Islamic Bank Audit Committee and Risk-Taking Behavior. A Conceptual Framework

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Abstract. This study intends to investigate the impact of bank audit committees' composite and bank risk-taking behavior in Malaysia from 2010 to 2019. The audit committee is accountable for assuring the accuracy of financial reporting disclosure, interacting with internal and external audit functions to strengthen the controls' function. The Islamic bank in Malaysia are required to adhere the Shariah compliance framework in their operational activities under the IFSA 2013. Following this, the Bank Negara of Malaysia (BNM) introduced new policy documents on corporate and Shariah governance in 2016 and 2019 respectively to further promote prudent risk management practices among Islamic banks in the nation. Audit committees play a crucial role in monitoring the risk-taking operations of banks to meet regulatory and relevant stakeholders' compliance requirements. Existing literature acknowledges the role of audit committees' effectiveness and corporate profitability performance relationship in non-banking sectors. This paper attempts to conduct an empirical study using the static panel data regression technique to examine the relationship between bank risk-taking and audit committees by comparing the composite changes over time to determine the effectiveness.

Keywords: Islamic bank · Risk-taking behavior · Audit committee

1 Introduction

It is strongly believed that banks' excessive risk-taking leads to a lack of successful regulatory supervision by the authorities. The failure to implement a regulatory framework for a more resilient banking sector to avoid such risk-taking was the primary cause of the

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global financial crisis (GFC) in the year 2008 (AlAbbad, Hassan, & Saba, 2019; Mollah, Hassan, Al Farooque, & Mobarek, 2017; Siddika & Haron, 2019). The weak bank's governance system contributes to banks' failure to assess risks and the institution's vulnerability to financial shocks (Moudud-Ul-Huq, 2020). Notwithstanding, Islamic banks (BIs) show a strong ability to cope with and recover from setbacks during financial crises and have increased significantly (Chazi and Syed, 2010).

Prior the global financial crisis, banks have played a diminished role in corporate governance, and controlling bank risk-taking has emerged as a significant problem (Nguyen, 2021). Few studies have noted how poor corporate governance contributed to the 2008 financial crisis and required more strict board supervision fostered excessive risk-taking (Nguyen, 2021; Wu, Habib, & Weil, 2012; Younas, Klein, Trabert, & Zwergel, 2019). Following the crisis in 2008, the audit committee's responsibility to monitor risk-taking increased. The Basel control change constrained banks' sheets of executives to take part in chance administration oversight. It prescribed a stand-alone hazard committee and review committee as a portion of a board that would center particularly on hazard.

The application of corporate governance as a duty of Islamic bank adhere to the Shariah requirement. Islamic financial systems require more robust internal controls since they handle many complex financial transactions and multiple contractual relationships in product development. Islamic banks must have a Shariah committee to examine and guarantee products that comply with Islamic commercial law (Farag, Mallin, & Ow-Yong, 2018; Mollah et al., 2017; Rahim & Rahman, 2015). The boards of Islamic banks are assisted by the Shariah committee and audit committee, by directly controlling the Shariah audit function, in eliminating non-complaint business activities (Kasim, NuHtay, & Salman, 2013; Nguyen, 2021; Rahim & Rahman, 2015).

In spite of the significance of their parts within the keeping money industry, there's need of observational prove assessing the part of review committees and Sharia in controlling risk-taking. Mollah et al. (2017) assert that Islamic banks with corporate management have a chance to perform way better and diminish dangers more successfully. As a result, not all of the bank's administration structure's components have a part in controlling risk-taking. Our inquire about can offer assistance Islamic banks by emphasizing the capacities of the review committee to extend corporate administration adequacy and diminish risk-taking behavior.

2 Literature Review

The agency theory relates to the conflicting interests between the principal and management. The principal owner is provide the capital to run the business but may lack the necessary abilities and skills to manage the operations. The owner can therefore choose to employ a professional manager, or agent, to manage the business on their behalf (Fama & Jensen, 1983; Jensen, 1976). The owner's objective is to maximize profits, whereas the manager's objective may be to improve the career self-benefit. Hence, corporate governance principles monitor and mitigate the clash of interests between the principal and agent (Brennan & Solomon, 2008). Effective corporate governance processes will provide monitoring to minimize conflicts between the principals' ownership and agency (Biswas, Bhuiyan, & Ullah, 2008; Brennan & Solomon, 2008; Eisenhardt, 1989).

By conforming to Shari'ah principles, the objective of an Islamic bank will provide its clients with social, ethical, and moral financial services. Islamic financial contracts provide a wider range of risk and profit-sharing arrangements between the bank and its customers. The effectiveness of Shari'ah compliance for an Islamic bank can have a substantial impact on the decisions of the board of directors and audit committee. An effective internal system to supervise Islamic banks' asserts ethical business orientations. The Shariah committee's establishment will probably provide shareholders more confidence that the bank's social norms are upheld (Islam, Bhuiyan, Kassim, & Rasli, 2021; Rahim & Rahman, 2015; Talavera, Yin, & Zhang, 2018). According to the IFSA 2013 act, Islamic banks in Malaysia are obligated to follow the Shariah compliance framework in all of their operating activities. The Bank Negara of Malaysia (BNM) released new policy documents on corporate and Shariah governance in 2016 and 2019, respectively, to further promote prudent risk management practices among Islamic banks in the nation (Isa, Lee, Bacha, & Ahmad, 2022; Laldin & Furqani, 2018). In order to satisfy the compliance requirements of major stakeholders and regulators, bank audit committees play a crucial role in overseeing the risk-taking activities of banks. To determine the function of audit committees in monitoring the risk-taking behavior of Islamic banks, we develop our theoretical framework for investigating the implications of the internal system of governance and the risk-taking activities in Malaysia's Islamic banking system.

2.1 Risk Taking Behavior (Z-Score)

The Z-score is used to determine the likelihood that a firm would collapse. Academics have used the Z-score as a proxy for measuring the resilience of banks, which may be used to predict the likelihood of bank failure. A higher Z-score indicates the bank is more stable and engages in less riskier operations (Jabari & Muhamad, 2022; Mokni, Rajhi, & Rachdi, 2016; Mollah et al., 2017). The equation is formed as follow:

$$Z = (\mu + c)/\sigma,$$

which μ is the return on bank assets, c is the bank total equity to bank total assets ratio, and σ is the volatility of the ban return on asset. Larger Z-scores indicate more substantial bank stability since they indicate a more significant buffer on the bank's equity reserve (Graham & Boyd, 1986).

2.2 Board Audit Committee (BAC)

The Board Audit Committee (BAC) is one of the board committees that assists the Board of Directors (BOD) in managing the financial reporting and internal controls of the bank. It also works with the external audit firm that audit the bank's financial statements. Given the committee's key role in the corporate governance process as control function to shareholder protection, the committee must be independent of management (Sun & Liu, 2014). The Basel committees have emphasized the importance of the independent audit committee on overseeing the risk management process and maintaining resilience uncertainty for the stability of banks' financial performance (Lee & Phua, 2022; Nguyen, 2021). In Malaysia, the banking industry, including the Islamic banks, should comprise independent members only. An audit committee made up of independent directors is more efficient in delivering bank performance. Audit committees with more independent members and accounting and auditing skills that more trustworthy will improve awareness of the financial and compliance aspects of the company's reporting system (Sun & Liu, 2014; Wu et al., 2012). Given the board does not actively oversee the risk-taking activities of banks; instead, this responsibility is delegated to the bank audit committee (Sun & Liu, 2014). The audit committee's efficiency is one factor that can affect risk-taking behavior in the banking industry. A recent study by Nguyen (Nguyen, 2021) found that the audit committee highly correlated with bank risk and stability. The proposed study's hypothesis is therefore presented as follows:

H1: The bank audit committee relates to lower bank risk taking behavior.

2.3 Board of Director

There were mixed findings discovered on how the number of board members influences an organization's performance. As a large board is formed with various expertise, it will lead to a better decision-making process. However, it was reported that a bureaucratic related issue may arises when the board size is large and in turn it will make the decision-making become more complex and time-consuming (Fama & Jensen, 1983; Jensen, 1976). The studies of Naushad and Malik (2015) found a significant inverse relationship between board size and bank performance in the Gulf Cooperation Council (GCC). For bank risk-taking related study, numerous studies suggest that organizations with smaller boards suffer more future performance uncertainty (Akbar, Kharabsheh, Poletti-Hughes, & Shah, 2017; Ferrero-Ferrero, Fernández-Izquierdo, & Muñoz-Torres, 2012; Nakano & Nguyen, 2012). The proposed study's hypothesis is therefore presented as follows:

H2: The bank board of director is connected with lower bank risk taking behavior.

2.4 Independent Director

The role of an independent director is to be a trustee of the shareholders and to be free from any conflicts of interest. Therefore, they are having absolute freedom in questioning the management when it is necessary. Based on the agency theory, it is suggested that independent board members be appointed to reduce any conflicts of interest (Fama & Jensen, 1983). Botti, Boubaker, Hamrouni, and Solonandrasana (2014) found a positive correlation between a high proportion of independent board members and a low level of agency issues. Moreover, while a firm makes more voluntary disclosures, they are more likely to reduce the information asymmetry between management and shareholders. In recent bank risk taking behavior study, Minton, Taillard, and Williamson (2014) examine the connection between banks performance and risk and based on the competence of independence board members, they found that independent members with solid financial backgrounds could reduce the cost of information collection. Moreover, the results of Lassoued (2018) found the association between the proportion of independent directors and the financial stability of Islamic banks was positively statistically significant. Therefore, the proposed study's hypothesis is therefore presented as follows:

H3: The bank independent director relates to lower bank risk taking behavior.

2.5 Shariah Committee

Shariah governance is an internal mechanism that ensure the compliance of Shariah in its operations and activities to promote a financial stability among Islamic financial institutions. The Shariah committee is appointed to oversee the compliance of shariah so being an independent body in performing their duties is completely important. The Shariah committee comprises scholars and specialists with an extensive understanding of Islamic commercial law and finance. Their duties include giving direction, supervision, and oversight of the application of Shariah principles to the operational and transactions of Islamic banks (Farag et al., 2018; Isa et al., 2022; Mollah et al., 2017; Rahim & Rahman, 2015). Shariah committee have played an essential role as the second layer of corporate governance by providing transparency and accountability information to the stakeholders, thus helping to reduce risk-taking behavior for Islamic banks (Islam et al., 2021; Mollah et al., 2017). Considering the literature review, the following is the hypothesis.

H4: The bank Shariah committee relates to lower bank risk taking behavior.

2.6 Bank Capital

This study determined the bank capital ratio using the book value of equity over total assets (Demirgüç-Kunt and Huizinga, 1999). Capital is the amount of funds a bank has available to support its operations and aims to protect the bank itself from risk. Banking regulators have therefore established capital requirements for banks. The Basel Committee has established a minimum capital ratio requirement of 8% for all banks. This is the mandatory requirement by which all banks evaluate the sufficiency of their capital rating (Demirgüç-Kunt & Huizinga, 1999; Louati, Gargouri Abida, & Boujelbene, 2015; Siddika & Haron, 2019). Chowdhury and Rasid (2016) analyzed Islamic banks in the GCC country from 2003 to 2015 and found statistically significant and positive relationship. Between Islamic banks' profitability and equity capital in GCC nations. Bitar, Naceur, Ayadi, and Walker (2017) investigated the effects of banks risk-taking and Basel requirement in 19 developing countries. According to the findings, bank compliance with Basel II capital standards will improves their performance, increases bank risk-taking protection, and there is no difference between Islamic and conventional banking systems. With sufficient capital requirements, banks can reduce the possibility of insolvency risk and increase profit performance (Hasman & Samartín, 2017). Since the capital played a significant impact in bank risk-taking, a bank more risker assets required to hold more capital requirement to satisfy regulation requirement. Hence, the high-risk business will be constrained by a higher capital ratio (Mokni et al., 2016). Below is the hypothesis based on the literature review:

H5: The bank capital is connected with lower bank risk taking behavior.

2.7 Bank Size

The bank's size is determined by the natural logarithm of its total assets and reveals how the bank allocates its total assets (Aktan, Turen, Tvaronavičienė, Celik, & Alsadeh, 2018). It is widely used as a controlling variable to identify the factors related to the dependent variable. The banks with larger total assets will have diverse investment opportunities, superior management and technological development compared to smaller banks. Therefore, larger size banks outperformed the smaller size banks (Camilleri, 2005). The studied of Siddik, Kabiraj, and Joghee (2017) is consistent and concluded that larger banks with more assets in their balance sheet perform better than smaller banks. However, for risk concern, due to the "too big to fail" concern, larger bank size can be a key influence in increasing of risk-taking behavior (Mishkin, 2006). In this regard, bank size is a factor in determining banking risk. Recent empirical research indicates that large banks with weaker capital ratios and less stable funding are more easily exposed to riskier operations (Laeven, Ratnovski, & Tong, 2014). Similarly, Čihák and Hesse (2010) found that the bank Z-scores increase for large banks and vice versa.

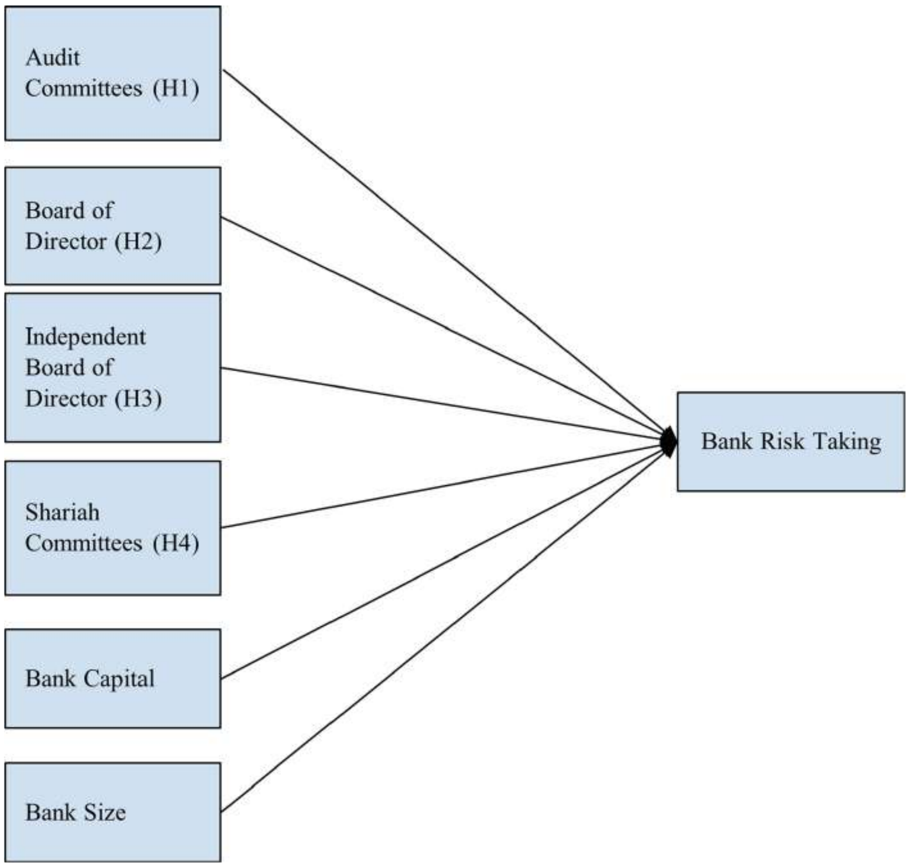

Fig. 1. Proposed Conceptual Framework

Louati et al. (2015) had similar viewpoints. They concluded that an Islamic bank's size increases due to income diversification, which is claimed to strengthen the strength and stability of the financial performance. Therefore, the proposed study's hypothesis is therefore presented as follows:

H6: The larger bank size is connected with higher bank risk taking behavior.

2.8 Conceptual Framework

The following framework is derived based on the literature and discussion (Fig. 1).

3 Research Methodology

The proposed sample period is from 2010 to 2019 and consists of 14 Islamic banks operating in Malaysia, which is based on the completeness of the availability of annual reports to gather the bank specific and governance data. We selected this period to assess the enduring impact of the Shari'ah governance framework implementation in the years 2016 and 2019 on the bank's risk-taking behavior. The study period aims to capture the role of the audit committee, board characteristics, and bank-specific control within Islamic banks in Malaysia by comparing the structural and functional changes pre and post establishment of the Shariah governance framework for the years 2016 and 2019 in the country. This study employed static panel data approaches to test the proposed theoretical framework between the bank specifics and governance structure towards bank risk-taking behavior. Combining cross-sectional and time-series, the panel data regression model has been shown to explain the heterogeneity of different variables. Additionally, the model gives more informative data, greater variability, less collinearity across variables, more degrees of freedom, and greater efficiency in explaining the dependent variable (Gujarati, 2021). The proposed baseline estimation regression equation is:

$$\begin{aligned} \mathrm{Z-Score_{it}} &= \alpha + \beta 1\mathrm{AuditComm_{it}} + \beta 2 Ln\mathrm{BoD_{it}} + \beta 3\mathrm{INDP_{it}} \\ &+ \beta 4\mathrm{SC_{it}} + \beta 5\mathrm{Capital_{it}} + \beta 6\mathrm{Size_{it}} + \mathrm{f_i} + \varepsilon_{\mathrm{it}} \end{aligned}$$

where,

α = intercept
Z-Score = Bank Risk taking behavior
AuditComm = Natural Log of Bank Audit Committee
LnBoD = Natural Log of Bank Board of Director
INDP = Bank Independent Director Ratio
SC = Shariah Committee
Capital = Total Equity/Total Asset
Size = Bank Size
f_i = Bank fixed effect,
ε_i = error term.

For static panel models in this study, Pool OLS, Fixed Effect Model (FEM), and Random Effect Model (REM) are evaluated, followed by F-Test, Hausman Test, and Breusch Pagan Lagrange multiplier to determine the most suitable model (Gujarati, 2021).

4 Conclusion

In conclusion, the purpose of this study is to investigate the relationship between the composition of bank audit committees and the risk-taking behavior of Islamic banks. The subprime crisis of 2008 and the recent uncertainty of financial markets due to the widespread of COVID-19 has urged immediate attention to revising the roles of corporate governance in monitoring and assessing the banks' risk-taking behavior. Audit committee functions are responsible for overseeing and controlling excessive risk-taking behavior of Islamic banks. From the foundation of the literature review, a conceptual framework was constructed for this study. The panel data regression analysis will test, validate, and enhance the model in the following forthcoming article.

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