

THE EFFECT OF CORPORATE GOVERNANCE AND RISK TAKING ON
FINANCIAL PERFORMANCE OF MALAYSIAN BANKS

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This thesis is dedicated to my inspiring parents,
brothers and sisters for their endless love,
encouragement, support and sacrifices.

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ABSTRACT

Corporate governance in both financial and non-financial firms is an important issue by researchers. A large number of corporate scandals across the world are due to financial scandals, weaknesses and failures in corporate governance, as well as risk taking that could attribute to poor financial performance. This study focused on the effects of corporate governance characteristics (board independence, board size, independent risk management committee, risk management committee size, independent audit committee, audit committee size and ownership concentration) on financial performance and risk taking. The study also assessed the role of risk taking as mediator on relationship among corporate governance and financial performance, besides comparing the financial performance of Islamic and conventional banks. This study was based on data collected from 37 published annual reports of Malaysian banks (21 conventional and 16 Islamic banks) for the period between 2005 to 2014. Data were analyzed using ordinary least square, fixed effect, generalized method of moments, approach of Baron and Kenny, Sobel test and independent t-test. The results stated that financial performance is positively related to corporate governance characteristics and there is a significant relationship between corporate governance and risk taking. On the other hand, risk taking plays the role of mediator between four characteristics of corporate governance (board independence, independent risk management committee, independent audit committee and ownership concentration) and financial performance in all banks as well as conventional banking sectors. Result of the study also showed full mediation between board independence and financial performance while partial mediation between independent risk management committee, independent audit committee and ownership concentration with banks financial performance. In contrast, risk taking has not mediated the relationship between board size, risk management committee size and audit committee size with financial performance in all banks, conventional and Islamic banks. However, there were significant differences between the financial performance of Islamic and conventional banks. This study contributes to the continuing debate on corporate governance and financial performance by providing a timely investigation of banks corporate governance, financial performance and risk taking. This study highlights the importance of effective future public policy to understand which aspects of corporate governance have the greatest impact on financial performance after considering risk taking.

ABSTRAK

Tadbir urus korporat di kedua-dua firma kewangan dan bukan kewangan merupakan satu isu penting bagi penyelidik. Sebilangan besar skandal korporat di seluruh dunia adalah disebabkan oleh skandal kewangan, kelemahan dan kegagalan dalam tadbir urus korporat dan juga pengambilan risiko yang boleh dikaitkan dengan prestasi kewangan yang lemah. Kajian ini memberi tumpuan kepada kesan ciri-ciri tadbir urus korporat (kebebasan lembaga, saiz lembaga, jawatankuasa pengurusan risiko yang bebas, saiz jawatankuasa pengurusan risiko, jawatankuasa audit bebas, saiz jawatankuasa audit dan penumpuan pemilikan) terhadap prestasi kewangan dan pengambilan risiko. Kajian ini juga menilai peranan pengambilan risiko sebagai pengantara antara tadbir urus korporat dan prestasi kewangan, selain membandingkan prestasi kewangan antara bank Islam dengan bank konvensional. Kajian ini adalah berdasarkan data yang dikumpul daripada 37 laporan tahunan yang diterbitkan oleh bank-bank di Malaysia (21 bank konvensional dan 16 bank Islam) untuk tempoh antara tahun 2005 hingga 2014. Data dianalisis dengan menggunakan kuasa dua terkecil biasa, kesan tetap, kaedah momen am, pendekatan Baron dan Kenny, ujian Sobel dan ujian-t bebas. Dapatan kajian menunjukkan bahawa prestasi kewangan mempunyai hubungan yang positif dengan ciri-ciri tadbir urus korporat dan terdapat hubungan yang signifikan antara tadbir urus korporat dengan pengambilan risiko. Sebaliknya, pengambilan risiko memainkan peranan pengantara antara empat ciri-ciri tadbir urus korporat (kebebasan lembaga, jawatankuasa pengurusan risiko yang bebas, jawatankuasa audit bebas dan penumpuan pemilikan) dan prestasi kewangan di semua bank termasuk sektor perbankan konvensional. Keputusan kajian juga menunjukkan terdapat pengantaraan penuh antara kebebasan lembaga dan prestasi kewangan serta pengantaraan separa antara jawatankuasa pengurusan risiko yang bebas, jawatankuasa audit bebas dan penumpuan pemilikan dengan prestasi kewangan bank. Sebaliknya, pengambilan risiko tidak mempunyai hubungan sebagai pengantara antara saiz lembaga, saiz jawatankuasa pengurusan risiko dan saiz jawatankuasa audit dengan prestasi kewangan di semua bank, konvensional dan bank Islam. Walau bagaimanapun, terdapat perbezaan yang signifikan antara prestasi kewangan bank Islam dengan bank konvensional. Kajian ini menyumbang kepada perdebatan berterusan tentang tadbir urus korporat dan prestasi kewangan dengan melaksanakan kajian yang tepat pada masanya tentang tadbir urus korporat bank, prestasi kewangan dan pengambilan risiko. Kajian ini menekankan kepentingan dasar awam masa depan yang berkesan untuk memahami aspek tadbir urus korporat yang mana mempunyai impak yang besar ke atas prestasi kewangan selepas menimbangkan pengambilan risiko.

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LIST OF ABBREVIATIONS

AAOIFI	-	Accounting And Auditing Organization for Islamic Financial Institutions
ACSIZE	-	Audit Committee Size
BAFIA	-	Banking and Financial Institutions Act
BCBS	-	Basel Committee on Banking Supervision
BIMB	-	Bank Islam Malaysia Berhad
BIND	-	Board Independence
BIS	-	Bank for International Settlement
BNM	-	Bank Negara Malaysia
BSIZE	-	Board size
CAR	-	Capital Asset Ratio
CEO	-	Chief Executive Officer
CLCD	-	Customer Loan to Customer Deposit
CR	-	Credit risk
EA	-	Eequity to Asset
FCCG	-	Finance Code Corporate Governance
FSIZE	-	Firm Size
GII	-	Government Investment Issues
GMM	-	Generalized Method of Moments
IAH	-	Investment Account Holders
ICAEW	-	Institute of Chartered Accountants of England and Wales
ICG	-	Islamic Corporate Governance
IFIs	-	Islamic Financial Institutions
IFSB	-	Islamic Financial Services Board
IMF	-	International Monetary Fund
INAC	-	Independent Audit Committee
INRMC	-	Independent Risk Management Committee

IR	-	Insolvency Risk
LA	-	Loan to Asset
LR	-	Leverage Risk
MII	-	Mudharabah Interbank Investments
OC	-	Ownership Concentration
OECD	-	Organization for Economic Co-operation and Development
OLS	-	Ordinary Least Squares
PLS	-	Profit and Loss Sharing
PR	-	Portfolio Risk
RMCSIZE	-	Risk Management Committee Size
ROA	-	Return On Asset
ROE	-	Return On Equity
RT	-	Risk Taking
SSB	-	Shariah Supervisory Boards
VIF	-	Variance Inflation Factors

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CHAPTER 1

INTRODUCTION

1.1 General Overview

In recent decades, performance of firms has been considered in many studies leading to the expansion of body of literature. Due to the significant contribution of performance measurement implemented in different corporate firms, assessment of firm performance has become extremely important. Furthermore, the difficulties that firms faced during the Asian and global financial crises also affected the performance of corporate firms. In fact, when a business is not capable of meeting its obligation commitment, it comes up with a poor performance. In this regard, assessment of business environment performance in firms has two major research streams. One line of research is based on non-financial performance, which is not expressed in monetary units, and includes measures of customer satisfaction and number of new products. The other stream of research is with regard to financial performance. Assessment of financial performance for the process of decision-making and specifically its contribution to strategy implementation is vital for any type of financial organization such as banking industry.

Since banking sector makes a significant contribution to countries' economic growth, its performance measurement has become a key topic in management research on financial performance. Presence of both Islamic and conventional banks in competitive environment has highlighted the necessity of addressing their performance. The rapid growth of Islamic banking requires having a greater understanding of its practices and drivers. Indeed, given the international spread of

Islamic banking practices, a study comparing the performance of Islamic and conventional banking is of great interest Iqbal (2001). The principles governing Islamic banks are significantly different from those of conventional banks. Islamic banks are organized under principles of Islamic law (shariah), and operate accordingly. This requires risk sharing and avoidance from the payment of interest (riba). In contrast, conventional banks are oriented mainly by the profit maximization principle (Olson and Zoubi, 2008). Banks performance can be assessed with the aim of looking at past and current trends, and determining future estimate. Achieving short and long-term obligations requires the consideration of factors that may affect performance.

1.2 Background of the Study

The emergence of financial crises across the world including the Asian financial crisis in 1997 and the global financial crisis in 2007/2008 have been documented in the literature (Haat *et al.*, 2008). The Asian crisis was attributed to inefficient and poor governance practices (Goldin and Vogel, 2010), while during global financial crisis in 2007/008, the stock price dropped and major banks entered into bankruptcy (Cheffins, 2009). Moreover, it ignited a deep global recession with concerns about the solvency of many of the world's largest financial firms, which led to catastrophic losses as a result of the mortgage crisis (Lang and Jagtiani, 2010). The global financial crisis has been the subject of a large number of theoretical and empirical studies that focus on two particular aspects; the sources and the consequences of the financial downturn (Asenova, 2011; Foster and Magdoff, 2009; Shiller, 2008; Vidal, 2010). These studies suggest that the subprime crisis, the Federal Reserve monetary policy in 2000, the bankruptcy of Lehman Brothers, and range of innovative financial products were at the root of the crisis.

In addition, the last few decades have witnessed several economic downturns and a large number of corporate scandals across the world. Corporate governance is an important issue due to these financial scandals, and has been taken in to consideration by researchers as well as investors. Lack of management oversight and

weakness of corporate governance practices are the two major causes identified during investigation of scandals (Kirkpatrick, 2009b). Furthermore, entrusting unlimited authority to executives has also provided the ground for abuse. All those conditions led to scandals in big companies around the world, including well-known companies like; World Come Inc, Enron and Adelphia (Munzig, 2003). To avoid such situations, proper governance of stakeholders through regular monitoring and auditing of the executive management is required, which is a process known as corporate governance.

Majority of the discussion in the area of corporate governance has focused on understanding the relationship between corporate governance and firm performance (Cadbury *et al.*, 1992; Dunlop, 1998; Shleifer and Vishny, 1997). Prior research on the relationship between corporate governance and company performance mentioned that a stronger corporate governance is related to a higher company performance (Ammann *et al.*, 2011; Bebchuk *et al.*, 2009; Core *et al.*, 2006; Cremers and Nair, 2005; Gompers *et al.*, 2003; Yermack, 1996). In addition, the role of corporate governance in the banking industry was examined in many studies which showed that effective corporate governance had positive effect on bank performance (Laeven and Levine, 2009; Macey and O'hara, 2003; Mishra and Nielsen, 2000; Sierra *et al.*, 2006). However, number of studies mentioned that banks corporate governance is different from nonfinancial firms, which is probably due to the banks having more stakeholders and complex business environment (Adams and Mehran, 2003; Andres and Vallelado, 2008; Bolton *et al.*, 2011). Dedu and Chitan (2013) investigated the influence of internal corporate governance on bank performance and found a negative relationship between them. Moreover, many scholars recommended that better financial performance relates to good governance, and powerful procedures may constraint managerial opportunisms (Bebchuk *et al.*, 2009; Cremers *et al.*, 2005; Gompers *et al.*, 2003).

To get the desired outcome, business needs to be organized and well-arranged. Lewis (2005) pointed out that the way firms are organized, directed and controlled, briefly called corporate governance, would be one aspect of a wider plan. Although the topic of corporate governance is addressed seriously by some

organizations such as Islamic development banks e.g. Chapra and Chapra (1992), Pomeranz (1997), Ahmad (2000), AAOIFI (2003), the research world lacks empirical work on corporate governance structure (Sourial, 2004). However, corporate governance in Islamic regulation provides a wide guideline that encompasses the duties of a Muslim. In addition, Islamic regulations encourage corporate governance in each and every individual activity of a Muslim including social activities. Furthermore, most studies during recent decades have focused on issues related to the comparison between utilized financial instruments and the performance of Islamic and conventional banks (Olson *et al.*, 2008; Srairi, 2009). Based on the above evidence and the importance of Islamic finance in the worlds' markets, the principle of corporate governance can be a key topic in Islamic business practices.

Another strand of empirical literature focused on comparing the performance of financial institutions such as banks. Competition in the banking industry has been intensified over the past decades and is threatening bank returns. The rapid growth of Islamic banking and its financial services around the globe in more than 70 countries have gained more attention (Choudhury and Hussain, 2005; Hasan and Dridi, 2011). There are a large number of studies comparing the differences between Islamic and conventional banks (Ahmad, 1989; Iqbal, 2001; Johnes *et al.*, 2013; Metwally, 1997; Safiullah, 2010; Samad, 1999, 2004; Siddiqui, 2005). Majority of the discussion was related to the differences in financial performance ratios such as liquidity, profitability, risk and solvency, capital adequacy and operational efficiency. Some studies indicated that Islamic banks are more liquid, less risky and operationally more efficient than conventional banks (Al-Muharrami, 2008; Ansari and Rehman, 2011; Beck *et al.*, 2012; Kadir *et al.*, 2011). In addition, some scholars investigated the effect of financial crisis on the banking industry. It is found that Islamic banks are more successful during a crisis compared to conventional banks (Abdulle and Kassim, 2012; Hasan *et al.*, 2011; Kassim and Majid, 2010; Maiwada, 2013).

The sources and the consequences of the financial crises are the subject of most previous theoretical and empirical research (Asenova, 2011; Foster and Magdoff, 2009; Shiller, 2008; Vidal, 2010). The soundness and stability of the

financial system was negatively affected by the crisis. During crises, the commercial bank suffered a large overhang of non-performing loans. The recession caused much business to flounder or fail. In addition, economic downturns and a large number of corporate scandals around the world have suffered by weak corporate governance practices. According to Clarke (2000), Johnson *et al.* (2000) and Ponnu and Ramthandin (2008) failure in corporate governance practice and management excessive risk taking caused to the financial crisis. Monitoring excessive risk-taking by management is particularly important in the financial sector. Corporate governance is responsible for monitoring and oversight of firms' risk related activities. Based on above evidence, the current study investigate the effect of corporate governance and risk taking on banks financial performance.

1.3 Problem Statement

Attention to corporate governance in developing countries is inadequate (Mulili and Wong, 2011). Yet, recent financial crisis along with the rising rate of globalization implies that the managing and structure of corporate governance might have more impact on performance. Corporate governance in Malaysia was practised in march 2000 and was derived from Hampel report 1998 and Cadbury report 1992 in UK (Haniffa and Hudaib, 2006). Malaysian business environment is different from that of the UK in many aspects. For example, there is high concentration of ownership in Malaysia. In addition, due to existence of more autonomous owners and shareholders of Malaysian firms, there is no separation among dominant family owners and managers. Moreover, the relationship between banks, firms and government in Malaysia is close compared to UK firms. Furthermore, Vafeas and Theodorou (1998) identified that across countries, there are differences in regulatory framework, economic environment, strength of markets and governance practices. Therefore, the corporate governance structures should be investigated separately.

The relationship between good corporate governance practices and firm performance continues to be a key issue in the financial literature. Gompers *et al.* (2003) and Bebchuk *et al.* (2009) suggest measures of governance which take into

account different provisions in an index. In both study, the results indicate that there is a positive relevance between good governance and performance. However, Bhagat and Bolton (2008) criticize a total measurement as a good proxy for overall good governance because an index requires that the variables are weighted and an appropriate system of weight is yet unresolved in the literature. These authors suggest that a single mechanism of corporate governance could be even more suitable proxy of good corporate governance than a general index. The board of directors, risk management and audit committee has recently received considerable attention by academics and legislators. There is a significant body of literature that remarks the board characteristics as a fundamental internal mechanism (Bhagat *et al.*, 2008; Jensen, 1993). Furthermore, a set of recommendations or norms addresses the behaviour and structure of the board through the use of codes and principles of good governance (Demise, 2006; Kirkpatrick, 2009a). However, risk management and audit committee has special relevance in monitoring and guiding corporate strategy, risk policy and overseeing the action of managers.

The global financial crisis raised the issue in academia about whether the mechanisms of corporate governance established in the firms, has adequately solved the conflicts of interest between stakeholders, growing the long-term value for the company. In this regard, prominent scholars have highlighted corporate governance weaknesses in the board practices and monitoring policy, which have encouraged to assume excessive corporate risk-taking (Abu-Tapanjeh, 2009; Erkens *et al.*, 2012). Based on evidences which discussed earlier, board of director is a fundamental internal control system in a firm since this body has final responsibility for the functioning of the firm (Bhagat *et al.*, 2008; Wagner III *et al.*, 1998). According to the Organization for Economic Co-operation and Development (OECD) and BCBS (2006), overseeing the manager actions and monitoring the risk policy and corporate strategy applying by board of director and board committees. This study assumes that banks financial performance depends on the quality of monitoring and decision making of corporate governance. Therefore, the first issue focuses on the relationship between corporate governance and financial performance across Malaysian banks.

In addition, during recent years, bank risk taking and its determinants have been widely discussed; whereby studies aimed to explain risk taking behaviour of financial regulators, policy makers and researchers (Thomas, 2005). Risk taking is defined in the literature as engagement in behaviours associated with some probability of undesirable results. It is also referred as the tendency to engage in behaviours that are likely to be harmful or dangerous (Beyth-Marom and Fischhoff, 1997; Furby and Beyth-Marom, 1992; Irwin Jr, 1993). Behaviours of financial intermediaries is considered as a key factor in economics and finance since controlling the risk taking in banking relates to protection of financial systems and depositors as a whole (García-Marco and Robles-Fernández, 2008).

Number of studies investigated the relationship between corporate governance and risk-taking (Akhigbe and Martin, 2008; Fortin *et al.*, 2010; Pathan, 2009). Pathan (2009) and Fortin *et al.* (2010) noted that corporate governance of a bank with a strong structure might take higher risk. Li (2009) showed a positive relationship between risk-taking and corporate governance. Similarly, OECD (2009) and Kirkpatrick (2009b), reported that failure of risk management was attributed to failure of corporate governance which could leads to poor performance. Srairi (2013) indicated that the risk originating from lack of sound corporate governance in Islamic banks contributes to financial distress. Corporate governance and risk-taking have played important roles in the recent financial crisis, and have shown positive relationship with each other (Rose, 2010). According to OECD (2009), the weakness and failure of corporate governance and excessive risk-taking were major factors in the financial crisis. Other studies pointed out that the arrangements of corporate governance regulations to forecast and prevent future crisis were inadequate (Cheffins, 2009; Grosse, 2010; Kirkpatrick, 2009b). Moreover, Kirkpatrick (2009b) noted that the weakness of corporate governance in protecting against intensive risk-taking was another factor contributing to the recent financial crisis. However, as with most of the East and Southeast Asian economies, the impact of global financial crisis on Malaysia were considerable, it is treatable whether excessive risk taking in corporate governance of Malaysian banks has an impact on their financial performance. Therefore, the second issue focuses on the relationship between corporate governance and risk taking across Malaysian banks.

However, Laeven *et al.* (2009) investigated the actual causes for the banking sectors' undertaking risk-taking. They found that the effect of bank regulations on risk-taking relates with its corporate governance. Peni and Vähämaa (2012) demonstrated that all statements and initiatives of banking supervisory highlight the importance of good corporate governance in banking sectors. It might be due to the role of corporate governance that can address importance of agency problem and risk taking control in financial firms. Therefore, it is essential to assess the potential implications of enhanced corporate governance on bank performance.

In addition, the concept of risk management has widely affected many aspects of corporate activities (Taylor-Gooby and Zinn, 2006). In this regard, some scholars investigated the relationship between risk-taking and firm performance (Berger and DeYoung, 1997; Kwan and Eisenbeis, 1997). Aaker and Jacobson (1987) and Xu and Malkiel (2003) mentioned that risk taking has a positive influence on performance. In contrast, Zhang *et al.* (2013) found a negative relationship between them. Risk-taking is one of the most relevant factors that determines firm performance in investment related decisions (Wiklund and Shepherd, 2003). Additionally, Cheffins (2009) and Grosse (2010) noted that excessive risk-taking in decision making contributed to firms' failure. Finally, Lang *et al.* (2010) showed that the principal of agency problem between stakeholders increased the motivation for greater profitability in business without considering the risk imposed on the firms, failed to be addressed by risk management system of numerous large financial institutions. This problem can be removed through a good structure of corporate governance. In addition, most scholars have agreed that during recent financial crisis, the inability of risk management practices in financial firms contributed to fouled corporate governance. Even so, it is treatable whether the corporate governance failure is a result of risk management inability. However, research discussion on the effect of corporate governance and risk taking during the recent crisis is still limited. A combined reading of King and Wen (2011), Nguyen (2011), Fratini and Tettamanzi (2015) suggests that corporate risk taking a possible mechanism that explains the linkage between corporate governance and financial performance of firms. It is this possibility that informs the practice in corporate governance where the top management is made part of the ownership structure as a way of gaining their

commitment to exercise of prudence in risk taking decisions (Chun *et al.*, 2011; Dong *et al.*, 2014; Rahman and Rejab, 2013). Thus, this study uses risk taking as a mediator in the relationship between corporate governance and firm financial performance. Based on author knowledge, there is no any research that investigated the particular role of risk-taking as a mediator in the relationship between corporate governance and banks financial performance. Therefore, the third issue, focuses on the mediating effect of risk taking on relationship between corporate governance and firm financial performance across Malaysian banks.

The recent financial crisis has shed doubts on the functionality of conventional banking leading to raising the attention to Islamic banking (Hasan *et al.*, 2011). Researchers and policy makers mentioned that shariah compliant products are very attractive for a population that demands financial services that are consistent with their religious beliefs. In addition, the importance of shariah compliant financial assets has been increasingly amplified. The total asset of Islamic financial institution has doubled up to USD 900 billion from 2006 to 2011 (Financial Times, 2011). Islamic financial institutions have relatively high market share in emerging markets such as Malaysia. However, there is still a little academic evidence regarding the function and guidance of Islamic banks. In addition, Islamic banks play an important role in the international financial system. Malaysia is one of the successful countries known for implementing Islamic banking practices along with the conventional banking system. Thus, the competitive condition of banks in this country with their different structures and performance makes the study considerable.

Additionally, existence of dual banking system (Islamic and conventional) in countries such as Malaysia makes it interesting to compare the differences of their financial performance through the effects of corporate governance and risk taking. Srairi (2013) indicated that poor performance of Islamic banks is related to the risk originating from lack of sound corporate governance. In this regard, few empirical studies investigated this aspect, and compared it with conventional banks (Ali, 2007; Čihák and Hesse, 2010; Cihk and Hesse, 2008; Hasan *et al.*, 2011). The theoretical and the practical aspects of risk management and corporate governance in Islamic banks may not be the same as the conventional banks. Islamic banks employs various

practices that do not involve charging or paying interest, which is different than as conventional banks. The Islamic financial system promotes the concept of participation in a transaction backed by real assets, utilising the funds at risk on a profit-and- loss-sharing basis. Several studies have compared financial performance of Islamic and conventional banks from different respects around the world (Beck *et al.*, 2012; Iqbal, 2001; Kassim *et al.*, 2010; Rosly and Bakar, 2003; Samad, 2004). As discussed before, excessive risk taking and corporate governance failure have contributed to the recent financial crises, which has affect Malaysian economy as well. Moreover, there is high concentration of ownership in Malaysia and due to existence of more autonomous owners and shareholders of Malaysian firms, there is no separation among dominant family owners and managers. All these reasons taken together have given rise to the need to make a comparison between the financial performance of Islamic and conventional banking system in Malaysia. Therefore, as final issue, it is required to make a comparison between the financial performances of Islamic and conventional banks through the effects of board structure, risk-taking.

1.4 Research Questions

The specific research questions for this study based on problem statement include the following:

1. Is there any significant relationship between corporate governance and banks financial performance?
2. Is there any significant relationship between corporate governance and risk taking?
3. Does relationship between corporate governance and banks financial performance mediated by risk taking?
4. Is there significance difference between financial performance of Islamic and conventional banks?

1.5 Research Objectives

This study investigates the effect of corporate governance on risk taking and banks financial performance. In addition, the role of risk taking is assessed as mediator on relationship between corporate governance and financial performance. Finally, it compares the differences of financial performance between Islamic and conventional banks through the effect of corporate governance and risk taking.

1. To examine the effect of corporate governance on financial performance
2. To examine the effect of corporate governance on risk taking.
3. To show the role of risk taking as mediator on the relationship between corporate governance and banks financial performance.
4. To show the differences of financial performance of Islamic and conventional banks in Malaysia.

1.6 Significance of Study

Generally, the significant contributions of this study are twofold, namely, theoretical development, and policy implication. In relation to theory development, this study fills the gap in the literature series by capturing the impact of risk taking on financial performance of banks in Malaysia. In relation to this point, number of studies such as; Ferrero-Ferrero *et al.* (2012), Munisi and Randøy (2013), Kryvko (2012), Hu and Izumida (2008), Haniffa *et al.* (2006) and Li *et al.* (2015) investigated the effect of corporate governance on firm performance. They did not address the effect of risk taking on the relationship between corporate governance and performance. In addition, reviewing the past literature on assessing the performance difference between Islamic and conventional banks has shown that there is not any evidence of comparing the financial performance of Islamic and conventional banks through the effect of corporate governance and risk taking. This is the first extensive study to the best of the author's knowledge that considers the performance differences of indicated banks through the effect of corporate governance and risk taking as mediator variable. However, comparing the financial

performance differences between Islamic and conventional banks will help to gain a more comprehensive view about how two banking systems faced the crisis. Since the present study investigates the corporate governance of two systems with regard to risk taking and their impact on financial performance, it takes an important step to complete the literature in the field of comparative study of the Islamic and conventional banking by identifying and analysing the causes of crisis particularly in Malaysia.

In relation to policy implication, this study highlights the importance of effective future public policy to understand which aspects of corporate governance have the greatest impact on financial performance after considering risk taking. The recent financial crisis and increasingly competitive environment in the banking industry have made the bank to pay more attention to the corporate governance and its effect on financial performance. This study contributes to the continuing debate on corporate governance and risk taking by providing a timely and comprehensive investigation of financial performance of Malaysian banks. This study highlights the role that corporate governance (board structure, risk management and audit committee) at financial institutions may have played in the risk-taking behaviour that likely effected performance.

This study provides useful guidelines for the corporate sectors, financial institutions, shareholders, depositors, and investors. The guidelines could assist firms to react effectively and efficiently during different economic conditions. Moreover, this study provides a good guideline for managers to consider an appropriate set of corporate governance model related to specific systems of banks (Islamic and conventional) in their decision making. It is highly important to explore the role of variables that may influence the financial performance of banks.

1.7 Scope of Research

Performance measurement is the most important concept in the financial management. The current study has investigated the relationship between corporate

governance (board size, board independence, independent risk management committee, risk management committee size, audit committee size, independent audit committee and ownership concentration) and banks financial performance (ROA and ROE). The purpose of this research is explaining the variables, which can affect financial performance of banks. In this regard, the effects of variables, like risk taking (credit risk, leverage risk) as a mediator variable and number of control variables such as (loan to asset, equity to asset, customer loan to customer asset, liquidity, banks type and bank size) have investigated. Nonetheless of investigating the linkage of these variables, the role of risk taking recognized on relationship between corporate governance and banks financial performance. Furthermore, the differences of financial performance between Islamic and conventional banks are demonstrated.

Due to the fact that a certain period of time is considered in financial and economic studies in order to avoid the effect of various factors in the course of time, this study employed a ten year panel data from 2005 to 2014. This study utilizes panel data techniques due to the nature of data which is considered as the combination of cross-section oriented and time series based data, and is also based on the number of banks certified by Bank Negara in Malaysia (conventional and Islamic banks). Malaysia is among the successful emerging countries in the world in well practicing of Islamic banking besides the conventional pair. As a result, the total assets in Islamic banking system rose from RM 1.2 billion in 1991 to RM 157.1 billion in 2007 and reached to RM 494.6 in 2014 in Malaysia (Chong and Liu, 2009; Sufian, 2010). The market share of Malaysians Islamic banking system comprises 14% of the total deposits and financing of the banking sector in this country (Sufian, 2010), however, this share is predicted to rise to 20 percent in 2020. Furthermore, this study lets the financial performance of Islamic banks to be compared with conventional ones. According to Chong *et al.* (2009), at the end of 2004, Malaysians banking system offers a full range of Islamic banking products and services. Based on this reasoning, the current study applied data collection from 2005. Twenty one conventional and sixteen Islamic Malaysian banks have been taken into account in this research which is consistent with Rahman *et al.*, (2013).

1.8 Definition of Important Terms

- **Return on Equity (ROE)** - Return on Equity (ROE) calculated by dividing a bank's total net income to total shareholder equity.
- **Return on Asset (ROA)** - Return on asset (ROA) calculated by dividing a bank's total net income earning by its total asset. ROA is one of the important variables to measure operating performance (Barber and Lyon, 1996).
- **Corporate Governance** - Cadbury (1992) defined corporate governance as the system by which companies are directed and controlled. According to (OECD 2004), corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders.
- **Board Independence** - Shows by percentage of independence non-executive directors in the board (BIND).
- **Board Size** - Measured by number of directors in a board (BSIZE).
- **Risk management committee size**- Measured by number of directors in a Risk management committee (RMCSIZE).
- **Independent risk management committee** - Shows by percentage of independence non-executive directors in the risk management committee (INRMC).
- **Audit committee size** - Measured by number of directors in Audit committee (ACSIZE).
- **Independent audit committee**- Shows by percentage of independence non-executive directors in the audit committee (INAC).
- **Ownership Concentration** – Equity percentage participation by the largest shareholder of Malaysian bank (OC).
- **Risk Taking** – An activity or action in someone or directors takes risks to achieve a benefit.

1.9 Research Outline

This study is organized as follows: This chapter (chapter 1) introduces the thesis and describes the research background, problem statement, objectives, research questions, scope, and potential contribution to knowledge and definition of terms.

Chapter 2 provides an extensive literature review, compares, analysis, discusses, and summarizes the studies which have been carried out previously. It also studied on corporate governance definitions and related theories, corporate governance principles, Basel committee, corporate governance in Malaysia, corporate governance at banks and financial determinants of banks performance. Moreover, it has developed conceptual frame work and hypotheses. The literature review also provides insights in to the relationships between corporate governance characteristics, risk taking and financial performance. However, this chapter discusses the performance differences between Islamic and conventional banks.

Chapter 3 discusses the methodologies employed in this study. This study utilizes the econometric techniques related to panel data analysis, that is, static models (pooled OLS and, GMM, and fixed effect analysis) using unbalanced panel data. In addition, Sobel test and Baron and Keny approach has been used to test mediator effect. However, for identify the financial performance differences between two banks the study applied to independent T-test.

As for the chapter 4, it reports on the empirical findings of the model tested. The chapter present the results of OLS, fixed effect, GMM, Sobel test, approach of Baron and Keny, and independent t-test for analysing statistical models in banking industry. This chapter aims to identify the effect of corporate governance on financial performance of Malaysian banks by mediating risk taking.

Finally, the chapter 5 discusses the statistical results, whereby it outlines the contributions that this research makes to the study of corporate governance, and risk

taking on financial performance of Malaysian banks. Thereafter, it discusses some limitations to the research and makes some suggestion for future study.

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