foundational work shown in Chapter 4. That paper, accepted in 2018, laid the groundwork for integrating Western CG standards with Islamic banking principles. This subsequent paper, now accepted for publication, furthers these insights, potentially offering new dimensions and perspectives to this complex field.*

**Objective and methodological approach:** *Like the first paper, this research focused on conceptualizing CG models that blend Islamic finance with Western governance frameworks. However, it aimed to deepen the analysis and introduce new elements by examining leading countries in the West and Islamic finance. The paper maintained a qualitative research approach, leveraging and expanding upon the theoretical frameworks employed previously, such as principal/agent theory, stakeholder theory and stewardship theory.*

**Expected contributions and scholarly impact:** *The future impact of this paper stems from its contribution to the thesis and its potential to significantly add to the broader academic discourse on Islamic banking governance. Furthermore, it seeks to reinforce and elaborate on the themes of compatibility and synergy between Western and Islamic banking governance systems, enriching the conceptual model initiated in the first paper.*

**Continuity and evolution:** *The submission of this paper to the same journal reflects a deliberate strategy to maintain continuity in the research contributions while also ensuring the evolution of ideas and frameworks within the thesis. It exemplifies a commitment to rigorous academic inquiry and the advancement of knowledge in the field of Islamic banking and CG.*

*In essence, Chapter 5 is a pivotal part of this thesis, offering new insights and further solidifying the intellectual groundwork laid in the previous chapters. Also, it exemplifies the dynamic and progressive nature of academic research, where each contribution builds upon the last, driving forward the frontiers of knowledge in Islamic banking and CG.*

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## **Abstract**

Research on the role of boards in CG and risk management is in its infancy. The global reach of financial institutions makes it important to compare and evaluate the unique position of Shari'ah committees or Shari'ah supervisory boards (SSBs) in addressing the unique risks of Islamic banks. Using a comparative analysis, this study evaluated risk management guidelines in the CG codes of the United Kingdom, Germany, Saudi Arabia and Malaysia. It found that boards were ultimately responsible for risk management, regardless of the governance structure, and Shari'ah -related risks fell under the board's purview. An innovative blend of Western CG frameworks and Islamic principles enhanced governance robustness through the strategic collaboration between boards and SSBs. This study provides evidence on the effective alignment of risk management practices with Shari'ah principles, offering a novel perspective on governance structures that support the resilience and sustainability of Islamic banks in the global financial ecosystem.

**Keywords:** Corporate governance, Islamic banking, Risk management, Shari'ah, Governance codes

## **5.1 Introduction**

Corporate governance (CG) in recent years has evolved from its presumption of fair standards and its view of stakeholder responsibilities, board competence and corporate sustainability as mere tick-box activities (Wadsworth 2020). Nonetheless, the definition of 'good governance' is a controversial topic. Many shareholder-focused theorists argue that the board of directors' primary responsibility is to maximise shareholders' wealth (Friedman 2007) and that the CG mechanism should logically aim to fulfil this purpose. In contrast, stakeholder theorists, such

as Freeman (2010), claim that shareholders are only one of many stakeholders that corporations ought to be accountable to and good CG must be designed to serve this broader range of stakeholders. Despite the range of concepts of CG, there are certain fundamentals that “good” CG will consider, including creating sustainable and retainable businesses, achieving corporate objectives, ensuring efficiency and resource allocation, defining roles and responsibilities, balancing companies' economic and social benefits and ensuring an efficient risk management strategy is in place (Crowther and Seifi 2010). These fundamentals are logical, given that CG started to garner attention with the onset of three major events over past decades, namely the Asian financial crisis in 1998, the wave of corporate scandals in 2001 and the start of the global financial crisis in 2007, all of which reflected diminished risk management standards and practices (Gennaro and Nietlispach 2021).

Effective risk management strategies are capable of mitigating financial dilemmas, ensuring sustainable investments and enhancing diligent decision-making (Gouiaa 2018). With the recent COVID-19 pandemic, it is arguably even more critical now to form active boards that are capable of leading the CG strategy and implementing a resilience plan to ensure smooth and effective operation in the financial services sector (Haben 2020). This is because financial markets are subjected to stiff competition and rapid innovation and are vulnerable to political, economic, institutional, financial and environmental risks, which have led to waning profit margins and increased capital adequacy requirements (Permatasari and Yuliyanto 2016). Lam (2014) suggests that interactions of the previously mentioned risks can be mitigated through efficient governance and boards.

The board of directors plays a vital role in determining the appropriate levels of risk appetite, reducing information asymmetry, managing and controlling risks and strategies and thereby increasing shareholder wealth (Gouiaa 2018; Gelter and Puaschunder 2021). These claims align with Geeta and Prasann's (2016) argument that risk management effectiveness is dependent on variations in a board's structure, operating procedures and characteristics. Nevertheless, research on CG systems, boards and risk management practices is in an embryonic stage and thus warrants further study. For example, Gouiaa (2018, p.14) asserts that *'the risk oversight function of the board of directors, as a central CG mechanism, has never been more critical and challenging than it is today'*.

To address the evident gap in the risk governance literature, this paper provides a comparative analysis of the latest CG reports in leading organisations in both Islamic and Western countries

to investigate what constitutes good CG when it comes to risk management and board responsibilities in financial institutions. Previously, Alatassi and Letza (2018) explored the idea of fusing Western CG elements with Islamic principles to create an evolved CG structure led by effective boards who are able to cope with the constant challenges and risks in the contemporary world. Prior research has evinced agency problems and risk-taking behaviour in the Middle East and North Africa-based Islamic banks (Fayed and Ezzat 2017); identified the CG–risk management nexus in conventional banks (Permatasari 2020); or unveiled risk management in a CG framework (Rehman et al. 2021).

There has been a dearth of empirical research related to conventional and Shari’ah governance and their relationship with risk management. This evident gap motivated this study—the first that we know of—to examine how a fusion of conventional and Shari’ah -based CG can be applied to risk management practices, particularly considering the board's contribution and responsibilities towards risk management. Alatassi and Letza (2018) have previously highlighted the unique position of CG in Islamic banks and proposed a model for further development combining the fundamental philosophical principles of Islam with the theories and practical structures, codes and systems developed in the West.

Through a comparative analysis, this paper sought to achieve three objectives: first, to examine the risk management policies in the United Kingdom (UK), Germany, Saudi Arabia and Malaysia; second, to assess the role of boards in leading the risk management strategy; and third, to evaluate the role of Islamic banks' board of directors and Shari’ah supervisory boards (SSB) in accommodating the unique requirements associated with the Islamic finance industry and traditional risks.

The study makes several contributions to the CG literature. First, the paper aids Islamic financial policymakers in identifying the gaps in the current CG structure and influencing smooth operations in the global markets. Second, it guides regulators, especially in the Islamic finance industry, to optimise the guidelines and aim to achieve good CG practises. Third, by examining the differences and similarities in governance structures, risk exposures and regulatory frameworks, this study provides valuable insights into the effectiveness of these practices in maintaining financial stability and resilience in Islamic banks in the face of economic turbulence. Furthermore, the paper offers possible solutions to bridge the research gap by suggesting potential improvements to governance structures and risk management

practices in both Western and Islamic banks. These include identifying best practices, enhancing board oversight and fostering a culture of effective risk management.

The rest of the paper is structured as follows: Section 5.2 reviews prior literature, while Section 5.3 highlights the methods and materials of the study. Section 5.4 reflects the key findings and the conclusion (Section 5.5) provides recommendations for future research.

## **5.2 Literature review**

### **5.2.1 Theoretical overview**

Following a series of corporate scandals and increasing socio-economic and political upheaval, the boards of financial institutions have been assigned the principal responsibility for overseeing impending and existing risk management processes (Gupta and Leech 2014), to avoid substantial institutional risk management failures. In terms of the theoretical approaches, Udayasankar (2008, p.2) states that

*‘despite the proliferation of multiple theories of CG, including resource dependency, stakeholder and institutional theories, the epistemological basis of this domain remains the agency theory’.*

The economic theory of agency conflict argues that both principals (owners) and agents (managers and board members) prefer to maximise utility, but there is a difference in the objectives behind each maximisation.

*‘Agency problems arise because, under the behavioural assumption of self-interest, agents do not invest their best effort unless such investment is consistent with maximising their own welfare’* (Barnea et al. 1985, p.26).

As far as financial organisations are concerned, the managers (board members) are assumed to exhibit self-interest, thereby showing a misalignment with shareholders' interests; indeed, managers may display risk aversion due to their incapacity to diversify risk because they are heavily dependent on the firm (Squires and Elnahla 2020).

Furthermore, agency theorists argue that the separation between the corporation's ownership (principal) and its management (agent) creates what is known as ‘agency cost’. Agency theory aims to reduce this cost caused by the ‘homo-economics’ model of people, where directors are self-serving and seek to maximise their wealth at the principal's expense (Jensen and Meckling 2019). Although agency theory has played a role in forming CG roles and regulations, it is restricted in scope and unable to explain the more complicated, non-economic factors in the

organisation. In contrast, stakeholder theory extends the directors' responsibility towards the shareholder and the broader constituencies that influence corporations, such as employees, customers, suppliers and society (Letza et al. 2004; Mallin 2016). Letza and Sun (2004a) and Alatassi and Letza (2018) argue that the clear-cut stable boundaries between stakeholder and agency theorists only exist in theory and real-world events indicate that directors take a more dynamic approach based on the actual situation, including a mixed approach where both shareholder and stakeholder values are taken into consideration. Another school of thought argues for the new concept of stewardship theory, where agents can be viewed as stewards trying to pursue a higher need than self-serving or value creation (Donaldson and Davis 1991; Bhatti and Bhatti 2010; Alatassi and Letza 2018).

There is no single 'best fit' theory for all countries and corporations. Each state will adopt an approach that can respond to the state's cultural and economic demands (Alatassi and Letza 2018). For example, the UK and US models of CG (the so-called Anglo-Saxon approach) focus on maximising shareholders' wealth, therefore, require a more agent theory-based course. Other countries, such as Germany, follow the broader stakeholder approach, which empowers other groups in the organisation, such as employees. In Islamic financial institutions, there is a more ethical approach by which the banks' stakeholders have a higher, more spiritual need to fulfil. Thus, the internal stakeholders of the bank ought to act as stewards.

While the stakeholder theory discussed earlier acts as the CG underpinnings for their operationalization, the Islamic governance model upholds Aqidah belief, Shari'ah and ethics, which are derived from the Islamic maxims of free will, unity, equilibrium and responsibility. These all act as cornerstones for Islamic banks' operational standards. Apart from the ethical doctrines advocated in the Holy Qur'an and Sunnah, al-Kahtani (2014) proposes secondary sources such as Ijmā (consensus of opinions) and qiyās (analogical deduction) as vital foundations on which to base governance under Islamic jurisprudence (as cited in Al-Malkawi and Pillai 2018, p.606). Furthermore, an in-depth study by Zein et al. (2008) alludes to Amanah (trust), Adalah (justice) and Shura (consultations) from the Tawhid and the Qur'anic verses to bring out the essence of the principal-agent relationship. Here, it is presumed that managers are entrusted with Amanah by the shareholders and its fulfilment would bring Adalah to the recipients. All this can be performed through Shura, or mutual decision-making. Additionally, Aljifri and Kumar Khandelwal (2013) addressed the specific features of Islamic financing, such as mandatory compliance with Shari'ah principles, the generation of fair returns to the investor, the ethical values of curtailing self-interest and the avoidance of excessive risk-taking, as

mitigators of agency-theory problems compared with their conventional counterparts, where the sole objective is profit generation without any embedded values. Alam et al. (2020) also highlighted that it is anticipated that the moral responsibility and ethical sense in Islamic banks will reduce agency-led implications, such as lowering necessary risk-taking actions (Alam et al. 2020).

## 5.2.2 Risk management

### 5.2.2.1 Introduction

Corporate failures and scandals have often been attributed to individuals like board members and executives. However, Power (2009) argues that the system itself also bears responsibility. Risk management, as a social construct, is influenced by its surrounding environment (Bhimani 2009). It involves identifying, assessing and prioritising risks, followed by the efficient application of resources to minimise and control their impacts (Hubbard 2020). Enterprise risk management represents a comprehensive approach to managing risks across an organisation, although a universally accepted definition remains elusive.

This paper focuses on the overarching risk management aspects in the context of Islamic banking. It recognises the similarities and differences between risk management and enterprise resource management while emphasising the importance of effective CG in addressing the various risks faced by financial institutions. The concept of risk management in Islamic banking is inherently interconnected with its governance structure and principles (Archer and Karim 2007a). Islamic banks are subject to unique risks that stem from their adherence to Shari'ah principles, such as the prohibition of interest (Riba) and excessive speculation (Gharar) and the requirement to engage in ethical transactions (Iqbal and Mirakhor 2007). This necessitates the development of tailored risk management approaches that accommodate the distinctive characteristics of Islamic financial institutions (Abdul Rahman 2010). In this regard, one such approach is the application of Shari'ah-compliant risk mitigation instruments, such as profit and loss sharing contracts, which allocate risks and returns more equitably between the involved parties (Iqbal and Mirakhor 2007). Moreover, Islamic banks are required to establish SSBs, which oversee and monitor compliance with Shari'ah principles, acting as an additional layer of governance (Al-Suwailem 2006). Risk management in Islamic banking also emphasises the importance of ethical considerations and social responsibility. The Maqasid al-Shari'ah (objectives of Shari'ah) framework guides institutions in achieving overall well-being and an equitable distribution of resources in society (Chapra et al. 2008). As such, Islamic

banks are expected to engage in socially responsible investments and avoid financing activities that may harm society or the environment (Hasan and Dridi 2010).

In summary, effective risk management in Islamic banking is a multifaceted endeavour that involves addressing both conventional financial risks and those unique to Islamic finance. This necessitates a holistic approach that integrates governance, compliance with Shari'ah principles and ethical considerations, while drawing on insights from the broader field of risk management (Archer and Karim 2007a; Iqbal and Mirakhor 2011).

#### *5.2.2.2 Risk in banking*

The strength of the banking systems, regardless of whether they are conventional or Islamic, lies in their ability to identify and manage risk levels and interest-rate spreads whilst maintaining strong liquidity, credible depositor bases and lucrative loan portfolios (Winterbottom 2014). Monitoring, identifying, managing and measuring different kinds of banking risks such as credit risk, operational risk and currency risk, are amongst the main missions of risk management to prevent such risks from occurring. On this note, Brunnermeier and Yogo (2009) argue that various types of bank risks may result in a liquidity risk which then causes a spiralling effect and impacts the bank's reputation and overall performance. Thereby, liquidity risk acts as an accomplice in the collapse of the overall financial system in the country or even exacerbates contagion (Adalsteinsson 2014).

Currently, liquidity risk has emerged as the most important element in an enterprise-wide risk management framework. Liquidity risk refers to the present and future risks arising from the bank's inability to meet its financial obligations. It arises from myriad factors such as unexpected cash outflows, large credit disbursements, unexpected market movements, the crystallisation of contingent obligations (see Winterbottom 2014), external shocks and inter-bank rivalry issues. Liquidity risk can be divided into two main types: funding/cashflow liquidity risk and market/asset liquidity risk. The former relates to the capacity of a firm to fund its liabilities and the latter refers to the degree to which it will be difficult to dispose of an asset fast enough to avoid potential losses. As the foundation of Islamic banks relies more on participation than mere financial intermediation, the scope and intensity of risks are likely to be greater due to the various roles played by Islamic banks as partners, investors, buyers and sellers in comparison with the customary lender status in traditional banking.

Banks have evolved from traditional practices solely based on receipts of deposits and generating loans, with new instruments being launched such as trading in financial markets and

income generation through fees (Archer and Karim 2007a). Van Greuning and Brajovic Bratanovic (2020) argue that this evolution of the banking system exposes banks to higher and more variable risks associated with the newly developed instruments. Also, banks must adapt quickly and gain risk management capabilities to survive in competitive financial markets and build consumer trust (Doğan and Ekşi 2020). Van Greuning and Brajovic Bratanovic (2020) divided banking risk into three main categories: first, financial risks, including traditional risks such as credit, balance sheet, solvency and income statement structure; second, environmental risk, including but not limited to macroeconomic and policy concerns and legal and regulatory factors; and third, operational risks including compliance, internal control, technology and IT security, fraud and business continuity concerns. In addition to the academic literature, similar risk classifications have been presented by other guidelines, such as the ACCA and the UK Code of Corporate Governance (McNulty et al. 2012; FRC 2024).

Sundararajan (2008) argued that Islamic financial institutions (IFIs) had seen a growth in the global markets due to globalisation and regulatory environment changes, which necessitated a more robust risk management system that enabled them to compete in financial markets. He also emphasised that IFIs were susceptible to more complex risks than their conventional counterparts, including contractual risk based on Islamic instruments that comply with Shari'ah principles, legal risk and governance risk. One of the main unique risks for Islamic banking, as deliberated in prior literature (Grassa and Matoussi 2014), is the reputational risk caused by non-compliance with Shari'ah rules, which is also part of the business risk identified by Archer and Karim (2007a). This current paper focuses on analysing risk management according to the main three categories determined by Archer and Karim (2007b) and Van Greuning and Brajovic Bratanovic (2020), namely: financial, business/environment and operational risk.

#### *5.2.2.3 Corporate governance and risk management*

Prior research attests the inter-relationship between the risk management–CG nexus (Bhimani 2009; Woods 2009; Muhammad et al. 2023). It argues that both subjects strongly influence public policy debates and corporate control. Bhimani (2009) states that management's CG and risk management concepts can only be actionable if they are construed within three primary dimensions—technical, analytical and calculable—as well as continuously reassessing and developing risk management to adapt to the world's ongoing economic fluctuations. Woods (2009) discusses risk management as a dimension of CG and argues that, although the principles of risk management are globally applicable, the industry's constant challenges require unique contingencies that can be generalized and adopted by enterprises later on. More



recently, Muhammad et al. (2023) emphasize the relevance of board characteristics in influencing firms' systematic and unsystematic risk.

Therefore, it is essential to understand the definition of CG and its correlation with the board's function and risk management. The 1990s were considered the tipping point in the contemporary CG system. This was influenced by myriad reasons, such as the reformation of the governance structure in both the USA and Germany, as well as a response to the collapse of the 1990s global stock markets and a shift towards a more enhanced shareholder model of CG (Cioffi 2006). The publication of the first Cadbury report in 1992 was considered the pinnacle of the UK code of CG and was arguably one of the most influential factors in policy and practice worldwide. However, the Islamic Financial Services Board (IFSB 2006) argued that all the core principles that helped form the modern norm of CG have existed in Islam since its establishment more than 1400 years ago. Therefore, CG as a set of values and standards is well known to all Muslims and Islamic institutions. Moreover, the IFSB (2006) argues that there are more similarities than differences between Islamic institutions and their Western counterparts when it comes to good governance and ensuring fairness, transparency and accountability. The sole element differentiating Islamic institutions from their more conventional peers is the religious factor and Shari'ah roots in IFIs.

Delving into the plethora of CG benefits, Charny (1998) highlighted the role that CG plays in three main areas, namely (a) reducing agency costs by monitoring executives and ensuring that all activities maximise shareholders' value; (b) establishing a good relationship between the corporation and its stakeholders, including employees, directors, creditors and shareholders; and (c) achieving the state's socio-political and economic goals such as shareholder primacy in the UK and US or codetermination in Germany. In addition, the chain of uncertainties looming in the economy has undermined investor trust, thereby demanding a system to document environmental, social and corporate governance (ESG) issues as well as to recognise and manage risks (Pillai et al. 2021).

On the above basis, this paper argues that CG in Islamic banking is still at the embryonic and formation stage and requires on-going reformation and development to reach the revolutionary stage that modern capitalism urgently needs. Therefore, a fusion between Western guidelines and Islamic principles might benefit the global banking sector by achieving a more robust CG system.

#### *5.2.2.4 Corporate governance and risk in conventional and Islamic banks*

Banks are the backbone of any economy due to their significant role in people's lives and in organisational development. Therefore, CG in the banking sector is a primary focus for government guidelines and policymakers (OECD 2010). Existing CG literature shows an orientation towards the banking sector, especially since 2007–2008 (Adams and Mehran 2003; De Andres and Vallelado 2008; Alatassi and Letza 2018; Doğan and Ekşi 2020). De Andres and Vallelado (2008) argue that CG is crucial for any country's economy because it provides financial institutions with appropriate rules and regulations to manage and participate in economic development. Islamic banking differs from its conventional counterparts by sharing profit and loss, prohibiting speculation and gambling, limiting non-performing loans (Ahmed and Chapra 2022) and, most importantly, banning fixed interests (Frag et al. 2018). Moreover, all Islamic banks' activities should comply with Shari'ah principles and be based on real investment, which adds new stakeholders and unique players to the banks' structure. Thus, the CG structures of Islamic banks differ from their western counterparts and require special attention (Safieddine 2009; Frag et al. 2018). Godlewski et al. (2014) also questions the pertinence of standardization in Shari'ah governance practices embedded in Islamic finance activities. With respect to risk, Zarrouk et al. (2016) emphasize the high degree of financial risks inherent in Islamic banks due to the mismatch between the undertaking of risky financial operations and returns guaranteed to customers.

Two prominent and unique stakeholders differentiate Islamic banks' structure from that of conventional banks and add risk layers that do not exist in traditional banking. Investment account holders are the first category that is considered one of the unique stakeholders in Islamic banking. They provide the banks with funds via equity-based contracts called Mudaraba and Musharaka. While depositors in conventional banks receive a fixed interest on their deposits, investment account holders in Islamic banks share profit and loss, including losses caused by their Shari'ah compliance investments, creating an extra unique risk assessment requirement to mitigate the additional risk. In this regard, Yanikkaya et al.'s (2018) findings related to incorporation of more non-murabah assets as a financing structure to mitigate risks in Islamic banks offer valuable insights.

Safieddine (2009) and Frag et al. (2018) argue that the unique nature and characteristics of the Islamic banking industry cause a specific and more complex agency problem compared with the typical agency dilemma. The typical agency dilemma is attributed to the separation between management and control. In Islamic banking, all stakeholders, including shareholders,

policymakers and investors, add a layer of agency caused by the separation between depositors' and investors' rights. Therefore, the managerial decisions should not only aim to maximise shareholders' wealth but also investment account holders' return on investment. The second category of stakeholders, namely the SSBs, are key players in Shari'ah governance system, which the Islamic Financial Board defined as

*‘the structures and processes adopted by stakeholders in an institution offering Islamic Financial Services to ensure compliance with Shari'ah rules and principles’* (IFSB 2009).

The Shari'ah board's role is to assure all stakeholders that the Islamic banks' investment and activities comply with Islamic laws and avoid any non-compliance risk (Alnasser and Muhammed 2012).

#### *5.2.2.5 The role of the board in corporate governance*

The board of directors is arguably the central pillar of the CG mechanism in all economies and plays a fundamental role in enhancing CG practices by taking on the responsibilities of monitoring and supervising the available resources (Fernandes et al. 2017; Doğan and Eksi 2020). One of the main differentiators between CG models worldwide is that the board structure is affected by many factors, including social, cultural and financial factors (Grassa and Matoussi 2014). Therefore, the board's role might vary from one country to another based on the structure (single or dual), rules, regulations and cultures. However, there are certain fundamentals that most CG guidelines in the world have in common.

The board's role within the governance structure is not only limited to internal processes but also encompasses external and internal duties. According to Heracleous (1999), the board of directors' duties formally include monitoring the C-level in the organisation and participating in their strategic directions. Heracleous (1999) also added that while the normative expectation from the board of directors was high, they have not delivered in the last few years, which increased the demand for different frameworks and policies designed to support the boards and boost their performance. Therefore, directors have been under pressure from their primary stakeholders, such as institutional investors, politicians and society, driven by disquiet and discomfort (Heracleous 1999). Shareholders in the Anglo-Saxon countries led by the USA and UK and the majority of the EU members, use a single board of directors who take responsibility for all corporations' activities. They hold this board accountable for maximising the value of the companies' shares. In contrast, countries such as Germany, Denmark and the Netherlands

adopt a dual board structure model where shareholders elect the supervisory board members. It is the supervisory board's responsibility to appoint the executive management board, who are then responsible for running the business. In the dual structure, employees might be represented on the supervisory board (Mallin 2016). There are pros and cons for each model (Farag et al. 2018). For example, a unitary board structure might benefit from many characteristics such as a faster decision process, higher meeting frequency and having both executives and non-executives engaged in the decision-making unit. However, a single-tier board lacks actual separation between managerial and supervisory activities. A dual-board structure allows for a broader stakeholder representation to achieve better performance. Researchers such as Farag et al. (2008) argue that Islamic banks' governance structure is based on a unique dual board structure: the board of directors and SSB. Nonetheless, Alatassi and Letza (2018) argue that the role of the SSB fluctuates between advisory and supervisory depending on the policies and regulations in the countries of operation.

Adding to the former, Grais and Pellegrini (2006) reported that the current role of the SSBs was limited to the Shari'ah compliance process, where SSBs approved and certified all financial instruments in Islamic banks before launching them in the market. Also, it is the SSB's responsibility to monitor the bank's activities and ensure all transactions comply with Shari'ah principles. Furthermore, the IFSB (2006) stated that SSBs should consist of at least three independent non-executive members, while Farag et al. (2018) contend that policymakers should allow a room for reformation in Islamic bank's governance structure by enhancing the independence of SSBs, because shareholders currently hold the board of directors responsible for appointing the members of SSBs (IFSB 2006). Furthermore, Farag et al. (2018) argue that policymakers for Islamic financial institutions should reform the design of the current CG structure in place and, instead of holding the boards of directors in Islamic banks responsible for appointing the SSB, the members of the SSBs should be given more independence to avoid any pressure from the board members. They also state that the regulators should reconsider the role that the SSB plays, changing it from a supervisory and consultative body to being mandatorily present in organisational affairs.

#### *5.2.2.6 The role of the board in risk management*

A bank's board is more critical for governance aspects than its non-bank counterparts for various reasons, which Doğan and Ekşi (2020) mainly attribute to the bank's ultimate responsibility towards both regulators and shareholders. Moreover, banks arguably face a high insolvency risk due to increased leverage, which also requires a premium to be paid to

depositors as compensation. Thus, risk control is a vital responsibility of the board and regardless of its composition (unitary, dual, Islamic, or conventional), a board must develop and enhance management activities to create precise risk management mechanisms (Deloitte 2018). Van Greuning and Brajovic Bratanovic (2009) mentioned that the quality of bank risk management, especially the risk management frameworks, is a critical concern in guaranteeing both individual bank's security and soundness and the overall financial framework. Furthermore, the ultimate responsibility for conducting a bank's business lies with the board of directors and the supervisory board, particularly where a dual board applies. The board also has to set strategic plans, appoint managers, establish operational policies and, most importantly, take responsibility for ensuring a bank's reliability towards risks.

Research by Deloitte (2018) discussed in depth the roles and responsibilities of risk oversight in a dynamic and turbulent business environment, where risk is constantly evolving and requires the boards to provide the same level of flexibility. It is the board's responsibility to monitor and guide the organization's activities regarding all risk activities, including, but not limited to, identifying, assessing and monitoring risks. Nevertheless, Deloitte (2018) argues that all boards should clearly define the risks that they will review regularly and properly delegate the rest to the appropriate board committees, mainly the audit committee.

The SSB in Islamic banks plays a pivotal role in managing Shari'ah non-compliance risk, which is a unique and significant risk type specific to Islamic financial institutions (Hassan and Lewis 2007). Shari'ah non-compliance risk arises when a financial transaction or product fails to comply with Islamic jurisprudence or Shari'ah principles, leading to the potential invalidation of contracts and financial losses (Karim and Archer 2002). This risk is distinct from conventional banking risks such as liquidity or credit risk, which are typically overseen by the main board of the bank. The SSB's expertise in Islamic jurisprudence is crucial for ensuring that all banking activities align with Shari'ah principles, including the prohibition of Riba (interest), Gharar (excessive uncertainty) and Maysir (gambling). This is only achieved by closely collaborating with the main board, because the SSB helps in structuring products and auditing transactions to avoid any form of non-compliance (El-Hawary et al. 2007). Their role extends to ongoing monitoring and reviewing of bank operations to ensure adherence to Shari'ah laws, thus safeguarding the bank against the reputational and financial risks associated with Shari'ah non-compliance (Errico and Sundararajan 2002). The SSB's guidance is indispensable for Islamic banks, because Shari'ah non-compliance not only affects the legality of transactions but also impacts customer trust and the bank's reputation in the market (Khan

and Bhatti 2008). Therefore, their strategic collaboration with the main board is essential for mitigating this unique risk and ensuring the overall sustainability and growth of Islamic banking institutions.

### 5.2.3 Summary

The research gap identified in the literature pertains to the lack of comprehensive and comparative studies on the role of board structures and risk management practices in conventional and Islamic banking systems (Grassa and Matoussi 2014). Although previous literature has acknowledged the unique dual-board structure in Islamic banks (Farag et al. 2018) and offered some insights into risk management frameworks (IFSB 2006; Deloitte 2018), there is still a dearth of knowledge in understanding the comparative effectiveness of these practices in both banking systems and how they may affect financial stability and resilience. A few initiatives, such as the guidelines provided by the Islamic Financial Services Board (IFSB 2006), have made progress in addressing the research gap by outlining the roles and responsibilities of the board and risk oversight in Islamic banks. However, these efforts do not provide an up-to-date and comprehensive understanding of the interaction between board structures, risk management practices and the impact on overall financial stability in both Western and Islamic banks—a gap that warrants further investigation.

## 5.3 Methodology

This section outlines the methodology used to conduct a comparative analysis of risk management guidelines in the CG codes of four countries, including the UK, Germany, Saudi Arabia and Malaysia, in both Western and Islamic banking systems. The core of this methodology is a document analysis approach, tailored to scrutinize the roles and responsibilities outlined in the CG codes regarding risk management.

The methodology, detailed by Bowen (2009), facilitates an in-depth exploration of textual data to unearth themes, patterns and insights relevant to board responsibilities in both Western and Islamic financial institutions. Following a structured approach, documents including CG codes, regulatory guidelines and Shari'ah governance frameworks were systematically reviewed and analysed. This enabled a comparative analysis of risk management policies, the role of boards in directing risk management strategies and the unique position of Shari'ah committees in Islamic banks. The approach is akin to the studies by Aguilera and Cuervo-Cazurra (2004) and others who have highlighted the global diffusion of governance codes and their implications on firm performance and governance practices. The document analysis approach, which is

rooted in qualitative research traditions, supports the synthesis of empirical evidence on the alignment of risk management practices with Shari'ah principles, contributing novel insights into the governance structures that bolster the resilience of Islamic banks within the global financial ecosystem.

The philosophical basis for the comparative analysis approach can be traced back to the works of several social science scholars and philosophers, most notably Emile Durkheim (1982). Comparative analysis is rooted in the belief that understanding complex social phenomena can be effectively achieved by comparing and contrasting different cases or instances. The underlying philosophy of comparative analysis is grounded in the positivist and interpretivist paradigms (Bryman 2001). On the one hand, positivism emphasises the use of empirical, systematic and objective methods to study social phenomena, while interpretivism, on the other hand, focuses on understanding the meanings that individuals and groups ascribe to their experiences. In comparative analysis, researchers seek to identify similarities and differences between the cases being studied, as well as uncover patterns, relationships and underlying mechanisms that can help explain the observed phenomena (Ragin 2014). By analysing multiple cases, comparative analysis allows for a deeper understanding of the social, political, economic and cultural contexts that shape the phenomena under investigation. Consequently, this approach helps researchers to test theories, identify factors that influence outcomes and generate new hypotheses for future research (Bryman 2001).

### 5.3.1 Data Collection

The data for this study were obtained from secondary sources, including the latest versions of the CG codes of the UK, Germany, Saudi Arabia and Malaysia, as well as relevant guidelines, regulations and frameworks published by the respective authorities. The data collection process entailed searching and reviewing various academic and professional databases, such as Google Scholar, ProQuest and EBSCOhost, using a combination of keywords like 'corporate governance', 'risk management', 'UK Code of Corporate Governance', 'German Code of Corporate Governance', 'Saudi Corporate Governance Code', 'Malaysian Corporate Governance Code', 'Shari'ah governance' and 'Islamic banking systems'. To ensure a comprehensive analysis, the paper focused on the application and adoption of risk management guidelines in each report, as well as the roles of the board and its committees. To compare and contrast the risk management guidelines across multiple countries and banking systems, this paper used a comparative analysis approach. Specifically, the study analysed the 2018 UK Code of CG and the 2020 German Code of CG to assess the board's roles and responsibilities

in risk management. In addition, the paper analysed the 2017 Saudi CG Code and the 2021 Malaysian CG Code, which are leading countries in Islamic banking, to provide a similar analysis. To further consider the unique requirements of Islamic finance, the study analysed the Shari'ah governance guidelines published by the Saudi Monetary Authority (SAMA 2020) and the Central Bank of Malaysia (2010) Shari'ah Governance Framework for IFIs.

The rationale for selecting the four countries in this study was based on their unique approaches to CG and Islamic banking and their prominence in the global economy (OECD 2014a). The UK and Germany are well-known for their strong CG systems, while Saudi Arabia and Malaysia are leading countries in the Islamic banking system. The UK is a world leader in CG and employs a single board structure, while Germany follows a dual board structure. The importance of CG and Islamic banking systems in these four countries cannot be overstated, because the effectiveness of these systems can significantly impact each country's economic and business conditions. For example, the 2008 global financial crisis highlighted the importance of effective risk management in CG, while the growth of Islamic finance has led to the development of new financial products and services in Saudi Arabia and Malaysia.

### 5.3.2 Analysis process

The document analysis methodology employed in this study was organized to scrutinize CG reports across the UK, Germany, Saudi Arabia and Malaysia, with an emphasis on understanding risk management frameworks within conventional and Islamic banking systems. The process commenced with the identification of essential keywords, including 'corporate governance,' 'risk management', 'Risk', 'Committee', 'Shari'ah governance', 'Shari'ah Board', among others, facilitating a targeted search for the most recent CG codes and related documents.

This preparatory step was instrumental in assembling a comprehensive database for analysis. Subsequently, a comparative document analysis was conducted, examining each CG code to delineate the roles and responsibilities attributed to boards in the realm of risk management, paying special attention to the incorporation of Shari'ah governance principles in Islamic financial institutions. This analysis was pivotal in extracting and synthesizing critical information, thereby enabling a structured evaluation of the alignment between CG codes and risk management practices. Special focus was given to analysing Shari'ah governance guidelines to assess their integration into the broader CG frameworks. This methodological approach offered profound insights into the governance mechanisms underpinning risk



management strategies, highlighting both the commonalities and disparities across different banking systems and underscoring the unique compliance with Shari'ah principles within Islamic banking.

This study built on the OECD's Risk Management and CG report (2014b), which applied similar methodology covering 27 jurisdictions, including the UK and Germany, and provided valuable insights for policymakers, regulatory bodies and financial institutions on how to improve risk management practices. The comparative analysis of the CG and Islamic banking systems in the four studied countries provided insights into their approaches to risk management, board structures and Shari'ah governance. This highlighted the importance of learning from the unique features of each system, which can lead to improvements in risk management practices, ultimately driving economic growth. The data analysis process involved reviewing the collected documents, extracting key information and comparing and contrasting the risk management guidelines across the four countries. The paper focused on specific aspects of risk management in CG codes, including application and adoption, board roles in risk management, committees and responsibilities and Shari'ah governance.

## **5.4 Results and findings**

### **5.4.1 Risk management guidelines in countries**

Table 1 shows the comparative analysis to assess the risk management guidelines in the CG codes of four studied countries, including the UK, Germany, Saudi Arabia and Malaysia. The board's roles and responsibilities towards risk management were examined by focusing on the 2018 UK Code of CG, the 2020 German Code of CG, the 2017 Saudi CG Code and the 2021 Malaysian CG Code. The unique requirements of Islamic finance were addressed by analysing the Shari'ah governance guidelines for Saudi Arabia and Malaysia.

In the UK, the 'comply or explain' approach struck a balance between flexibility and accountability within CG frameworks, allowing companies to adapt to dynamic market conditions while maintaining transparency. Therefore, integral to this structure was the audit committee, whose oversight was vital for upholding financial integrity and managing risk, ensuring that organizations adhered to high standards of financial reporting and control.

In Germany, CG was characterized by stringent legal requirements that mandated robust risk governance. The supervisory board was central to this system, functioning independently of the management board. It was tasked with compliance oversight, reinforcing the division

between strategic supervision and operational management. This demarcation underlined the German model's emphasis on checks and balances.

**Table 1: Comparison of risk management in CG codes in the UK, Germany, Saudi Arabia and Malaysia**

<b>Criteria</b> <b>Country</b>	<b>United Kingdom</b>	<b>Germany</b>	<b>Saudi Arabia</b>	<b>Malaysia</b>
<b>Application &amp; Adoption of the codes</b>	Comply or explain	Mandatory (Law Enforcement)	Mandatory with some guidance	Mandatory (Islamic Financial Services Act)
<b>Board's Role in Risk Management</b>	Strategic planning, risk monitoring and internal control	Strategic decision-making, risk supervision and compliance	Comprehensive strategy, risk culture development, risk management instruments	Overall governance structure and compliance, Shari'ah related matters
<b>Committees &amp; Responsibilities</b>	Audit Committee: risk management systems, internal control and financial reporting	Supervisory Board: oversight of management board, risk management and compliance	Advisory Risk Committee: risk plans, risk assessment, acceptable risk levels	Shari'ah Committee: Shari'ah governance, risk implication, oversight of internal audit, risk management and compliance
<b>Shari'ah Governance (if applicable)</b>	N/A	N/A	Shari'ah Governance Framework	BNM Shari'ah Governance

**\*\*Note:** Table 1 is a summary of the key aspects of risk management in CG codes in the UK, Germany, Saudi Arabia and Malaysia. The full text is available at <https://www.ecgi.global/content/codes>.

In contrast, Saudi Arabia embedded risk management within its strategic framework, with a pronounced emphasis on fostering a risk-aware culture across corporate entities. This approach was supplemented by the Shari'ah Governance Framework, which imposed a unique set of compliance standards that ensured corporate practices were in line with Islamic principles, thereby integrating ethical considerations into the core of business operations.

Finally, in Malaysia, the CG landscape was similarly influenced by Islamic principles, as enforced by the Islamic Financial Services Act. The Shari'ah Committee was pivotal in this context, ensuring that all financial practices complied with Shari'ah law. This compliance was not just a legal formality but a defining trait of the Malaysian financial sector, distinguishing its governance model on the global stage.

Each of these countries demonstrated a unique confluence of regulatory compliance, cultural ethos and governance mechanisms, illustrating the diversity of approaches to CG in different legal and cultural settings.

#### *5.4.1.1 The board's role in risk management*

The UK and German codes both placed the responsibility of risk management on the board, with a focus on strategic planning, risk monitoring and internal control in the UK and strategic decision-making, risk supervision and compliance in Germany. The Saudi code placed an emphasis on setting a comprehensive strategy, developing a risk culture and providing risk management instruments, while the Malaysian Shari'ah Governance Guidelines held the board accountable for the overall governance structure and compliance, including Shari'ah -related matters.

#### *5.4.1.2 Committees and responsibilities*

All four countries had designated committees responsible for specific aspects of risk management. The UK and German codes highlighted the role of the Audit Committee in overseeing risk management systems, internal control and financial reporting. The Saudi Code required companies to form an Advisory Risk Committee with duties including setting risk plans, assessing risk-taking abilities and determining acceptable risk levels. The Malaysian Shari'ah Governance Guidelines assigned the Shari'ah Committee responsibilities such as Shari'ah governance, risk implication and oversight of internal audits, risk management and compliance.

#### *5.4.1.3 Shari'ah governance*

Shari'ah governance played a significant role in the risk management guidelines of Saudi Arabia and Malaysia. The Saudi Shari'ah Governance Framework focused on setting roles and responsibilities, ensuring the integration of Shari'ah principles in finance and reinforcing the competence of internal control and risk management committees. The Malaysian BNM Shari'ah Governance Guidelines stressed the importance of identifying, measuring, monitoring and reporting Shari'ah non-compliance risks and emphasised the management of reputational risks associated with Shari'ah non-compliance. The UK and German codes did not directly address Shari'ah governance, because it was not applicable to their banking systems.

This critical comparative analysis highlighted the similarities and differences in the risk management guidelines within the CG codes of the UK, Germany, Saudi Arabia and Malaysia. All four countries placed significant emphasis on the boards' roles and responsibilities in risk

management, but they adopted different approaches in application and enforcement. The Shari'ah governance aspect played a crucial role in the Islamic banking systems of Saudi Arabia and Malaysia. While Western and Islamic banking systems differed significantly in their governance structures, there were shared principles that transcended cultural and religious boundaries. For instance, the importance of risk management, transparency and accountability were universally recognised as crucial components of a robust CG framework. Ultimately, understanding these shared principles and learning from the unique features of each system can lead to better governance practices worldwide.

#### 5.4.2 Similarities and differences between CG and risk management guidelines in the four countries

Table 2 highlights the key differences and similarities between the CG and risk management guidelines in the UK, Germany, Saudi Arabia and Malaysia. The table establishes a comparative analysis of the countries studied and identifies areas where each country's guidelines could benefit from the experience of the others.

**Table 2: Key differences and similarities in risk management guidelines**

<b>Criteria</b>	<b>UK</b>	<b>Germany</b>	<b>Saudi Arabia</b>	<b>Malaysia</b>
<b>Application &amp; Adaption</b>	Comply or Explain	Obligation	Mandatory	Comply or Explain
<b>Board Structure</b>	Single Board System	Dual Board System	Single Board System	Single Board System
<b>Risk Management Role</b>	Board of Directors	Management Board	Board of Directors	Board of Directors
<b>Risk Reporting</b>	To stakeholders	Supervisory Board	To stakeholders	To stakeholders
<b>Shari'ah Governance</b>	Not Applicable	Not Applicable	Applicable	Applicable
<b>Board Composition</b>	No specific requirement	No specific requirement	Encourages inclusion of Shari'ah committee member	Encourages inclusion of Shari'ah committee member

Source: Authors' own work

## Analysis

On the basis of the comparison, it was evident that while all four countries placed significant emphasis on the boards' roles and responsibilities in risk management, they adopted different approaches in application and enforcement. The UK and Malaysian codes followed a 'comply or explain' approach, allowing for flexibility in the application of the core principles. In contrast, the German and Saudi codes leaned more towards obligatory enforcement. The German code also featured a unique dual board structure, with a management board and a supervisory board, which differed from the single board systems adopted in the UK, Saudi Arabia and Malaysia.

The Shari'ah governance aspect was a crucial difference between the Islamic and Western banking systems. Both Saudi Arabia and Malaysia had specific guidelines addressing Shari'ah risk management and the roles of the board of directors in overseeing compliance with Shari'ah principles. However, it should be noted that even within the Islamic banking systems, differences exist in the application and adaptation of their CG codes, with Saudi Arabia adopting a more stringent, mandatory approach and Malaysia following a 'comply or explain' policy.

In all four countries, the board of directors had a direct relationship with the risk management and audit committees. In Germany, the management board reported to the supervisory board, which then had a relationship with the audit committee. In Saudi Arabia and Malaysia, the board of directors also had a direct relationship with the Shari'ah committee and the compliance committee. Additionally, both Saudi Arabia and Malaysia had a unique relationship where the board of directors was responsible for the Shari'ah governance framework.

### 5.4.3 Board–committee relationships

Finally, the structure and governance of corporate boards and their associated committees played a pivotal role in the effective oversight and accountability of organisations. Table 3 offers a comprehensive perspective on the intricate relationship between the board and its committees across four distinct nations: the UK, Germany, Saudi Arabia and Malaysia.

**Table 3: Board-committee relationship**

<b>Board's Relationship</b>	<b>UK</b>	<b>Germany</b>	<b>Saudi Arabia</b>	<b>Malaysia</b>
Board of Directors -> Risk Management Committee	Direct	Via Management Board	Direct	Direct
Board of Directors -> Audit Committee	Direct	Via Supervisory Board	Direct	Direct
Board of Directors -> Shari'ah Committee	N/A	N/A	Direct	Direct
Board of Directors -> Compliance Committee	Direct	Via Supervisory Board	Direct	Direct
Board of Directors -> Shari'ah Governance Framework	N/A	N/A	Direct	Direct

**Source: Authors' own work**

### **Analysis**

In the UK, the relationship between the board of directors and the risk management committee was direct, suggesting a streamlined approach to risk management that benefited from immediate oversight from the board. However, German's board structure was notably distinct, embracing a dual-board system. This system bifurcated the board into a management board and a supervisory board where the former assumed direct responsibility for the risk management committee, while the latter provided oversight for the audit committee. This tiered structure, inherent to German's corporate landscape, strove to strike a balance between executive decision-making and supervisory control, even though it could introduce potential communication challenges. Both Saudi Arabia and Malaysia depicted analogous governance structures. Their board of directors maintained a direct relationship with the risk management committee, audit committee and, more uniquely, the Shari'ah committee. The emphasis on the Shari'ah committee and the accompanying Shari'ah governance framework underscored the profound significance of compliance with Islamic principles in Islamic banking operations. This commitment to Islamic principles resonates with the growing global acknowledgment of the importance of Islamic finance. Moreover, the inclusion of a compliance committee in their governance structure augmented the emphasis on rigorous adherence to both the regulatory framework and religious guidelines. In essence, while countries like the UK and Germany mould their governance structures to suit their distinct economic and regulatory environments, nations such as Saudi Arabia and Malaysia embed Islamic principles within their governance paradigms. Therefore, this analysis emphasises the importance for corporations, especially

those operating across various jurisdictions, to possess a deep understanding of these diverse board and committee relationships.

In summary, the paper's findings aligned with those reported in the literature (Bhimani 2009; Woods 2009; Muhammed et al. 2023), namely that both CG and risk management are interrelated. Moreover, results also evince that the board of directors is ultimately responsible for managing the risk regardless of the CG structure, single or dual system. Finally, the ultimate responsibility for Shari'ah risks lies with the directors and not the committees, because it is the board's responsibility to adhere to the recommendations of the SSB, also known as the Shari'ah committee.

## **5.5 Conclusion, limitations and future research**

The paper outlines a comparative analysis of CG and risk management guidelines in four countries, namely, the UK, Germany, Saudi Arabia and Malaysia. It focuses on the relationship between the board of directors, committees and various aspects of risk management in both Western and Islamic banking systems. The research aimed to compare and contrast risk management policies across the studied countries, assess the board's roles in leading risk management strategies and review the Shari'ah committee or SSB's position in accommodating the unique risks of Islamic banks.

The analysis found that each country's codes and guidelines aimed to boost stakeholders' confidence, increase CG effectiveness and support institutions in managing various types of risks. Moreover, the application and adoption of these codes varied, with Western countries such as the UK adopting a more flexible approach with a 'comply or explain' policy, while Germany took a more rigid stance using terms like 'obligation' to emphasise law enforcement. In the Islamic banking sector, Malaysia followed the UK's 'comply or explain' approach, whereas Saudi Arabia's code application was mandatory.

In terms of the board's role in managing risk, all codes in both Western and Islamic countries held the board of directors ultimately responsible for risk management, establishing strategies and forming committees. However, there were some unique requirements depending on the country and board structure. For example, Germany's dual board structure held the management board responsible for adhering to the law, reporting to the supervisory board on strategic matters, overseeing risk operations and establishing committees.

Regarding Shari'ah risk management, Malaysia and Saudi Arabia held the board of directors ultimately responsible while encouraging a comprehensive risk management approach that included Shari'ah aspects, with the SSB being an additional layer board. In contrast, leading Western countries such as UK and Germany neglected the Shari'ah aspect, despite the significant share of Islamic finance in their economies.

These findings align with previous research by Alatassi and Letza (2018) which explored the idea of fusing Western CG elements with Islamic principles to create a more robust governance structure, including risk management. This study can assist policymakers, regulatory bodies and financial institutions in improving risk management practices by learning from the unique features of each system.

However, the paper is not free from limitations due to its focus on CG codes in only four major Western and Eastern nations and the qualitative analysis performed. Future research could explore a broader spectrum of countries in Islamic finance, perform an empirical study and analyse banks' publications and annual reports to assess compliance with best practice codes. It would also be useful to investigate the extent to which the SSB influences risk management strategies and the ethical behaviour of the board. Also, studies can explore the possibility of highlighting the board's responsibility to Shari'ah activities in Western countries where Islamic finance is being adopted.



## Chapter 6: Paper 3—Exploring the complex impact of internal corporate governance mechanisms on risk management in GC's Islamic banks

*Chapter 6, titled 'Exploring the complex impact of internal corporate governance mechanisms on risk management in GC's Islamic banks,' represents an important critical and independent contribution to my thesis. It is a full paper currently under consideration for the British Academy of Management Conference 2024, to be held in Nottingham.*

*This chapter provides a deeper investigation into the CG nuances within Islamic banks in the Gulf Cooperation Council (GCC) region using a qualitative panel data analysis.*

**Introduction:** *This chapter continues the exploration into Islamic banking governance, shifting the focus to the intricate interplay between internal governance mechanisms and risk management strategies within the GC's Islamic banks. Building on the theoretical and empirical foundations laid out in previous chapters, this paper aimed to provide a comprehensive understanding of how various elements of CG influence risk management effectiveness in the unique context of Islamic financial institutions.*

**Objective and methodology:** *With the goal of enhancing the understanding of CG's impact on risk management, this paper employed a qualitative research approach. It delved into various aspects of internal governance, including board characteristics, ownership models and Shari'ah compliance and their collective influence on the risk profile of Islamic banks. The research methodology encompassed a thorough analysis of existing literature, and conduct a Discriminant analysis which offer a multifaceted view of the subject matter.*

**Expected contributions:** *This work is poised to make significant contributions to the academic discourse on Islamic banking. It aims to elucidate the complex relationship between governance mechanisms and risk management in Islamic banks, offering fresh insights and perspectives that can inform better regulatory policies and governance practices within the industry. By addressing this gap, the paper seeks to enhance the understanding and implementation of effective governance structures in Islamic banks, particularly in the GCC region. It will be published in a peer-reviewed journal.*

**Continuity and evolution:** *Submitting this paper to a prestigious conference like the British Academy of Management showcases a commitment to engaging with and contributing to the broader academic community. Moreover, it represents both continuity in the thematic*

*exploration of Islamic banking governance and an evolution of thought and research methodology. Furthermore, this paper reflects a maturation of academic inquiry, signifying a more profound, independent investigation into the critical aspects of CG and risk management in Islamic banking.*

*In summary, Chapter 6 stands as a pivotal and distinctive piece of research within the thesis. It not only demonstrates an expanded scholarly capability but also significantly contributes to the body of knowledge on CG and risk management in Islamic banks, reinforcing the thesis's overall objective and scholarly value.*

### **Abstract:**

This research explored the complex relationship between internal corporate governance (CG) mechanisms and risk management in Islamic banks within the Gulf Cooperation Council (GCC) region. The empirical investigation used a robust dataset spanning from 2005 to 2021 that encompassed multiple internal CG measures, including board characteristics, Shari'ah supervisory board characteristics, ownership models, corporate social responsibility (CSR) and internal control and audit characteristics. The risk management performance of banks, measured through Z-scores, served as the dependent variable. Findings from the discriminant analysis indicated that CSR, government holdings and board duality were significant predictors of a bank's financial health, while board size and firm age demonstrated less predictive value. The study's insights underscore the importance of robust CG mechanisms and sound risk management strategies in enhancing the resilience of Islamic banks. These results not only provide vital contributions to the Islamic banking literature but also offer meaningful regulatory recommendations and best practices for Islamic banks in the GCC region.

## **6.1 Introduction**

Effective CG and sound risk management have increasingly become vital areas of study in preventing fraudulent activities or unethical behaviour in commercial dealings. The global finance sector specifically has seen a significant increase in the use of Shari'ah-compliant commercial instruments, leading to an increased popularity of Islamic banking institutions, especially in the Gulf Cooperation Council (GCC) (Nawaz 2020). It is pertinent to understand that the principal operating difference between conventional banks and Islamic banks is centred around the adherence to Shari'ah law or Islamic law in every stage of product development (Grais and Pellegrini 2006). As suggested by Hassan and Kayed (2009), the

central tenets of CG in Islamic banks revolve around the principles of accountability, transparency and fairness, all rooted in Shari'ah law. CG in Islamic banks encompasses unique principles that distinguish it from conventional banking systems.

In the context of Islamic banks, accountability extends beyond the typical fiduciary responsibilities to include compliance with the ethical and moral standards set forth by Shari'ah law. Banks are not only accountable to their direct stakeholders but also to society at large, reinforcing the role of Islamic banks in promoting socio-economic development and welfare. Transparency is fundamental for maintaining stakeholder trust and is achieved through clear, accurate and timely reporting of financial and non-financial information, which must be compliant with both international standards and Islamic accounting principles (IFSB 2006). Fairness underscores the Islamic concept of justice and is manifest in the equitable treatment of stakeholders, inclusive decision-making processes and the provision of ethically compliant services. In addition to these principles, the regulatory framework for CG in Islamic banks involves unique mechanisms like the Shari'ah supervisory board. This body, comprised of Shari'ah scholars, oversees the bank's adherence to Islamic principles in its operations and product offerings, supplementing the traditional roles of the board of directors (Hassan and Kayed 2009).

Islamic banks differ significantly from conventional banks primarily due to their adherence to Shari'ah principles (Grais and Pellegrini 2006). While the latter are largely profit-driven, Islamic banks are oriented towards ethical and social responsibility. This orientation is reflected in their prohibition of interest-based transactions (Riba) and their risk-sharing approach to financing, which distinguishes them from the risk-transfer approach of conventional banks (Khan 2010).

Therefore, in Islamic banking systems, where adherence to Shari'ah laws is paramount concerning product and service offerings, good governance pillars can lead to effective risk management strategies. In terms of CG, this ethical and social focus of Islamic banks translates into a unique governance structure. While conventional banks primarily focus on fiduciary responsibilities to shareholders, Islamic banks adopt a broader approach encompassing not only shareholders but also depositors and society as a whole. This wider scope of accountability creates a distinctive CG model for Islamic banks that ensures ethical integrity and promotes stakeholder trust (Archer and Karim 2007a).

However, this uniqueness also introduces specific challenges, such as the need for a comprehensive understanding and application of Shari'ah law in financial practices. Such challenges underline the importance of robust internal CG mechanisms and effective risk management strategies for Islamic banks, especially in the rapidly growing Islamic finance industry in the GCC region (Nawaz 2020).

Risk management aims to identify, evaluate and mitigate various risks that could hinder a bank from achieving its objectives (Grais and Pellegrini 2006). In Islamic banks, the operational principles of profit and loss are based on sharing mechanisms accompanied by asset-backed financing mechanisms that prohibit interest bearing transactions (Riba). This creates a series of unique risks such as credit risk, market risk, operational risk and non-compliance with Shari'ah laws among others (Grais and Pellegrini 2006).

In spite of the inherent risks, the GCC's promising economic future has contributed significantly to the rapid expansion of Islamic banking industries across the world with regional trading centres demanding Shari'ah-compliant products Nawaz (2020). Moreover, Nawaz (2020) argues that there is a growing importance placed on internal CG mechanisms in Islamic banks operationalizing in the GCC region. CG can assist in enhancing overall stability and resilience within these institutions thus promoting the stability of financial systems regionally. Moreover, the CG mechanisms will improve reliability and lead to expansion/growth whilst also providing policymakers/regulators with a diverse climate to solidify guidelines. Competent CG regulations will help mitigate potential risks within Islamic banks globally.

The importance of the GCC as a key player in the Islamic finance stems from variety of reasons. First, the GCC region houses some of the world's largest and most influential Islamic banks, making it a global hub for Islamic finance (Khan and Bhatti 2008). The region's wealthy economy, fuelled predominantly by oil and gas resources, allows for significant liquidity in its financial markets, thereby driving growth in the Islamic finance sector. Second, the population in the GCC region is predominantly Muslim, which creates a strong cultural and religious inclination towards Islamic banking. This forms a large customer base that is also inherently inclined towards Shari'ah-compliant financial services (Chong and Liu 2009). Third, GCC governments have shown strong support and commitment towards the growth and development of Islamic finance. Regulatory bodies in these countries have established comprehensive regulatory and supervisory frameworks that are specifically

designed for Islamic financial institutions. These include guidelines for Shari'ah governance, risk management and financial reporting standards, all tailored to meet the unique needs of Islamic banks (Wilson 2009). Fourthly, the diversity among GCC countries in terms of their level of development, regulatory environmental frameworks and market maturity makes the region an ideal setting for comparative studies in Islamic banking and finance. The uniqueness of the GCC region not only provides a rich context for research but also offers valuable insights for other regions seeking to develop or enhance their Islamic finance sectors (Abedifar et al. 2013).

That said, although these governance frameworks facilitate compliance with Shari'ah principles for corporations (Hassan et al. 2019), Islamic banks face a unique set of risks and regulatory requirements compared with conventional banks (Samad 2015). Therefore, effective internal governance structures like boards of directors are necessary to maintain competitive standards by minimizing risks while ensuring the institution addresses financial challenges optimally. Furthermore, implementing these mechanisms demonstrates a commitment towards ethical practices which encourages stakeholder confidence within the GCC's banking sector (Al-Tamimi 2012). By ensuring efficient operations that align with Shari'ah principles, these mechanisms serve as key drivers in the industry's growth and competitiveness on a global scale.

Internal CG mechanisms are crucial for Islamic banks in the GCC region, and their adoption has become increasingly important due to the growth of the Islamic finance industry within the region, all of which served as prime motivators for this research. The main research question that drove this study was: what is the relationship between internal CG mechanisms and risk management and how do these factors impact the financial health and resilience of Islamic banks in the GCC region? To address the aforesaid questions, this research examined the intricate relationship between internal CG mechanisms and risk management within Islamic banks in the GCC region and analysed how these factors contribute to the overall financial health and resilience of these institutions. The paper also deepens the understanding of the unique challenges and risks posed by the compliance to Shari'ah principles in the Islamic banking context and how effective governance and risk management strategies can be leveraged to ensure sustainable operations.

## 6.2.Literature review

### 6.2.1 Corporate governance in Islamic banks

The governance structure within Islamic banks is notably distinct, necessitating adherence to the specific precepts derived from the Holy Qur'an and the Sunnah. This unique framework integrates principles that advocate social justice and accountability, as elucidated by Karbhari et al. (2020). It is incumbent upon Islamic financial institutions to ensure that their objectives, activities, operational strategies and management policies are in strict compliance with Shari'ah principles. This requirement underscores the pivotal role of Shari'ah conformity in their governance systems, a point emphasized by Hassan et al. (2017). In the realm of Islamic CG, the theoretical framework advocates for a dialogic process, transparency and active institutional involvement. These elements collectively contribute to reducing transaction costs, thereby distinctively characterizing the CG within Islamic banks, as highlighted by Choudhury and Hoque (2006).

In Islamic banks, CG practices are shaped by a set of unique Shari'ah laws and resulting requirements. A comprehensive framework that emphasizes key players such as SSBs together with board directors, coupled with clear communication channels across every level, can help achieve effective governance practices throughout all operations within an Islamic bank (Chapra and Ahmed 2002; Alatassi and Letza 2018). In order to establish stability that promotes long-term success amidst changing socio-economic conditions across growth markets that are focused on growth building, credible governance mechanisms have become increasingly important, both domestically and internationally. Global bodies such as the IFSB have launched guidelines on CG standards for Islamic banking to help organize policies led by key pillars including supervisors and board directors whose roles are integral to framework of governance guideline (IFSB 2006). This enhances transparency while monitoring potential hazards during periods of significant sectoral boom or recovery from setbacks (IFSB 2006; AAOIFI 2010). The AAOIFI (2010) has developed governance standards aimed at ensuring proper functions in the operations of Islamic banks whilst enhancing accountability and transparency, according to their website. These guidelines include selection processes outlining qualifications required from SSB members; disclosure requirements concerning financial information; and mechanisms providing oversight of internal controls, amongst others.

Thus, an essential prerequisite in upholding these standards entails effective risk management practices alongside the ethical levels required for sustainability over time. For example, in

order to promote transparent decision-making processes, it is integral that an independent relationship is maintained between the bank's management and its board (Cadbury 1992). The role of executive management in Islamic banks significantly extends beyond the boardroom, overseeing daily operations and ensuring alignment with strategies outlined by directors (Eisenhardt 1989b). In addition to managing risks and enforcing Shari'ah principles, executive management fosters transparency and accountability within a bank. The core pillars in CG for Islamic banks include internal control measures along with audit functions. These play a crucial part in assuring financial integrity regulatory compliance as well as adherence to Shari'ah principles, alongside the safeguarding of critical assets held by a bank (Haridan et al. 2020).

Effective governance is crucial for preventing violations of stakeholder rights and maintaining public trust, while also contributing to long-term sustainability (Renn 2015; Akkucuk 2019). Stakeholder involvement is a key aspect of effective governance because it ensures that the knowledge, values and interests of all parties are considered in risk policy making (Renn 2015). Good governance that is characterized by accountability, transparency and stakeholder involvement is essential for sustainable value creation. It also plays a critical role in reducing the susceptibility to disasters and fostering development (Ahrens 2006). In the context of risk management, governance for sustainability requires knowledge integration and multi-actor dimensions (Shiroyama 2012).

Despite the progress made thus far to improve corporate governing structure within Islamic banking institutions, challenges prevail and, therefore, efforts need to be made towards streamlining harmonization by adopting consistent standards across different locations whilst improving Shari'ah supervisory capacities. This can be done through fostering a culture that promotes ethical conduct coupled with accountability levels, in line with industry best practices for successful outcomes (Nawaz 2020). The growth opportunities presented by the evolving industry demand stricter adherence to robustly transparent CG procedures that are specific yet responsive to stakeholder needs and that highlight stability and credibility as a fundamental competitive advantage in the ever-congested financial services sector.

#### 6.2.2 Risk management in Islamic banks

The unique nature of Islamic banking, with its Shari'ah-compliant transactions, requires a distinct approach to risk management (Al-Adwan 2014). This is particularly important in emerging markets, where Islamic banks face specific challenges such as immature money

markets and limited lender of last resort facilities (Aldoseri 2016). Yamin (2019) emphasizes the need for Islamic banks to analyse, manage and control risk, given their commitment to Shari'ah rules. Shaikh (2009) further underscores the importance of risk management in Islamic banks, particularly in comparison with conventional banks and suggests that Islamic banks may face more risk due to their involvement in business operations. In addition to conventional risks such as credit, market, liquidity and operational risk, Islamic banks face a range of unique risks related to their adherence to Shari'ah law.

First, Islamic banks face the 'profit and loss sharing' risk. Unlike conventional banks that have a predetermined interest rate, the return on assets for Islamic banks is not guaranteed and can vary depending on the actual profit or loss made by the business venture financed by the bank. The variable nature of returns can lead to unpredictability and potential disagreements between the bank and its customers (Iqbal and Mirakhor 2011).

Second, there is a 'Shari'ah non-compliance' risk, which arises when a financial product or transaction is later deemed to be not in accordance with Shari'ah law. Non-compliance not only leads to the transaction being nullified, but it can also harm the reputation of the bank and erode the trust of its customers (Archer and Karim 2007a). Additionally, 'displaced commercial risk' is another significant risk faced by Islamic banks. When the returns on the investment accounts are lower than the market benchmark, the bank may forego a portion of its share of the profit to prevent the loss of investment account holders. This practice may affect the bank's profitability and expose it to additional risk (Archer and Karim 2007a).

Third, the 'equity investment risk' arises from the involvement of Islamic banks in direct equity investments. Because this type of financing is subject to business performance, the bank may lose part or all of the capital if the venture fails. The rate of return risk also plays a role as the returns on profit-and-loss sharing accounts are not fixed and can lead to uncertainty (Iqbal and Mirakhor 2011).

### 6.2.3 Risk management framework and strategies

Given the unique nature of risks involved in Islamic banking, the implementation of a robust and comprehensive risk management framework is fundamental. Alatassi and Letza (2018) proposed an innovative framework, combining principal/agent theory, stakeholder theory and stewardship theory. This model incorporated the *UK Stewardship Code*, IFSB's '*Corporate governance principles for Islamic financial services*' and the Central Bank of Malaysia's '*Investment Account*' policy. It advocates for shared stewardship responsibility between the



board of directors and institutional investors, improved by a combined governance and risk committee. This committee enhances oversight and risk management for investment account holders.

This approach resonates with existing prudent banking practices such as stringent credit appraisal processes, effective liquidity management and constant monitoring of market risks (Hassan and Kayed 2009). The use of advanced risk quantification tools, like Value-at-Risk, Profit-at-Risk and Cash Flow at Risk, assists in assessing the maximum potential loss under varying market conditions. Additional stress testing and scenario analyses further evaluate the bank's resilience under adverse conditions. Risk management committees, comprising senior management and risk management experts, oversee the implementation of these strategies and ensure their alignment with Shari'ah principles. They also delineate the bank's risk tolerance levels (Iqbal and Mirakhor 2011).

#### 6.2.4 Relationship between internal corporate governance mechanisms and risk management in Islamic banks

The internal CG mechanisms and risk management practices in Islamic banks play an integral role in their resilience, operational efficiency and adherence to Shari'ah principles (Grassa 2013). These institutions face unique risks that necessitate a well-coordinated system of CG and robust risk management strategies.

##### 6.2.4.1 *Interplay between corporate governance mechanisms and risk management*

The board of directors and the Shari'ah supervisory board serve as the linchpins in maintaining the balance between Shari'ah compliance and risk management. These governance entities ensure that Islamic banks conduct their operations within the ambit of Shari'ah principles and manage risks accordingly (Safieddine 2009). Their involvement ranges from supervising risk management strategies to ensuring compliance with Shari'ah principles, thereby safeguarding the banks' interests and those of their stakeholders.

##### 6.2.4.2 *Impact of ownership structure on risk management*

The ownership structure significantly influences the risk management approach in Islamic banks. Particularly, the profit and loss sharing principle in contracts like Mudarabah necessitates sophisticated risk management systems to ensure fairness in profit and loss distribution among stakeholders (Ahmed 2011). In such contexts, strong CG mechanisms foster trust and ensure adherence to agreed-upon profit and loss sharing arrangements.

#### *6.2.4.3 The role of internal control and audit*

In Islamic banks, internal control systems and audit functions are paramount for risk management. They guarantee compliance with internal and Shari'ah principles, assure the accuracy of financial and non-financial data and assess the efficiency of risk management systems (Karim 2001). Furthermore, internal audits contribute significantly to the detection and prevention of fraud, operational errors and other risk types, thereby reinforcing the bank's financial integrity.

#### *6.2.4.4 Corporate social responsibility and risk management*

CSR, which is deeply rooted in Islamic principles of justice, equity and public welfare, plays an essential role in Islamic banking (Dusuki 2008). By prioritising CSR, Islamic banks effectively manage reputational risks and nurture trust among stakeholders. Additionally, a proactive CSR approach can aid in anticipating and managing social and environmental risks, which is increasingly pertinent in today's business context.

In conclusion, the multifaceted interplay between internal CG mechanisms and risk management is pivotal for the success and sustainability of Islamic banks, particularly within the GCC region. The board of directors and Shari'ah supervisory board are crucial in balancing Shari'ah compliance with effective risk management, thereby safeguarding stakeholder interests. Ownership structures, especially in profit and loss sharing contracts, demand sophisticated risk management systems, where robust governance mechanisms play a vital role in fostering trust and adherence to Shari'ah principles. Additionally, the importance of internal control and audit functions cannot be overstated, because they ensure compliance, accuracy of data and effectiveness of risk management systems, contributing significantly to the financial integrity of these banks. Furthermore, corporate social responsibility, rooted in Islamic values, is essential for managing reputational, social and environmental risks. These complex relationships suggest that a well-structured CG framework is not merely a regulatory necessity but a strategic imperative for Islamic banks. It underpins effective risk management, ensures Shari'ah compliance and reinforces the resilience of these institutions. This study aimed to empirically investigate this relationship, using a robust dataset and discriminant analysis, to provide deeper insights into how internal CG mechanisms impact risk management in Islamic banks in the GCC region. This understanding is crucial for formulating regulatory recommendations and identifying best practices to enhance the resilience and operational efficiency of these banks.

#### 6.2.5 Internal corporate governance mechanisms and hypothesis development:

Internal CG mechanisms are fundamental to the functioning of Islamic banks, guiding the organizational structures and decision-making processes in line with Shari'ah principles (El-Gamal 2006; Hasan 2009). These governance frameworks not only serve to mitigate various types of risks (Ahmad and Hassan 2007; Al-Tamimi 2010) but also ensure compliance with both Shari'ah laws and broader financial regulatory requirements (Archer and Karim 2009). Moreover, they aim to inculcate ethical behaviour in every aspect of banking operations (Grais and Pellegrini 2006; Wilson 2009).

Central to these governance mechanisms is the dual emphasis on profitability and adherence to Islamic ethical and moral principles (Chapra and Ahmed 2002; Khan and Bhatti 2008). In an Islamic banking context, internal CG comprises key elements like board characteristics, Shari'ah supervisory boards, ownership models, CSR and internal control and audit systems (Alam 2010; Farook et al. 2011). Each of these components plays a unique role in shaping the bank's overall governance landscape (Hamza 2013). Given the multifaceted roles these internal mechanisms play in Islamic banks, it leads us to question how each specific element impacts the bank's risk management efficacy. This question sets the stage for the formulation of hypotheses, aimed at rigorously analysing the relationships between these internal governance mechanisms and the risk management performance of Islamic banks in the GCC region.

##### 6.2.5.1 *Ownership model*

Ownership in Islamic banks may take various forms, including state ownership, private ownership and foreign ownership. Regardless of the form, an essential consideration is the alignment of the owners' interests with Shari'ah principles and the banks' socio-economic objectives. Studies suggest that the ownership structure can influence a bank's risk profile, financial performance and level of corporate social responsibility (Belkhir 2009).

##### 6.2.5.2 *Insider shareholding*

Insider shareholding in Islamic banks serves as a pivotal element affecting the institution's risk management. With a nuanced grasp of the bank's actual risk profile and prospects, insiders can substantially guide managerial decisions on risk-taking (John et al. 2000). The implications of insider shareholding can go in two distinct directions: they can either drive the bank towards higher risk-taking for larger potential returns, or steer it towards a conservative risk stance, depending on the alignment of interests between insiders and external shareholders (Chen et al. 2006). Given the contradictory potential effects of insider

ownership, its role in risk management is complex. The insider's position can either enhance the stability or amplify the risk profile of the bank, contingent upon factors such as market conditions and broader governance issues.

Drawing upon agency theory, which portrays insiders as potential agents whose actions can either align or diverge from broader shareholder interests, the hypothesis is framed as:

H1: *Ceteris paribus*, insider shareholding has a significant positive impact on the risk management strategies in GCC's Islamic banks.

#### *6.2.5.3 Government ownership*

The role of government ownership in Islamic banks is a critical factor that impacts the risk management strategies. Studies indicate that government ownership often results in more conservative risk profiles due to the implicit or explicit promise of governmental support in times of crisis (Iannotta et al. 2007). However, this stabilizing aspect has its critics. Some argue that government ownership can introduce moral hazards where the bank may indulge in higher risk-taking activities, assuming that the government will bail them out if things go awry (Farazi et al. 2011). This dichotomy suggests that the influence of government ownership on risk management is not straightforward and may be contingent on factors such as the strategic objectives of the government and the governance structure of the bank.

Incorporating agency theory, which posits that the government as a significant stakeholder acts as an agent shaping the bank's strategy and considering the empirical evidence for and against the role of government in risk management, the hypothesis is formulated as follows:

H2: *Ceteris paribus*, government ownership has a significant negative impact on the risk management strategies in GCC's Islamic banks.

#### *6.2.5.4 Institutional ownership*

Institutional ownership plays a critical but multifaceted role in influencing risk management strategies within Islamic banks. Acting as pivotal shareholders, institutional investors have the power to both propel and restrain the bank's appetite for risk (Macey and O'Hara 2003). Specifically, they can foster a culture of increased risk-taking in pursuit of higher returns, yet their long-term investment horizons may equally necessitate a more conservative, stability-oriented approach. This dual influence is subject to debate. Critics argue that the divergence in institutional investors' objectives can lead to suboptimal risk decisions and internal

governance conflicts (Edmans 2009). This adds a layer of complexity to the already challenging task of risk management within Islamic banking.

Drawing upon the stewardship theory, which argues that institutional owners can act as effective stewards due to their significant stake in the bank and in consideration of the mixed empirical evidence regarding the role of institutional ownership in risk management, the hypothesis is shaped as follows:

H3: *Ceteris paribus*, institutional ownership has a significant positive impact on the risk management strategies in GCC's Islamic banks.

#### *6.2.5.5 Bank age*

The age of a bank offers a multifaceted lens through which its risk management practices can be understood. Scholars suggest that older institutions are generally more conservative in their approach to risk management due to years of experience and the weight of stakeholder expectations (Berger et al. 2013). Such banks typically benefit from well-established systems and protocols, implying greater efficacy in managing various forms of risk (Petersen and Rajan 2002). However, this is a contentious viewpoint. Critics argue that older banks may be hindered by organizational inertia, which can block innovation and adaptability (Staikouras 2009). The legacy systems and traditional modes of operation may not be agile enough to respond to the evolving financial landscape, rendering these institutions susceptible to emerging forms of risks (Laeven and Levine 2009).

Given this dichotomy, the age of a bank presents a complex variable with the potential to both positively and negatively affect risk management strategies. Thus, the hypothesis is formulated as:

H4: *Ceteris paribus*, the age of the bank has a significant negative influence on the risk management practices in GCC's Islamic banks.

#### *6.2.5.6 Board of directors and specifications*

Grounded in both agency theory (Jensen and Meckling 1976) and stewardship theory (Donaldson and Davis 1991), the role of the board of directors in Islamic banks can be viewed through dual lenses: either as a potential source of internal conflicts or as a facilitator of strategic objectives. Agency theory posits that the board serves to mediate the interests between shareholders and management, while stewardship theory suggests the board acts in the best interests of the organization, thereby harmonizing objectives.

Empirical evidence lends complexity to these theoretical positions. For instance, Archer and Karim (2007b) and Choudhury and Hoque (2006) found that the board of directors played a pivotal role in enforcing ethical norms and ensuring Shari'ah compliance in Islamic banks. Boards were central to shaping risk management frameworks and guiding the bank's overall operational governance. Adding another layer to this is the concept of board diversity. Research indicates that a diverse board—in terms of skills, experience and gender—contributes positively to decision-making and overall bank performance (Carter et al. 2003; Mollah and Zaman 2015). However, this is not without contestation. Adams and Ferreira (2009) argue that too much diversity could hinder effective risk management by leading to internal disputes. Similarly, Pathan and Faff (2013) point out that larger board sizes could potentially reduce efficacy in risk management.

Considering these divergent viewpoints, the hypothesis is formulated as follows:

H5: The composition and specifics of the board of directors has a significant positive impact on risk management in Islamic banks in the GCC. This impact is modulated by factors such as board duality, size and focus.

The hypothesis aimed to reconcile these contrasting perspectives by investigating how specific board characteristics influence risk management, particularly in the unique context of Islamic banks in the GCC region.

#### *6.2.5.7 Board duality*

Board duality, a governance structure in which the CEO also assumes the role of board chair, holds contrasting implications for risk management within Islamic banks. The centralization of power can facilitate quick and efficient decision-making, potentially enhancing the institution's risk management practices (Dalton et al. 1998). This streamlined governance structure allows for a more agile and comprehensive response to emerging risks. However, the concentration of authority is not without its drawbacks. Critics suggest that such centralization may encourage excessive risk-taking due to a lack of checks and balances (Fama and Jensen 1983; Pathan 2009). In such a setting, the dual role could lead to strategic decisions that may not necessarily serve the broader interests of shareholders, thereby complicating its impact on risk management.

Given these opposing viewpoints and building upon agency and stewardship theories, which suggest that concentrated power can either serve or undermine shareholder interests, the hypothesis is formulated as follows:

H6: Ceteris paribus, board duality has a significant positive impact on the risk management strategies in GCC's Islamic banks, depending on the balance between efficient decision-making and adequate risk oversight.

#### *6.2.5.8 Corporate social responsibility*

In Islamic banking, CSR is a critical element that aligns with the ethical and moral principles of Shari'ah law. Therefore, this aspect of governance extends beyond traditional financial metrics, emphasizing a broader commitment to social, ethical and environmental responsibilities. Furthermore, Islamic banks, by their nature, are expected to integrate CSR into their operations, resonating with the Islamic principles of social justice and public welfare (Kamla 2009). CSR in Islamic banking is not merely a philanthropic activity but an integral part of governance and risk management frameworks. Moreover, the adherence to Shari'ah principles necessitates a proactive approach to CSR, ensuring that all banking activities promote social welfare and ethical conduct (Haniffa and Hudaib 2007). This approach helps Islamic banks to establish trust and credibility among their stakeholders, which is vital for long-term sustainability and growth.

Drawing from stakeholder theory, which emphasizes the importance of considering the interests of all stakeholders in CG (Freeman 1984) and legitimacy theory, which posits that organizations seek to operate within the bounds of societal norms and values (Suchman 1995), the hypothesis is formulated as follows:

H7: Ceteris paribus, the integration and effectiveness of CSR practices in Islamic banks in the GCC has a significant positive impact on their risk management efficacy and stakeholder trust.

### *6.2.6 Control variables*

#### *6.2.6.1 Shari'ah supervisory board*

The Shari'ah supervisory board (SSB) is a unique governance mechanism in Islamic banks that plays an instrumental role in shaping risk management practices. These boards ensure that all banking activities comply with Shari'ah law, thereby influencing both operational and financial risk (Hassan and Kayed 2009). Scholars on the board are tasked with reviewing and approving new financial products and advising the board of directors, serving as a crucial layer of oversight (Grais and Pellegrini 2006). However, some argue that the presence of a religious board may introduce another layer of complexity and potential for internal conflict that could inhibit effective risk management (El-Gamal 2006).



Furthermore, while the SSB is fundamental to maintaining the ethical and religious integrity of the bank, its effectiveness in mitigating financial risk is not universally agreed upon (Sundararajan 2008). Sundararajan contends that while the board's ethical considerations are undoubtedly beneficial, they may not always translate into effective financial risk management strategies.

Thus, drawing from the agency theory, where the SSB acts as an agent for the shareholders in ensuring Shari'ah compliance and considering the empirical support and critiques from the literature.

#### *6.2.6.2 Internal control and audit*

Internal control and audit mechanisms hold a pivotal role in the governance framework of Islamic banks, serving to safeguard operational efficiency while fortifying risk management practices (Graiss and Pellegrini 2006; Karim 2001). These systems are designed to ensure compliance with regulatory mandates, heighten the accuracy and reliability of financial disclosures and facilitate the early identification of potential operational irregularities and emergent risks (Al-Tamimi 2002; Arens et al. 2012). Despite their acknowledged importance, the efficiency and effectiveness of internal control and audit functions are subject to ongoing scrutiny. Critics suggest that these systems may be inadequate in addressing the unique risk profiles that Islamic banks face due to their compliance with Shari'ah law (Al-Tamimi 2002). The relevance and effectiveness of these functions can also be influenced by external factors such as regulatory changes, technological advancements and market volatility (Basel Committee on Banking Supervision 2011).

Drawing upon agency theory, which proposes that internal controls and audits can act as an agent for shareholders in enforcing compliance and managing risk and stewardship theory, which suggests that well-designed controls can guide management towards the best interests of the stakeholders (Davis et al. 1997).

Effective internal control and audit systems are essential for risk management and operational efficiency in Islamic banks (Graiss and Pellegrini 2006). The role of internal control systems and audit functions is also paramount in Islamic banks for risk management. All the systems assure compliance with regulatory requirements and enhance financial reporting integrity (Karim 2001). They also facilitate early detection of irregularities and potential risks (Arens et al. 2012).



## 6.3 Methodology

### 6.3.1 Data collection and sampling

For the purpose of this research a dataset was collected examining data from the period between 2005 and 2021. The focus was on Islamic banks operating within the GCC countries. The selection of banks was based on their comprehensive disclosure of pertinent information and their status as fully operational during the studied timeframe.

Data were collected from a variety of sources including annual reports, financial statements and other relevant disclosures provided by the banks. In addition, databases such as Datastream and Bloomberg were also utilised for supplementary information. This comprehensive data gathering aimed to ensure the robustness and credibility of the research by analysing 337 cases which is the available data for the 22 Islamic banks in GCC and treating each year in isolation similar to the work of (Iheanacho and Okpara 2016). The variables for the analysis and their roles are detailed below.

### 6.3.2 Variables and roles

The following variables were used in the analysis to capture the internal CG mechanisms that are fundamental to the functioning of Islamic banks and to answer the hypotheses outlined previous (Table 4).

**Table 4: Variables used in the discriminant analysis**

Name	Role
Zgroup	Dependent variable
Ownership Model (INSD)	Independent variable
Ownership Model (GOVT)	Independent variable
Ownership Model (INST)	Independent variable
Bank age (FIRMAGE)	Independent variable
Board Characteristics (Size)	Independent variable
Board Characteristics (Duality) (DLTY)	Independent variable
Corporate Social Responsibility (CSR)	Independent variable
Shari'ah Supervisory Board	Control variable
Internal Control and Audit	Control variable

### *6.3.2.1 Dependent variable: risk management performance*

**Z-score:** The primary dependent variable used in this research was the Z-score. The Z-score is a widely accepted measure for evaluating bank stability and risk (Boyd et al. 2006). The Z-score is computed as the return on assets plus the capital asset ratio, divided by the standard deviation of the return on assets.

### *6.3.2.2 Independent variables: internal corporate governance mechanisms*

**Ownership model:** The ownership model was considered, focusing on insider shareholding, government shareholding and institutional shareholding. The details of these ownership types were obtained from the annual reports of the selected banks.

**Bank age** Bank age was considered due to its potential impact on risk management, with older banks often displaying more stability (Kosmidou 2008). Bank size, measured by total assets, was considered due to its potential influence on the bank's risk profile (Demsetz and Strahan 1997).

**Board characteristics:** These factors encompassed the board size and board duality. Board size was the total number of directors on a board (Adams et al 2010), while board duality occurred when the roles of CEO and board chair were held by the same individual (Fama and Jensen 1983).

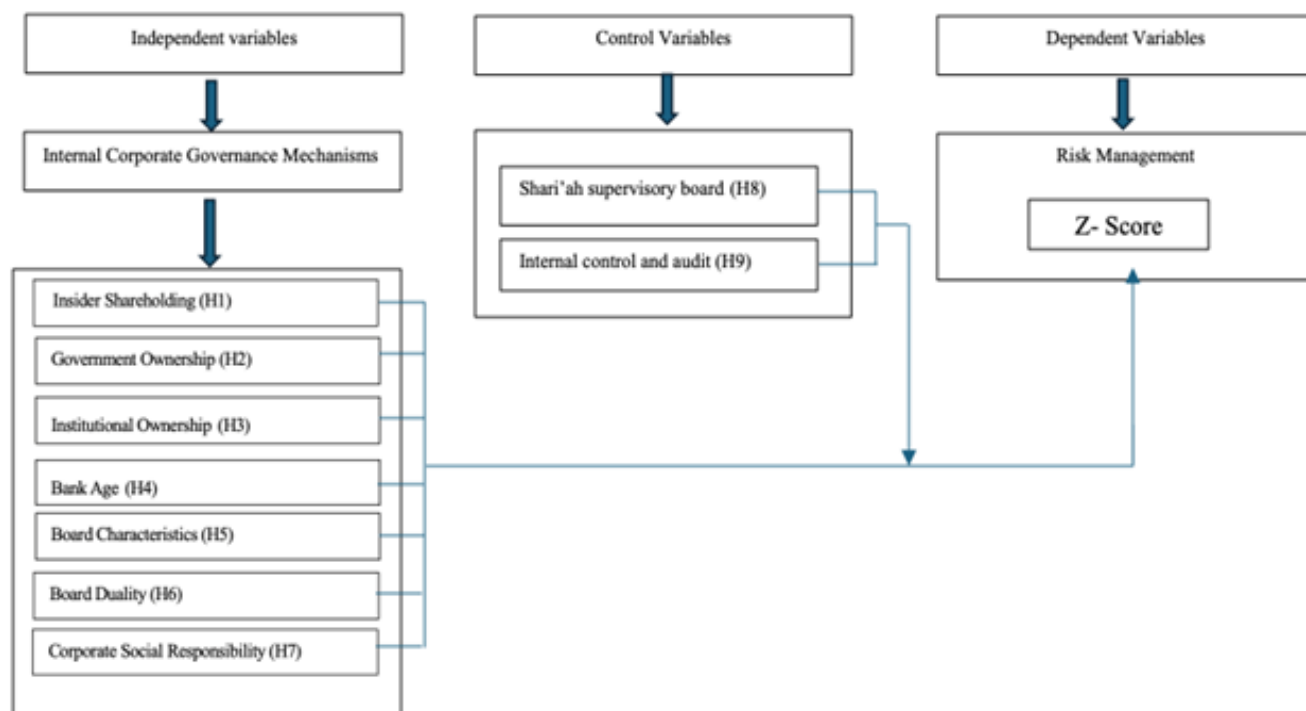
**Corporate social responsibility:** CSR was measured using disclosures in annual reports, following previous studies (Jo and Harjoto 2011).

**Shari'ah supervisory board characteristics:** This variable referred to the presence of a SSB in an Islamic bank, a critical factor in ensuring compliance with Islamic banking principles.

**Internal control and audit characteristics:** The presence of an internal audit department and the adoption of internal control measures were included as governance mechanisms, following prior research (Al-Twaijry et al. 2004).

Figure 8 shows the relationship between the independent, control and dependent variables used to analyse risk management performance. The analysis in this chapter used the z-score as to quantify the risk of insolvency. The Z-score is widely accepted as a reliable measure of bankruptcy risk, focusing on a bank's profitability (ROA), capital adequacy (CAR), and risk volatility (Boyd and Graham 1986). The decision to use one-year data in this study is justified by its ability to capture short-term risks and offer timely insights into the bank's financial health. While a three-year rolling window might provide a more stable view of long-term risk

by smoothing out annual fluctuations, one-year data is more appropriate for assessing immediate risk exposure in an evolving financial environment, especially given the volatile nature of financial markets.



**Figure 8** Relationship between the independent, control and dependent variables used to analyse risk management performance (Conceptual framework)

The focus on bankruptcy risk addresses the primary concern of insolvency, which is a key determinant of a bank's survival. Insolvency risk represents the most immediate and critical threat to a bank's operations, making it the central focus of this chapter. However, as noted in Alatassi and Pillai (2024), Islamic banks face additional risks, such as Shari'ah compliance risk, liquidity risk, and credit risk, which are vital to the governance framework of these institutions. These risks, while important, are more concerned with operational sustainability and compliance, rather than immediate solvency, and thus do not need to be fully incorporated into the Z-score methodology.

The Z-score, though valuable for insolvency analysis, does not encompass all risk measures identified in Alatassi and Pillai (2024). For instance, it does not directly account for Shari'ah compliance risk, which involves adherence to Islamic legal principles, nor does it capture liquidity risk, which is significant for Islamic banks due to limited access to conventional liquidity markets (Grais and Pellegrini, 2006). While the Z-score provides insights into a

bank's ability to withstand financial shocks, it should be complemented by other risk metrics for a comprehensive analysis. Liquidity Coverage Ratio (LCR) could address liquidity risk, and Shari'ah audit frequencies could assess compliance risk. Nonetheless, the Z-score remains a robust tool for focusing on the core issue of insolvency.

In conclusion, the Z-score is a justified and valuable tool for assessing short-term insolvency risk, which is the primary concern of this study. The use of one-year data is well-supported as it provides a more dynamic, responsive measure of financial distress, which is essential in fast-changing financial markets. While it does not encompass broader risk categories such as Shari'ah compliance and liquidity risk, these risks are less critical in an insolvency-focused model and can be addressed through complementary indicators if necessary. The methodology is, therefore, well-aligned with the overarching thesis objectives while ensuring a focused and analytically rigorous approach to risk measurement in Islamic banking.

The data collected for these variables were analysed through descriptive statistics and discriminant analysis using SPSS. Discriminant analysis is a statistical technique extensively employed in various academic disciplines and practical applications (Friedman 1989 ; McLachlan 2005). It plays a pivotal role in classification and grouping tasks, effectively discriminating between predefined categories or groups based on multiple predictor variables. This multivariate method seeks to maximize the variance between groups while minimizing the variance within groups, making it invaluable in distinguishing and characterizing different populations.

In the realm of finance, discriminant analysis has proven to be a robust tool for assessing the creditworthiness of individuals or firms. By analysing financial ratios, credit history and other relevant factors, it aids in categorizing borrowers into risk groups, thus informing lending decisions and risk management strategies (Altman 1968). Discriminant analysis was used to identify the variables that differentiated unhealthy and healthy banks, thus offering valuable insights into the risk management performance of the selected banks.

## 6.4 Findings

### 6.4.1 Descriptive statistics

In finance, particularly in credit analysis and risk management, the Z-score is used as a financial ratio to evaluate the financial health and risk of a company. It was developed by Edward Altman in the (1968) as a tool to predict the likelihood of a company going bankrupt. High Z scores portray healthy and less risky organisations and low Z scores depict unhealthy and risky organisations.

In accordance with the research methodology, the 337 selected cases, were categorized into two distinct groups based on a calculated median Z-score of 10.14. This median value served as the demarcation point for differentiating between ‘unhealthy’ and ‘healthy’ organizations as seen in the work of Cornett and Tehranian (2002). Specifically, entities with Z-scores equal to or below 10.14 were categorized as ‘unhealthy,’ whereas those exceeding the median value were classified as ‘healthy.’ There were a total of 169 cases in the ‘unhealthy’ category and 168 cases in the ‘healthy’ category.

Then, a comprehensive statistical analysis was conducted that calculated the mean and standard deviation for the variables considered in the research. This rigorous analytical approach is instrumental in providing a robust and methodologically sound foundation for the research findings.

The descriptive statics of various factors considered for the research are shown in Table 5. The first group was in regard to the bank ownership model. The first factor was insider shareholding. Here, the average holding in unhealthy organisations was 1.4%, compared with a mean score of 4.6% in healthy organisations. This showed that there were less average insider shareholdings in unhealthy organisations. For government holdings, unhealthy organisations

had an average of 9.6% government holdings which was half that of healthy organisations (18.7% government holdings). The average institutional shareholding for unhealthy and healthy organisations was 30.5% and 16.5%, respectively. This finding showed that healthy organisations had comparatively fewer institutional holdings.

The other independent variables related to factors such as the age and board characteristics of the institution and CSR (Table 5). There was little difference in the average age of banks, with unhealthy organisations being 23.18±14.14 years, while healthy organisation were slightly younger at 21.44±14.70 years. However, there was a marked difference in the average board size, where the average board size in unhealthy organisations was only 0.60 while that of healthy organisations was 8.67. The average board duality for unhealthy and healthy organisations was 0.029 and 0.078, respectively, showing that healthy organisations had comparatively less board duality. Both unhealthy and healthy organisations had SSBs and same audit type (Table 5).

**Table 5: Descriptive statistics for healthy and unhealthy organisations**

	Unhealthy Org		Healthy Org	
	Mean	Std. Deviation	Mean	Std. Deviation
Ownership Model (INSD)	.014	.063	.046	.094
Ownership Model (GOVT)	.096	.121	.187	.199
Ownership Model (INST)	.305	.331	.165	.183
Bank age (FIRMAGE)	23.186	14.707	21.443	14.148
Board Characteristics (Size)	.592	1.698	8.667	1.076
Board Characteristics (DLTY)	.029	.169	.078	.268
Corporate Social Responsibility (CSR)	.721	.449	.446	.499
Shari'ah Supervisory Board Characteristics	1.000	.000	1.000	.000
Internal Control and Audit Characteristics	1.000	.000	1.000	.000

#### 6.4.2 Box's test of equality of covariance matrices

In order to identify the discriminant function, which distinguished unhealthy organisations from healthy organisations the researcher applied a discriminant analysis. The first analysis in was the Box's test of equality of covariance matrices. In this test, the larger the log determinant in the table, the more that group covariance matrix differs (Table 6).

**Table 6: Box's test of equality of covariance matrices**

Log Determinants			Test Results	
Z groups	Rank	Log Determinant		
Unhealthy	7	-11.767	Box's M	457.762
Healthy	7	-11.640	F	15.988
Pooled within-groups	7	-10.337	df1	28
			df2	391027.543
			Sig.	.000

Note: The ranks and natural logarithms of determinants are those of the group covariance matrices

The result of Box's M test was significant at 99% confidence level. Because the discriminant analysis assumes homogeneity of covariance matrices between groups, the result showed that the determinants were relatively equal and statistically valid. Similar, the log determinants of unhealthy and healthy banks were significant at 99%, hence the unhealthy and healthy groups had equal covariance matrices.

In the present study, a canonical discriminant function analysis was employed to investigate the variance within the dependent variable—categorized into two groups, namely unhealthy and healthy organizations—based on multiple predictors. As demonstrated in the analysis, the eigenvalue, a critical statistical measure, stood at 0.391 (Table 7). This figure indicates that the initial discriminant function accounted for 39.1% of the variance (Huberty and Olejnik 2006) between the unhealthy and healthy organizations. The magnitude of the eigenvalue is particularly noteworthy because it signifies the extent to which the discriminant function is successful in explaining the variance in the dependent variable.

**Table 7: Summary of canonical discriminant functions eigenvalues**

Function	Eigenvalue	% of Variance	Cumulative %	Canonical Correlation
1	.391 <sup>a</sup>	100.0	100.0	.530

#### 6.4.3 d. First 1 canonical discriminant functions were used in the analysis.

The analysis table elucidates that the discriminant function encapsulated 100% of the explained variance (Table 7). This was evidenced by the percentage of variance, which reached its totality solely with the first function, as reflected in the cumulative percentage. The canonical correlation, reported at 0.530, identified a moderate association between the discriminant function scores and the categorization of organizations into unhealthy and healthy based on their Z-scores (Sherry and Henson 2005). The canonical correlation thus provided a quantifiable measure of the relationship strength between the model's discriminant scores and the predefined groups.

This discriminant function analysis served as a pivotal tool for assessing the classification's accuracy into the dichotomous groups—unhealthy versus healthy—based on the predictor variables. A robust canonical correlation is indicative of an efficacious model capable of accurately discerning the organizations into their respective classifications. The findings herein lay the foundation for subsequent inquiries and discussions concerning the elements that distinguish healthy from unhealthy organizations within the realm of Islamic banking.

The associated chi square statistic tested the hypothesis that the means of the functions listed were equal across groups. The significant value was less than 0.01, which indicated that discriminant function did better than chance at separating groups (Table 8).

**Table 8: Wilks' lambda score**

Test of Function(s)	Wilks' Lambda	Chi-square	Df	Sig.
1	.719	109.302	7	.000

The discriminant function is a latent variable that is created as a linear combination of independent variables. These variables are also called as discriminating variables. The canonical discriminant function coefficient shows the correlation between predictors and standardized canonical discriminant function. The standardized discriminant function



coefficients in Table 9 indicated the relative importance of the independent variables in predicting the membership in Z groups. They allowed a comparison of variables measured on different scales. Coefficients with large absolute values corresponded to variables with greater discriminatory ability. CSR was the most important predictor variable followed by board duality and government holding. Board size and firm age were the least important predictor variables.

**Table 9: Standardized canonical discriminant function coefficients**

	Function
	1
INSD	.434
GOVT	.553
INST	-.490
FIRMAGE	-.063
BOD	.015
DLTY	.582
CSR	-.663

Table 10 depicts the structure matrix of the pooled within-groups correlations between discriminating variables and standardized canonical discriminant functions. CSR was the most correlated variable followed by government holdings. Variables were ordered by absolute size of correlation within the function. CSR, institutional holding and firm age were negatively correlated, while all the other four variables had a positive correlation.

**Table 10: Structure matrix**

	Function
	1
CSR	-.466
GOVT	.438
INST	-.420
INSD	.315
DLTY	.171
FIRMAGE	-.097
BOD	.042

Table 11 contains the unstandardized discriminant function coefficients. These can be used like unstandardized coefficients in the multiple regressions and were used to construct the discriminant function.

**Table 11: Canonical discriminant function coefficients**

	Function
	1
INSD	5.424
GOVT	3.354
INST	-1.828
FIRMAGE	-.004
BOD	.010
DLTY	2.597
CSR	-1.396
(Constant)	.480

Unstandardized coefficients

$$\text{Bank Health (Di)} = 0.480 + 5.424 \text{ INSD} + 3.354 \text{ GOVT} - 1.828 \text{ INST} - 0.004 \text{ FIRMAGE} + 0.01 \text{ BOD} + 2.597 \text{ DLTY} - 1.396 \text{ CSR}$$

The equation provided the regression model that determinants of bank health, encapsulating a comprehensive analysis within the Islamic banking sector. This model is predicated on the premise that various internal governance mechanisms, influence the overall health of Islamic banks.

Bank health, operationalized as the dependent variable (Di), is assumed to integrate multiple facets of banking performance. The model posits that bank health is a function of several independent variables, each representing a distinct aspect of governance mechanism,

Insider Ownership (INSD), with a coefficient of 5.424, affirms Hypothesis H1 by demonstrating a significant positive relationship between insider ownership and the bank's health, thus underscoring the value of insider stakes in contributing to financial stability and operational integrity. This finding is pivotal, highlighting the alignment of insider interests with the long-term success of the institution.

Conversely, Government Ownership (GOVT) yields a coefficient of 3.354, which, while indicative of a positive influence on bank health, challenges Hypothesis H2 that predicted a

negative impact. This outcome reveals the beneficial aspects of government involvement, likely through enhanced regulatory compliance and access to support mechanisms, thereby contributing positively to the bank's risk management framework and financial soundness.

Institutional Ownership (INST), represented by a coefficient of -1.828, aligns with the anticipation of a negative effect on bank health, refuting Hypothesis H3. This finding suggests a discord between the short-term objectives of institutional investors and the long-term stability and governance practices essential for sustaining bank health.

The Age of the Firm (FIRMAGE), although presenting a minimal negative coefficient of -0.004, offers limited support to Hypothesis H4. The impact of a bank's legacy and operational rigidity on its health is suggested to be marginal, highlighting that while older banks may face challenges in adaptability and innovation, this does not significantly detract from their overall health.

The Board of Directors (BOD) and Board Duality (DLTY), with coefficients of 0.01 and 2.597 respectively, substantiate Hypotheses H5 and H6 by showcasing the positive impacts of board composition and unified leadership on bank health. These findings emphasize the importance of effective governance and strategic oversight, as well as the benefits of streamlined decision-making and alignment of strategic objectives, in enhancing the bank's stability and performance.

Corporate Social Responsibility (CSR), with a coefficient of -1.396, presents a nuanced view that challenges Hypothesis H7 by indicating a slight negative impact on financial performance in the short term. This highlights the complexities involved in balancing CSR activities with financial outcomes, underscoring the need for Islamic banks to manage resource allocation effectively to uphold ethical banking principles while ensuring financial health.

In sum, this comprehensive analysis delineates the multifaceted determinants of bank health within the Islamic banking sector, offering profound insights into how governance structures significantly shape the financial and operational outcomes of Islamic banks. The empirical evidence, through the support and refutation of the hypothesized relationships, enriches our understanding of the intricate dynamics governing bank health, thereby contributing invaluable perspectives to the discourse on governance and risk management in Islamic banking.

Centroids reflect the mean discriminant scores for each group. Table 12 shows the cutting point for classifying cases. The optimal cutting point is the weighted average of the two values. SPSS does the classification automatically, and these values are for information purposes only. A negative discriminant value depicted unhealthy firms. A positive discriminant value indicated healthy firms.

**Table 12: Functions at group centroids**

<b>Zgroups</b>	<b>Function</b>
	<b>1</b>
Unhealthy	-.621
Healthy	.625

Unstandardized canonical discriminant functions evaluated at group means

Table 13 show the accuracy of the predicted membership with the discriminant function.

**Table 13: Classification results<sup>a,c</sup>**

		<b>Zgroups</b>	<b>Predicted Group Membership</b>		<b>Total</b>
			<b>Unhealthy</b>	<b>Healthy</b>	
Original	Count	Unhealthy	132	37	169
		Healthy	40	128	168
	%	Unhealthy	78.1	21.9	100.0
		Healthy	23.8	76.2	100.0
Cross-validated <sup>b</sup>	Count	Unhealthy	132	37	169
		Healthy	48	120	168
	%	Unhealthy	78.1	21.9	100.0
		Healthy	28.6	71.4	100.0

a. 77.2% of original grouped cases are correctly classified.

b. Cross validation is done only for those cases in the analysis. In cross validation, each case is classified by the functions derived from all cases except that case.

c. 74.8% of cross-validated grouped cases are correctly classified.

The discernment function correctly classified more than 75% of cases, making a similar proportion of mistakes for both categories. Overall, 77.2% of the cases were correctly classified.

## 6.2 Discussion and interpretation of the results

This analysis elucidated the correlation between Z-scores and the financial health of the selected Islamic banks in the GCC region, indicating higher Z-scores for healthier, less risky banks and lower Z-scores for riskier entities. The median Z-score for the chosen banks was identified as 10.14, categorising 169 banks as unhealthy and 168 as healthy. A notable observation was the prevalence of lower insider and government shareholding in unhealthy banks compared with their healthier counterparts. In contrast, institutional shareholding appeared to be larger in unhealthy organisations. Healthy banks exhibited larger board sizes, lower board duality and higher CSR scores, while being slightly younger on average. Regardless of their health status, all banks maintained consistent audit types and Shari'ah Boards. Using a discriminant function to distinguish between healthy and unhealthy banks, it was inferred that CSR, board duality and government holdings emerged as the most impactful predictors, while board size and firm age were less significant. The function's classification accuracy exceeded 75%, indicating its effectiveness in accurately categorising the organisations under examination. Table 14 summarises these findings.

**Table 14: Summary of the key findings of the analysis**

Characteristic	Healthy Banks	Unhealthy Banks
Z-Score (Median Value)	> 10.14	< 10.14
Corporate Social Responsibility (CSR) Score	Higher (Significant)	Lower (Significant)
Insider Shareholding	Lower (Significant)	Higher (Significant)
Government Shareholding	Lower (Significant)	Higher (Significant)
Board Size	Larger (Nonsignificant)	Smaller (Nonsignificant)
Board Duality	Lower instances (Significant)	Higher instances (Significant)
Firm Age	Younger (Nonsignificant)	Older (Nonsignificant)
Shari'ah Supervisory Board	Presence (Nonsignificant)	Presence (Nonsignificant)

In the context of this paper, 'unhealthy' and 'healthy' banks were terms used to categorize Islamic banks based on their financial stability and risk management capabilities. A more detailed explanation follows.

1. **Unhealthy Banks:** unhealthy banks were those that exhibited signs of financial instability and poor risk management. Characteristics included:

- Lower CSR scores
- Higher insider and government shareholding
- Smaller board sizes
- Higher instances of board duality
- Older in terms of firm age
- A Z-score below the median value of 10.14, suggesting weaker financial health.

2. **Healthy Banks:** Conversely, healthy banks demonstrated strong financial stability and effective risk management. Characteristics of healthy banks, as identified in the paper, included:

- Higher scores in CSR
- Lower levels of insider and government shareholding
- Larger board sizes
- Lower instances of board duality (where the CEO also serves as the board chair)
- Generally younger in terms of firm age
- A Z-score above the median value of 10.14, indicating better financial health.

The Z-score, in this context, was a crucial measure used to differentiate between unhealthy and healthy banks. It is a statistical tool that measures a bank's risk of bankruptcy by combining profitability, leverage and variability of earnings. A lower Z-score indicated a higher risk of financial distress, categorizing the bank as 'unhealthy'. Conversely, with a higher Z-score, the bank was less likely to face financial distress, and hence it was categorized as 'healthy'.

This classification is central to the paper's analysis of the impact of factors like CSR, board structure and ownership on the financial health and risk management of Islamic banks in the GCC region. The analysis provided significant insights into the risk management performance of Islamic banks within the GCC region. By applying the Z-score as a measure of risk, this research underscores the crucial role of various internal governance mechanisms, ownership models, corporate social responsibility initiatives and internal control and audit characteristics in shaping the risk profile of these banks.

The results are partially consistent with prior literature. As suggested by Boyd et al. (2006), a higher Z-score indeed indicates a healthier financial institution, which is less exposed to risk.

The analysis revealed that organisations with lower insider and government holdings tended to have higher risk levels. This aligns with the argument put forth by Laeven and Levine (2009), who suggested that ownership concentration could negatively influence risk-taking. Furthermore, that ownership concentration, which included significant insider or government stakes, might dampen risk-taking due to the potential for concentrated owners to exercise greater control over managerial decisions, aligning them more closely with shareholder wealth maximization, which typically involves risk mitigation (Laeven and Levine 2009). In contrast, dispersed ownership structures might lack sufficient monitoring and control over management, leading to increased risk-taking.

Therefore, the observed relationship in the analysis, where organizations with lower insider and government holdings exhibit higher risk levels, might exist due to a reduced alignment of managerial actions with shareholder risk preferences and less conservative government influence, leading to a greater propensity for risk-taking within the organization's strategic decision-making process. In contrast, the results showed that healthy organisations tended to have lesser institutional holdings, which was not in accordance with the findings of prior research (Macey and O'Hara 2003). This new finding may be explained by the unique nature of Islamic banking, and it warrants further investigation.

### **6.3 Conclusion, implications and future research**

This study offered comprehensive insights into the profound impact of internal CG mechanisms on risk management within Islamic banks operating in the GCC region. The research illuminated how different governance factors, specifically board characteristics, ownership models, SSB features, CSR and internal control and audit attributes, influenced the risk management capabilities of these institutions. Furthermore, this study contributes to the extant literature by providing a nuanced understanding of risk management in Islamic banks, especially within the GCC region.

Evidence from the analysis reaffirmed the critical role of the board of directors and the SSB in ensuring adherence to Shari'ah principles and managing the unique risks associated with Islamic banking. Furthermore, the significance of the ownership model, particularly in the context of profit and loss sharing contracts, was underscored. An interesting observation from the analysis pertains to the internal control systems and audit functions which were found to be instrumental in managing risks within Islamic banks.

Importantly, the CSR initiatives were not only viewed as essentially linked to the underlying Islamic principles of justice, equity and public welfare but were also noted to contribute significantly to risk management by maintaining trust among stakeholders. Moreover, the role of firm age and size, as control variables, underlines the multifaceted nature of the relationship between CG and risk management.

The findings contribute to the extant literature by integrating multiple aspects of CG and their influence on risk management in the specific context of Islamic banking. The study, however, is not without limitations, primarily due to the specific geographic focus on GCC Islamic banks. Future research can extend this line of inquiry to a broader spectrum of Islamic banks across different regions. Moreover, future studies may delve into a more granular examination of the relationships explored in this study, such as the role of specific Shari'ah supervisory board characteristics in risk management. This study also considered a set of specific internal governance mechanisms. Future research could explore other potential determinants of risk, such as external governance mechanisms, cultural factors, or technological adoption. It would also be interesting to explore why institutional holdings play a different role in Islamic banks compared with their conventional counterparts.

#### **6.4 Implications for policymakers and practitioners**

**Regulatory recommendations:** The research findings highlight the importance of a strong internal governance mechanism in lowering risk levels. Regulators could, therefore, enforce stricter standards on insider and government holdings. In addition, considering the unique finding related to institutional shareholding, regulators may need to review and possibly reframe rules on institutional investors in Islamic banks.

**Best practice for Islamic banks in the GCC region:** The importance of internal control and audit characteristics, as well as CSR initiatives, cannot be understated. Banks that adhered to strong internal control mechanisms and took substantial CSR initiatives tended to have healthier Z-scores. Therefore, this underscores the need for Islamic banks to strengthen their internal control systems and enhance their CSR initiatives.



## Chapter 7: Synthesis of papers, discussion and integration

Embarking on as journey to unravel the complexities of CG within the Islamic banking sector, this thesis primarily focused on the integration of Western CG models into Islamic CG and their consequential impact on risk management and Shari'ah compliance. The research navigated through a multifaceted landscape, encompassing the formulation of a conceptual model for CG in Islamic banks, a comparative analysis across Western and Islamic financial institutions and a detailed examination of governance mechanisms within the Islamic banks of the Gulf Cooperation Council.

Chapter 7 is the culmination of this investigative journey and aims to bring together the findings from the preceding paper-style chapters into a cohesive synthesis. First, this chapter integrates the key insights from each paper, providing a unified understanding of the research undertaken. The synthesis not only explores how each paper contributes to the overarching thematic framework of the thesis but also highlights the interplay between the conceptual and operational aspects of CG in Islamic banking.

Second, the chapter critically examines the collective contributions of the three papers to the broader field of Islamic banking and CG. Furthermore, it evaluates the novel insights and advancements made in understanding the dynamics of governance within Islamic banks, particularly in light of the integration of Western governance models.

Third, this chapter integrates the research findings within the wider context of existing academic literature by offering a reflective analysis of how the findings align with, diverge from, or augment the current body of knowledge in the field. This includes assessing the extent to which the research objectives have been achieved and considering the implications of these findings for future scholarly inquiry and practical application in the Islamic banking sector.

In summary, Chapter 7 not only synthesizes the extensive research conducted throughout the thesis but also provides critical insights and future perspectives for the field of Islamic banking and CG. Thus, it bridges the gap between theoretical exploration and empirical reality, shedding light on the intricacies and potentials of Western CG models within Islamic banking institutions.

## 7.1 Analysis of the interrelationship between the papers

In this integrated thesis, each paper contributes uniquely yet cohesively to the field of CG in Islamic banking, underpinned by a blend of theoretical foundations and practical implications. The progression from a conceptual model to comparative analyses and then to specific regional studies delineates a comprehensive journey in understanding and redefining CG within Islamic finance.

### 7.1.1 Contribution of each paper

**Paper 1:** *Best practice in bank corporate governance: the case of Islamic banks.* This paper, making up Chapter 4, established the foundational theoretical framework for the entire thesis. It proposed a novel conceptual model that synergized the principles of Islamic finance with Western CG standards. The model addressed the unique ethical and operational dimensions inherent in Islamic banking. By employing theories such as principal/agent theory, stakeholder theory and stewardship theory, the paper provided a robust conceptual underpinning that set the stage for subsequent empirical investigations.

**Paper 2:** *A comparative analysis of corporate governance and risk management: an evaluation of board responsibilities in Western and Islamic financial institutions.* Building upon the conceptual groundwork laid in Paper 1, the second paper, making up Chapter 5, expanded the scope of research by conducting a comparative analysis to evaluate the CG structures and risk management practices in leading Western and Islamic financial institutions. The comparative approach not only highlighted the differences and similarities between the two systems but also underscored the potential for integrating Western governance elements into Islamic banking. The paper enriched the understanding of how diverse governance models can be adapted and applied in the context of Islamic finance, contributing significantly to the discourse on cross-cultural CG.

**Paper 3:** *Exploring the complex impact of internal corporate governance mechanisms on risk management in GC's Islamic banks.* This paper, making up Chapter 6, narrowed the focus to a specific geographical context—the Gulf Cooperation Council region. It offered an in-depth analysis of the internal CG mechanisms in Islamic banks within the GCC and their impact on risk management. This regional focus provided empirical insights and added depth to the thesis by illustrating how theoretical models and comparative analyses translated into practice within a specific Islamic banking context.

### 7.1.2 Interconnectedness and theoretical foundations

The progression of thought and research in these papers is not linear but rather is interconnected, each enriching the other. The transition from a broad conceptual model in Paper 1 to a comparative analysis in Paper 2 and finally, to a focused regional study in Paper 3, demonstrates a well-structured approach to exploring CG in Islamic banking. Furthermore, the underlying theories—principal/agent, stakeholder and stewardship—provide a consistent theoretical backbone throughout the thesis. These theories are not only academically robust but also of practical relevance, offering insights into the real-world applications and implications of CG in Islamic banks.

The findings from the three papers fill identified gaps in the literature, particularly concerning the practical application of Western governance practices in Islamic banking and the empirical evaluation of their impact. By providing theoretical models, comparative analyses and region-specific investigations, the thesis offers a unique contribution that bridges theoretical constructs with empirical observations, advancing the scholarship of Islamic banking CG and offering a template for future research endeavours in this dynamic field.

In summary, the papers collectively contribute to a comprehensive and nuanced understanding of CG in Islamic banking. Also, they highlight the potential for integrating Western governance practices into Islamic banks and explore the operationalization of these practices in diverse contexts. This approach not only contributes significantly to academic knowledge but also offers practical insights for practitioners and policymakers in Islamic finance.

## **7.2 The papers' collective contribution to the field of Islamic banking and corporate governance**

Collectively, the findings from these papers have profound practical implications for Islamic banks by suggesting that the adoption of Western governance standards can lead to enhanced risk management capabilities, which are crucial for the stability and sustainability of Islamic financial institutions. Furthermore, the findings indicate that such an integration can be achieved without compromising Shari'ah compliance, which is central to the identity and operations of Islamic banks.

There are several practical implications from these findings. First, they offer Islamic banks a roadmap to bolster their governance structures in a manner that aligns with global best practices while remaining true to Islamic finance principles. Second, the insights from this

thesis can inform regulatory policy, guiding the development of governance codes that cater to the unique needs of Islamic banks.

In conclusion, the collective findings from the individual papers provide a solid affirmation of the thesis objective. They contribute to a body of knowledge that supports the integration of Western CG practices into Islamic banking, suggesting that such integration can enhance firm performance and risk management without sacrificing Shari'ah compliance. These contributions are not merely academic; they hold substantial practical value for Islamic banking practitioners, regulators and policymaker.

### **7.3 Discussion of findings in the context of the overall thesis objective**

This research project embarked on an ambitious objective to bridge the gap in CG practices between Islamic and Western banking systems by exploring corporate governance in Islamic banking, integrating Western corporate governance principles, and examining risk management in Islamic banking. The research also explored the feasibility and implications of integrating Western CG principles with those inherent in Islamic banking—a venture that is both timely and pertinent given the significant growth of Islamic banking and its increasing interaction with global financial markets. Finally, the study examined risk management in Islamic banking. This exploration involved a detailed analysis of existing governance structures in Islamic banks, comparing them with those prevalent in Western banks and proposing methodologies through which elements from Western CG could be effectively integrated into Islamic banking practices. The aspects examined included board structures, risk management practices and compliance mechanisms, all within the ambit of Shari'ah compliance.

The exploration of CG in Islamic banking, as evidenced in the first paper, outlines a complex landscape where traditional Western models are not entirely applicable. This thesis's contribution lies in its development of a conceptual model that integrates Islamic finance principles with elements of Western governance, thereby addressing the unique operational ethos of Islamic banks. The model highlights the divergences in governance priorities, especially the focus on real assets and ethical considerations prevalent in Islamic banking, as opposed to the debt-centric focus of Western banks. This contrast not only elucidates the unique challenges faced by Islamic banks but also suggests that their prudent approach to banking could serve as a model for Western financial institutions.

In terms of integrating Western CG principles, the second paper's comparative analysis provides a critical bridge between Islamic and Western banking systems. This integration, a cornerstone of the thesis's objectives, is imperative for enhancing the governance structures of Islamic banks. The research findings indicate that such integration could lead to more effective and robust governance structures, enabling Islamic banks to effectively compete in the global financial market. This integration also plays a crucial role in aligning Islamic banks with international governance standards, thereby enhancing their global appeal and operational efficiency.

Finally, the examination of risk management in Islamic banking—a focal point of the third paper—reveals the critical role of internal governance mechanisms in managing unique risks inherent to Islamic banks, such as adherence to Shari'ah laws. The study's empirical investigation within the GCC region provides valuable insights into the effectiveness of risk management practices in Islamic banks. It underscores the importance of the board of directors in managing these risks and highlights how robust governance mechanisms can enhance the resilience and operational efficiency of Islamic banks.

Collectively, the results of this thesis provide a comprehensive understanding of the intricacies involved in CG and risk management within Islamic banking. Moreover, the research contributes significantly to the field by offering a framework that balances effective governance with Shari'ah compliance. This framework is not only pertinent for Islamic banks but also contributes to the broader discourse on CG in diverse banking systems.

In summary, the thesis makes a profound contribution to the field of Islamic banking and finance, elucidating how Islamic banks can effectively navigate the complexities of CG while maintaining their Shari'ah-compliant ethos. This contribution is crucial for enhancing the governance structures of Islamic banks and ensuring their stability and integrity within the global financial system. Finally, the integration of Western governance principles, as suggested by the research, holds the potential to ensure the long-term sustainability and ethical operations of Islamic banks, aligning them with global governance practices while respecting their unique Shari'ah-compliant nature.

#### **7.4 Integration of insights from paper-style chapters with the wider literature and research objectives**

In the realm of Islamic finance research, this thesis stands as a seminal work, connecting the insights drawn from its distinct paper-style chapters with the broader body of existing

scholarly literature. This connection delineates a nuanced comprehension of CG and risk management within Islamic banking, a field that, as Abdel Karim and Archer (2007) and Obid and Naysary (2014) articulate, remains in its embryonic stages of development.

#### 7.4.1 Ethical and philosophical underpinnings

The thesis, echoing the ethical convergence underscored by Nicholson et al (2017) and Abu-Tapanjeh (2009), investigated the philosophical foundations of Islamic banking. It juxtaposed these with Western governance models, revealing a rich interplay between the rationalistic and empirical approaches of the West and the moral and ethical dimensions emphasized in Islamic philosophy. This ethical and philosophical integration aligned with the assertions by Abuznaid (2009), Hasan (2010), Abdullah (2014) and Muhamad and Sulong (2019) that the unique ethical and moral dimensions of Islamic banking necessitate a distinct approach to CG that is deeply embedded in Shari'ah law and Islamic principles.

#### 7.4.2 Corporate governance in Islamic banking

Addressing the gaps identified in the existing literature, the thesis offered a critical analysis of CG structures in Islamic banks, set against the backdrop of their Western counterparts. As highlighted by Alam (2017) and Elasrag (2014), the thesis accentuated the unique challenges and opportunities inherent in Islamic banking governance, advocating for robust, transparent and ethically grounded governance structures. Moreover, the thesis's exploration and critique of CG models in Islamic banking significantly contribute to addressing the research gap identified by Abdel Karim and Archer (2007) and Mollah and Zaman (2015).

#### 7.4.3 Theoretical frameworks

In its application and critique of key theoretical frameworks—agency theory, stakeholder theory and stewardship theory—the thesis provided a comprehensive understanding of CG within Islamic banking. This approach, as suggested by Mallin (2013) and Letza et al. (2004), offered a dynamic analysis of CG, considering both shareholder and stakeholder perspectives. The thesis's novel contribution lies in its linkage of stewardship theory to Islamic banking, thereby broadening the theoretical discourse being deliberated in Islamic and conventional banking (Obid and Naysary 2014).

#### 7.4.4 Risk management in Islamic banking

The thesis's focus on risk management practices in Islamic banking aligned with the literature's emphasis on the unique risks inherent to Islamic banking due to Shari'ah compliance (Hasan and Dridi 2010; Hussain and Al-Ajmi 2012). The comparative analysis

conducted within the thesis resonates with the findings of Bashir and Azeez (2022) and Zakarneh et al. (2022), and offers empirical insights into risk management practices in Islamic banks, highlighting the need for tailored strategies that are cognizant of Islamic banking's unique operational principles.

## **7.5 Conclusion and integration with research objectives**

The thesis integrates the insights from individual papers with the wider literature, addressing and fulfilling the key research objectives. Furthermore, it offers a pioneering analysis of CG and risk management in Islamic banks, enhancing the understanding of their unique challenges and opportunities. The research not only contributes to the theoretical discourse, as emphasized by the studies of Chazi et al. (2018) and El- Halaby and Hussainey (2016), but also has practical implications for Islamic banking practitioners, regulators and policymakers. It paves the way for future research in this evolving field, particularly in the areas of Shari'ah compliance, ethical governance and the integration of Islamic and Western CG models.

This integrated thesis presents a detailed and structured exploration of corporate governance (CG) in Islamic banking, encompassing conceptual development, comparative analysis, and empirical assessment. Through three interconnected papers, it examines how governance frameworks in Islamic banks can evolve by incorporating elements of Western CG while preserving adherence to Shari'ah principles. The research not only contributes to academic literature but also offers practical insights for regulators, policymakers, and practitioners aiming to enhance governance standards in Islamic financial institutions.

The first paper lays the theoretical foundation by proposing a governance model that harmonizes Islamic finance principles with established Western CG frameworks. This model introduces a structured approach that aligns the ethical and operational dimensions of Islamic banking with recognized governance mechanisms. By applying governance theories such as principal-agent theory, stakeholder theory, and stewardship theory, it provides a conceptual lens for understanding governance dynamics within Islamic banks. These theories frame the interactions between stakeholders—including shareholders, depositors, regulators, and Shari'ah boards—highlighting how governance structures can balance financial performance, risk oversight, and ethical compliance.

Building upon this theoretical foundation, the second paper extends the discussion by conducting a comparative analysis of governance structures in Western and Islamic banking institutions. It identifies core similarities and distinctions, particularly in board composition,

risk management practices, and the role of regulatory oversight. The study finds that while Islamic banks incorporate additional governance layers—such as Shari’ah Supervisory Boards (SSBs) and investment account holder (IAH) protections—they share fundamental governance principles with Western institutions, such as the need for independent board oversight, transparent disclosure, and structured risk management frameworks. The comparative findings demonstrate that governance mechanisms commonly applied in conventional banks can be adapted to Islamic banking without compromising Shari’ah compliance, offering opportunities for regulatory alignment and improved governance efficiency. The third paper focuses on the Gulf Cooperation Council (GCC) region, presenting empirical evidence on the effects of internal governance mechanisms on risk management in Islamic banks. By examining board structures, ownership patterns, and risk management practices within Islamic banks operating in GCC countries, the study provides insights into governance challenges and opportunities in the region. The findings indicate that governance mechanisms influence risk exposure, financial stability, and compliance effectiveness, underscoring the practical implications of governance reforms. This regional case study highlights the role of regulatory bodies in shaping governance frameworks and demonstrates how banks can leverage governance improvements to enhance risk mitigation and operational resilience.

The three papers are interconnected in their contribution to a cohesive understanding of corporate governance in Islamic banking. The first paper conceptualizes governance frameworks, the second validates governance principles through comparative analysis, and the third offers empirical evidence on governance outcomes in a specific regional context. Together, they provide a comprehensive examination of governance mechanisms, addressing theoretical, comparative, and practical dimensions.

A key strength of this integrated approach is its reliance on established governance theories. Principal-agent theory explains the role of governance in mitigating conflicts between shareholders, depositors, and bank executives, while stakeholder theory broadens the governance perspective to include ethical considerations and Shari’ah compliance. Stewardship theory further refines the governance model by emphasizing the role of board members and executives as stewards of ethical and financial responsibilities. These theories collectively underpin the governance model proposed in the first paper, validated through comparative analysis in the second paper, and tested in real-world applications in the third paper.



The interconnectedness of these papers also highlights the evolving nature of governance in Islamic banks. While traditional governance models in Islamic finance emphasize ethical and Shari'ah compliance aspects, the research findings suggest that governance improvements—such as enhanced board independence, structured risk oversight, and transparency—can strengthen financial stability and regulatory alignment. This integration of governance mechanisms from Western models offers a pathway for Islamic banks to meet global standards while maintaining their ethical identity.

The research findings emphasize that integrating Western CG principles into Islamic banking is both feasible and beneficial, provided that the integration respects Shari'ah compliance and ethical considerations. One of the major findings across the three papers is the role of the board of directors in ensuring governance effectiveness. The research highlights that while Islamic banks have additional governance bodies—such as SSBs—ultimate responsibility for governance remains with the board. By adopting governance structures that enhance board independence, such as appointing non-executive directors and establishing specialized risk committees, Islamic banks can reinforce oversight and reduce conflicts of interest. The comparative analysis in the second paper underscores that best practices in Western CG, such as requiring a majority of independent board members, could be adapted to Islamic banks to improve decision-making processes.

Risk management emerges as a central theme across the three papers, with the research demonstrating that robust governance structures contribute to better risk oversight. The third paper's empirical findings from the GCC region suggest that banks with well-defined governance structures—such as dedicated risk management committees and clear board responsibilities—tend to have lower risk exposure and improved compliance. Integrating Western CG elements, such as the Basel III guidelines on risk governance, can help Islamic banks establish clearer risk oversight mechanisms. Additionally, positioning Shari'ah risk as a core component of enterprise risk management can enhance governance effectiveness by ensuring that financial, operational, and compliance risks are managed holistically.

Transparency and disclosure are critical components of effective governance, influencing stakeholder trust and regulatory compliance. The research finds that while Islamic banks emphasize ethical finance and social responsibility, disclosure practices often lack the rigor seen in Western banking institutions. By incorporating international reporting standards—such as IFRS and Basel reporting guidelines—Islamic banks can improve transparency, enhance investor confidence, and align with global regulatory expectations. The comparative

study highlights that countries with stronger governance disclosure requirements tend to have more stable banking institutions, reinforcing the argument that improved transparency contributes to governance resilience.

A noteworthy implication of integrating Western CG principles is the potential for Islamic banks to align more closely with international regulatory frameworks. The research suggests that regulatory harmonization, such as aligning governance codes with international standards while maintaining Islamic finance principles, can facilitate greater cross-border banking cooperation and enhance the competitiveness of Islamic banks. The empirical findings from the GCC study indicate that countries with clearer governance regulations tend to have banks with stronger financial performance and lower governance-related risks. This suggests that refining governance frameworks in Islamic banking to include best practices from international standards could yield positive economic and regulatory outcomes.

One of the unique contributions of this thesis is its emphasis on integrating Shari'ah compliance within broader governance frameworks. While Islamic banks have SSBs to oversee Shari'ah matters, the research suggests that Shari'ah governance should not operate in isolation. Instead, it should be embedded within risk management structures and board-level governance oversight. The conceptual model in the first paper proposes establishing a Governance and Risk Committee that directly liaises with the SSB, ensuring that compliance is actively monitored alongside financial and operational risks. This approach strengthens both governance integrity and Shari'ah adherence by institutionalizing compliance processes within standard governance mechanisms.

This thesis contributes to the academic literature by bridging corporate governance theories with empirical research on Islamic banking. It advances the understanding of how governance mechanisms function in different financial contexts and offers a roadmap for integrating best practices across conventional and Islamic financial institutions. The research also holds practical implications for policymakers and regulators, providing guidance on governance reforms that enhance transparency, risk management, and regulatory alignment.

By demonstrating that Western governance principles can be adapted to Islamic banking without compromising Shari'ah compliance, this research provides a foundation for future governance developments in the industry. It highlights the need for continuous regulatory evolution, stakeholder engagement, and governance innovation to ensure that Islamic banks remain competitive in an increasingly interconnected financial landscape.

By synthesizing conceptual insights, comparative evaluations, and regional case studies, this research contributes to both academic knowledge and industry practice. It provides a structured approach for policymakers, regulators, and practitioners to refine governance frameworks, ensuring that Islamic banks operate with integrity, resilience, and ethical commitment. Through this integration of governance perspectives, the thesis lays the groundwork for more sustainable, transparent, and efficient governance systems in Islamic banking.

## Chapter 8: Conclusion and future work

### 8.1 Summary of key findings and their implications for Islamic banking and corporate governance

The thesis successfully juxtaposed Western CG models with Islamic banking practices, offering a critical comparative analysis of risk management policies and the roles of boards in directing these strategies within Islamic banks. It also evaluated the distinctive position of Shari'ah committees or SSBs in addressing the unique risks of Islamic banking, thus establishing a foundation for integrating Western governance practices with Islamic principles to create robust governance structures/

The exploration began with a theoretical overview, highlighting the role of boards in risk management and the interplay between different CG theories such as agency theory, stakeholder theory and stewardship theory. This theoretical framework formed the basis for understanding the divergence in governance practices between Islamic and Western institutions and the resultant implications for risk management. Furthermore, the findings underscored that while there is a universal responsibility of boards in risk management across different banking systems, Islamic banks face unique challenges due to their compliance with Shari'ah law. Thus, the findings identified tailored risk management approaches and introduced additional stakeholders, such as investment account holders and SSBs, which created complex layers of risk that were not present in conventional banking. It was found that Islamic banks, through their adherence to Shari'ah principles and ethical considerations, offer an innovative perspective on risk management that emphasises social responsibility and equitable resource distribution. Furthermore, this approach aligns with the Maqasid al-Shari'ah framework, which aims to achieve overall societal well-being.

Through the methodological lens of comparative analysis, the thesis examined CG codes from the UK, Germany, Saudi Arabia and Malaysia, revealing variations in the application and adoption of risk management guidelines. The research emphasized the importance of Shari'ah governance in Islamic banking, which plays a pivotal role in risk management practices in Saudi Arabia and Malaysia. However, the thesis argued that, despite some differences, there were more similarities between the CG and risk management guidelines in the studied countries. For example, the 'comply or explain' approach common in Malaysia and the UK and the ultimate responsibility of the board in risk management were notable similarities across both Western and Islamic banking systems.

Finally, the geographical lens used to explore the impact of internal CG mechanisms on risk management in Gulf Cooperation Council's Islamic banks provided an empirical and novel contribution to the field. The research examined the influence of these mechanisms, including board characteristics, SSB characteristics, ownership models, CSR and internal control and audit characteristics, on risk management strategies. Employing a discriminant analysis identified that CSR, government holdings and board duality were significant predictors of a bank's financial health. In contrast, board size and firm age showed less predictive value. These findings highlighted the critical role of robust CG mechanisms and sound risk management strategies in enhancing the resilience of Islamic banks.

The practical implications of the findings from this thesis are profound for Islamic banking and CG, offering a critical roadmap for Islamic banks to enhance their governance structures and risk management capabilities. Therefore, this thesis's contribution is considered to be important for their sustainability and ethical operations. The research provides nuanced insights into governance complexities, furnishing practitioners, policymakers and regulators with guidance for developing governance codes that address the unique needs of Islamic financial institutions.

Paper 3 (Chapter 6) in particular, underscored the significance of strong internal governance mechanisms in reducing risk levels and fortifying financial health within Islamic banks. Furthermore, it offered essential regulatory recommendations, advocating for stricter standards on insider and government holdings and underlining the need for Islamic banks to reinforce their internal control systems and amplify their CSR initiatives. Thus, the recommendations are considered crucial for the advancement of governance structures within Islamic banks, ensuring their alignment with international standards while maintaining their Shari'ah-compliant nature.

In summary, this thesis linked theoretical constructs with empirical observations, significantly contributing to the field of Islamic banking and CG. It elucidated how Islamic banks can adeptly navigate CG complexities, while upholding their Shari'ah-compliant ethos. These findings collectively add to the stability and integrity of the global financial system, providing a foundation for future studies and offering valuable insights for practical applications in the Islamic banking sector. This research thus stands as a seminal contribution, enhancing the understanding of the integration of Western CG principles into Islamic banking and its implications for the broader financial landscape.

## 8.2 Directions for future research, considering the gaps identified in the study.

In light of the findings and implications elucidated in this thesis, several avenues for future research emerge, that address the gaps identified and augment the scholarly understanding of CG within the Islamic banking sector. These potential research directions are rooted in both the empirical and theoretical realms of Islamic finance and CG.

- 8.2.1 **Geographical expansion of research:** Future studies could extend the geographical scope beyond the GCC region to include areas where Islamic banking is rapidly increasing, such as Southeast Asia or North Africa. Comparative analyses across these diverse regions would enrich the understanding of how varying cultural, regulatory and economic contexts influence the implementation and efficacy of Western CG models in Islamic banks.
- 8.2.2 **Longitudinal empirical studies:** The implementation of longitudinal research methodologies would facilitate a deeper comprehension of the long-term effects of Western governance practices integration on Islamic banks, focusing on aspects such as performance, risk management and Shari'ah compliance.
- 8.2.3 **Impact of technological advancements:** In an era of significant digital transformation within the financial sector, examining the influence of technological advancements, including fintech innovations, on CG in Islamic banking presents a compelling research prospect.
- 8.2.4 **Analysis of stakeholder perceptions:** Investigating how various stakeholders perceive and are impacted by the integration of Western CG practices in Islamic banks could provide a more comprehensive understanding of its effectiveness and acceptability.
- 8.2.5 **Ethical and social responsibility considerations:** Future research might delve into the ethical and social responsibility dimensions of Islamic banks, particularly how these are influenced by the integration of Western governance models, in alignment with the Maqasid al-Shari'ah principles.

**8.2.6 Comparative studies with conventional banking systems:** Further studies comparing Islamic and conventional banking systems, with a focus on their respective governance structures and their impacts on various risk types, would enhance understanding of the unique and common aspects of these systems.

These research directions, firmly anchored in both theory and practice, aim to broaden the horizons of CG in Islamic banking. They offer a pathway to navigate the evolving landscape of global finance, addressing unique challenges and leveraging emerging opportunities within the Islamic banking sector





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## 10. Appendices

### Appendix 1 Steve consent

Consent Form from Prof. Steve Letza to Bchr Alatassi

Date: February 21, 2024

To Whom It May Concern, Bournemouth University, Business School, Examiners

Dear Examiners and Whom It May Concern,

I, Prof. Steve Letza, am writing to express my written consent for the use of our joint paper, "Best practice in bank corporate governance: The case of Islamic Banks," published in the Economics and Business Review Journal, within Bchr Alatassi's PhD thesis at Bournemouth University.

This consent is to affirm that the contributions made to the paper are primarily (more than 90%) attributed to Bchr Alatassi's individual efforts, under my guidance and co-authorship. I recognize the necessity of this consent for meeting the university's criteria for including co-authored works in Bchr Alatassi's dissertation.

I hereby provide my approval and wish Bchr Alatassi the best in completing their PhD program.

Best regards,

Prof. Steve Letza



Signature: \_\_\_\_\_ Date: \_\_\_\_\_ 22.2.24 \_\_\_\_\_

## Appendix 2 Rekha consent

Date: 23/02/2024

To Whom It May Concern, Bournemouth University,

Dear Examiners and Whom It May Concern,

I, Dr. Rekha Pillai, hereby provide my written consent for the inclusion of our co-authored paper titled "A Comparative Analysis of Corporate Governance and Risk Management: An Evaluation of Board Responsibilities in Western and Islamic Banks," accepted for publication in the Economics and Business Review Journal, as part of Bchr Alatassi's PhD thesis at Bournemouth University.

This letter serves to confirm that the work presented in the paper is predominantly (over 90%) the original work of Bchr Alatassi, under our collaboration and co-authorship. I understand this confirmation is required for the completion of Bchr Alatassi's thesis and to fulfil the university's requirements for the incorporation of co-authored publications.

I am pleased to support Bchr Alatassi's academic endeavours and provide this consent as acknowledgment of their significant contribution to our collaborative research.

Sincerely,

Dr. Rekha Pillai

Signature: *Rekha Pillai*

Date: 23/02/2024

## Appendix 3 Second paper analysis

### Appendix 3.1 Board's responsibility toward risk in the West:

#### 1. The UK Code of Corporate Governance

##### **Application and adoption**

The UK code requires the boards to apply the 'spirit' of the principles, leading globally to the 'comply or explain' path. The code is not presented as a rigid set of rules but follows a guiding approach on what 'should be' the board/corporations responsibilities toward stakeholders instead. The directors should also use the code's flexibility wisely and the investors decide to deem the application of the guidance as satisfactory. Furthermore, the UK code encourages the board of directors not to limit themselves to the code itself but consider the other guiding principles published by the Financial Reporting Council (FRC), such as guidance regarding audit committees, risk management, internal control and related financial/business reporting aspects.

##### **Board's role in risk management**

The code holds the board accountable for sourcing and allocating resources to ensure the corporation achieve its objectives. Also, the code considers the board ultimately responsible for establishing all the strategies and frameworks, including risk management. Furthermore, the UK code requires boards to report how the trade-off between risks and opportunities has been managed to achieve the companies' sustainable growth, thereby aligning with Hubbard's (2009) definition of risk management as *identification, assessment and prioritisation*. Moreover, the relationship between risk, governance and strategy is an explicit element of the code's discourse. The code highlights that board's accountability is not limited to setting the strategic plan and framework, but it is also responsible for setting the internal process and monitoring the coordination between the internal committees. Furthermore, the board should be assessing the company's principal risk, which was defined by the UK code of corporate governance (2018, p.12) as

*'Principal risks should include, but are not necessarily limited to, those that could result in events or circumstances that might threaten the company's business model, future performance, solvency, liquidity and reputation. In deciding which risks are principal risks, companies should consider the potential impact and probability of the related events or circumstances and the timescale over which they may occur.'*



Moreover, the code highlights the split of responsibilities between the board itself and its committees (mainly the audit committee), in line with Deloitte (2018) recommendations. The code holds the audit committee responsible for reviewing its internal financial controls and risk management systems unless the board decides otherwise. Finally, the code urges the board to implement a robust review to monitor the risk management strategy's appliance and adherence to the principal risks they approved.

## 2. The German Code of Corporate Governance

### **Application and adoption**

The German code of CG (2022) takes a stronger position than its UK counterpart, with the extended use of strong and authoritative words such as 'obligation', 'compliance' and emphasis on the obligation and law enforcement for board's responsibilities.

The German code highlights the importance of transparency and clarity of its principles and requires all listed companies by law to follow a dual board structure that will lead the application of these guidelines. The management board is responsible for managing the company, whereas the supervisory board's responsibility is mainly to advise and supervise the management board's members with a direct involvement in all strategic and fundamental decisions.

### **Board's role in risk management**

The German code holds the management board accountable for regularly reporting all strategic issues to the supervisory board, including planning, business development, risk management, risk status and compliance. Nonetheless, the management board is responsible for ensuring the appropriate risk management and risk control in their company. Moreover, the German code holds the management board ultimately responsible for adhering to legal requirements and ensuring compliance across all managed companies. The management board is responsible for forming the compliance management system, enabling the company to assess the risk situation. The code requires the chair of the supervisory board to meet regularly with the management board's chair/spokesperson to take a role in all strategic decisions including the risk situation, risk management and compliance.

Like the UK code, the German code encourages the supervisory board to establish an audit committee responsible for overseeing all accounting processes, internal control, audit, risk and compliance. Finally, the code highlights that the code was designed to ensure compliance with

the law and is ethically crucial to boost stakeholders' confidence. Therefore, the code requires the management board to inform the supervisory board of any strategic issues including risk and compliance 'without delay' and then it is the supervisory board's responsibility to keep all stakeholders informed regarding any significant changes.

## **Appendix 3.2 Board's responsibility toward risk in the East/Islamic countries:**

### **1. The Malaysian code of corporate governance**

#### **Application and adoption**

The Malaysian code of corporate governance (MCCG) argues that 'proper' and 'good' governance aims to split the rights and responsibilities between all stakeholders and make all the rules, including internal control and risk management, available for all. The MCCG follows a 'comply or explain' approach similar to the UK Code and urges the boards in all Malaysian companies to consider the code's spirit instead of just ticking the compliance box. Furthermore, the MCCG requires all boards to allow a level of flexibility to cope with global consent changes, including mindset and culture changes. Boards should adapt to their companies' business environment, size, complexity and the risk they face. The MCCG takes a more advisory approach and the language used aims to guide all Malaysian companies to apply the core behind the published principles rather than applying them to get regulatory sign-off.

#### **Board's role in risk management**

The MCCG argues that the core purpose of CG principles is to '*reduce risk, corruption and mismanagement*'; therefore, it requires the board to understand the code's principles and apply its spirit fully. This argument aligns with prior research (Bhimani 2009) that studied the relationship between CG and risk management and highlighted their role in influencing public policy.

The MCCG holds the board accountable for ensuring a sound framework of risk management to meet the company's expectations. Similar to the UK code of CG, the MCCG requires the board to understand the principal risks, set the risk appetite, manage and overlook all substantial financial and non-financial risk. The MCCG applies the same approach as other leading countries in the world, by splitting the board and its committees' risk management responsibilities. Therefore, the MCCG argues that influential committees, especially risk and audit committees, can enhance the company's transparency; however, the ultimate responsibility for a company's risk management sits with the board.

The code sets the audit committee as a critical player in the governance structure that is responsible for financial reporting, internal control and risk management. Furthermore, the code separates the risk management's focus on '*identifying threats and opportunities*' while internal control focuses on '*counter threats and taking advantage of the opportunities*'. Finally, the MCCG links a company's 'success' with integrating

*'effective governance structures and processes with performance-focused risk management and internal control at every level of the company and across all operations'.*

Therefore, the board should consider all risk types, including finance, operations, compliance, reputation and cybersecurity.

## 2. The Saudi code of corporate governance

### **Application and adoption**

The Saudi Code of CG introduces a set of regulations that express the guidelines and standards that direct an organisation's management to guarantee its consistency with the best governance standards and ensuring the protection of all stakeholders' rights. Furthermore, applying the code articles is considered obligatory to organisations aside from the arrangements that contain a reference to 'guiding'. In addition, without bias to these regulatory arrangements, other supervisory authorities' laws and guidelines also apply to organisations that are subject to them.

### **Board's role in risk management**

The Saudi Code argues that the board's primary functions are setting a comprehensive strategy, including the main business plans, policies and risk management instruments. Furthermore, the code holds the board responsible for developing the appropriate risk culture by assessing, forecasting and managing the risk via the correct procedures. Like all previous standards, the Saudi Code splits the responsibility between the board and its committees and requires all companies to form an advisory risk committee, including a detailed listing of its duties. Furthermore, the code holds the risk committee responsible for setting the next '12 months' risk plan, assessing the risk ability to take risks, reviewing the financial issues raised by the audit committee and most importantly, determining the 'acceptable' level of risk the company may face.

## Appendix 3.3 Shari'ah governance

Despite full detailed guidelines, both the Malaysian and the Saudi codes follow a similar setup and approach to its western counterparts. There are no unique measures or procedures for the Islamic financial institutions. Therefore, this thesis examined the '*Shari'ah Governance*' document published by the central bank of Malaysia (BNM 2010) and '*Shari'ah governance framework for local banks and banks operating in the Kingdom of Saudi*' published by the Saudi Monetary Authority (SAMA 2020). This step allowed a more comprehensive view on the East/Islamic leading countries' practice to ensure the IFIs aspects were analysed, in contrast to Western countries (Germany and the UK), where the CG codes and guidelines cover all players in the financial markets.

### 1. The BNM Shari'ah Governance

#### **Application and adoption**

The Central Bank of Malaysia (Bank Negara Malaysia 2010) provided the '*Shari'ah governance*' guidelines entailing detailed principles covering all Shari'ah aspects to support Islamic financial institutions in fulfilling their responsibilities toward stakeholders. The Shari'ah governance structure, similar to the conventional governance codes, presents risk management as a critical element in the CG structure. The BNM defined Shari'ah risk management as

*'a function that systematically identifies, measures, monitors and reports Shari'ah non-compliance risks in the operations, business, affairs and activities of the IFI'* (BNM; 2010, p.25).

The guidelines focus on the Shari'ah non-compliance element in particular because of its impact on the IFIs, enabling them to manage any reputational risk non-compliance might carry. This is aligned with a number of studies (e.g., Abdel Karim and Archer 2007; Abdullah Saif Alnasser and Muhammed 2012; Grassa and Matoussi 2014). The BNM highlighted that these guidelines should be read together with all other relevant central bank's policies such as CG code, risk governance and operational risk. The policy document applies to all Islamic financial institutions and is required by law to pursue many of the Islamic Financial Services Acts, which arguably puts these guidelines in a stronger position than any other governance guidelines analysed previously.

### **Board's role in Shari'ah risk management**

The BNM argue that applying these policies aims to strengthen all Islamic financial institutions' governance structure to respond to their complex business model and unique compliance and risk management requirements. The BNM policy introduces an extra layer of supervision on the board, Shari'ah committee and other stakeholders responsible for Shari'ah governance. These guidelines highlight that Shari'ah governance and compliance must be integrated with all other conventional business and risk strategies. Therefore, the board of directors are ultimately accountable for the overall governance structure and compliance, including Shari'ah related matters.

Moreover, the policy highlights the board's primary responsibilities to include four components: (a) approving all governance structure, reporting, risk management and Shari'ah non-compliance risk management; (b) supervising the application of the Shari'ah Advisory Council's rulings whilst advising the Shari'ah committee on the risk implications evolving from such implementations; (c) being accountable for overseeing senior management's and internal auditors' performance to ensure a sound governance structure in place, minimising the risk and maximising compliance; and (d) appointing one of the Shari'ah committee members as a board member to boost the integration between the Shari'ah governance and the overall business and risk strategy. Furthermore, the policy states that effective management of the Shari'ah non-compliance risk is mainly dependent on this comprehensive approach.

## **2. The Shari'ah governance framework for local banks and banks operating in the Kingdom of Saudi Arabia**

### **Application and adoption**

Shari'ah governance is one of the primary elements in the success of Islamic finance. Thus, the Saudi Arabian Monetary Authority introduced the Shari'ah governance framework for Islamic banks operating in Saudi (SAMA 2020). SAMA argue that the introduction of Shari'ah governance would reduce the Shari'ah non-compliance risk, attract foreign investment, and boost the stakeholders' confidence in the IFIs, including but not limited to; shareholders, IAHs and investors.

The SAMA framework aims to set the roles and responsibilities for Shari'ah governance in all Islamic financial institutions, including the accountabilities of the board, Shari'ah committee, executive management, risk management and internal control. Therefore, all board members in Islamic banks should understand the basics of Shari'ah principles and their application in

finance and in parallel, all Shari'ah board members should ensure sufficient knowledge in finance and banking principles to ensure competence in their decisions and ruling. SAMA considers that applying these guidelines is the minimum prerequisite for ensuring a sound Shari'ah governance is in place, thereby enabling the Islamic banks to comply with all the Islamic rules and requirements.

### **Board's role in Shari'ah risk management**

SAMA argues that forming a Shari'ah governance framework is a critical pillar supporting the board of directors in achieving a high-efficiency level toward their responsibilities. Furthermore, the Shari'ah framework aims to boost the competence of the internal control and risk management committees.

SAMA holds the board of directors ultimately responsible for the bank's Shari'ah governance and its compliance with Shari'ah rules. Moreover, boards are accountable for continuous review of Shari'ah governance and its compatibility with the banks' size and complexity. Furthermore, SAMA's focus is not solely on the Shari'ah non-compliance risks but also on ensuring the risk management mechanism is robust and considers the wider Islamic banks' unique stakeholders such as IAHs and depositors who participate in profits and losses. Finally, SAMA requires all Islamic banks to form a Shari'ah risk management framework that must be a part of the banks' more comprehensive risk management framework to ensure coherence in the banks' decisions and behaviour toward risk management.