THE MEDIATING EFFECT OF INNOVATIVE BEHAVIOR AND ENTREPRENEURIAL PASSION ON THE RELATIONSHIP BETWEEN TRANSFORMATIONAL LEADERSHIP AND ORGANIZATIONAL EFFECTIVENESS IN ISLAMIC BANKS

HAMED TAHSILDARI

A thesis submitted in fulfilment of the requirements for the award of degree of Doctor of Philosophy

International Business School
Universiti Teknologi Malaysia

DECEMBER 2015
DEDICATION

By the grace of almighty Allah (SWT)

The great soul of my father, to my beloved mother, and my brother (Amin)
ACKNOWLEDGEMENT

I would like to express my immense gratitude and thanks to Almighty Allah SWT who bestowed upon me this opportunity to pursue and succeed in the completion of my PhD study. This achievement could not have been possible without the support from various individuals. First and foremost, I wish to thank my pillars of strength, my loving mother and brother who dream and pray the best for me. Second, I extend my sincere and deepest thanks to my supervisors, Professor Dato’ Dr. Mohd Taib Hashim and Dr. Wan Normeza Wan Zakaria for their valuable guidance, support and encouragement. I have profound appreciation for the considerable time and efforts invested by them on reviewing and commenting on the drafts of this thesis. Finally, I would like to appreciate my brother Amin Tahsildari who has been always listening to me and supporting me in my whole life.
ABSTRACT

In recent years, there has been growing body of knowledge on the aspect of Islamic banking effectiveness worldwide. Nevertheless, there are a limited number of studies on the efficiency and effectiveness of Islamic banking in Malaysia. Accordingly, this study attempts to fill the gap in the current analysis on the effectiveness of Islamic banking in Malaysia. If Islamic banks measure their effectiveness based on their customers’ perception, they can achieve superior results. Transformational leadership motivates staffs who work with customers which can lead to the improvement of organizational effectiveness. In this regard, this thesis develops a model in order to investigate the impact of transformational leadership on organizational effectiveness of Islamic banking through the mediating effects of innovative behaviour and entrepreneurial passion. A quantitative research approach was used to conduct this study in which 418 customers of Malaysian Islamic banks were surveyed through purposive sampling procedure. Structural Equation Modelling was used to analyse the data. The structural model demonstrated satisfactory reliability and validity measures. The measurement model also showed satisfactory convergent and discriminant validity. Furthermore, all paths in the research model were found to be significant. Particularly, the results revealed that transformational leadership strongly affects the organizational effectiveness. This study contributes to theoretical and practical knowledge by providing the evidence on the relationship between transformational leadership and organizational effectiveness. In general, findings of the study respond to the needs of the transformational leadership to consider innovative behaviour of employees and to bring about entrepreneurial passion which subsequently can result in increased effectiveness of Malaysian Islamic banks. This study is based on cross-sectional research design and future research is recommended to undertake longitudinal analysis in order to explore changes over time as changes unfold.
ABSTRAK

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<td>AOIFI</td>
<td>Auditing Organization for Islamic Financial Institutions</td>
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<td>BIMB</td>
<td>Bank Islam Malaysia Berhad</td>
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<tr>
<td>BNM</td>
<td>Bank Negara Malaysia</td>
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<td>CIMB</td>
<td>Commerce International Merchant Bankers</td>
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<td>EP</td>
<td>Entrepreneurial Passion</td>
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<td>HSBC</td>
<td>Hongkong and Shanghai Banking Corporation</td>
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<td>IB</td>
<td>Innovative Behaviour</td>
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<td>IAS</td>
<td>International Accounting Standards</td>
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<td>IAIB</td>
<td>International Association of Islamic Banks</td>
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<td>IIRA</td>
<td>International Islamic Rating Agency</td>
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<td>IDB</td>
<td>Islamic Development Bank</td>
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<td>KFH</td>
<td>Kuwait Finance House</td>
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<td>OCB</td>
<td>Organizational Citizenship Behaviour</td>
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<td>PLS</td>
<td>Partial Least Square</td>
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<td>OE</td>
<td>Organizational Effectiveness</td>
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<td>OIC</td>
<td>Organization of Islamic Conference</td>
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<td>RBV</td>
<td>Resource Based View</td>
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<td>SEM</td>
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<td>SPSS</td>
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CHAPTER 1

INTRODUCTION

1.1 Introduction

Today, through the great competitiveness environment, organizations are expected to be more effective for the purpose of securing their financial circumstances and their positions in the market. Many organizations struggle to meet the challenges of optimizing effectiveness. Organizations that successfully manage their effectiveness measures achieve superior results. Effectiveness reveals itself as crucial to organization development and to the fulfilment and viability of modern society. In this regard, organizations have to care that the degree to which a product or service meets customer requirements and expectations. Undeniably, the effectiveness of organizations has to be based on customer requirements.

According to Muijs (2011), leadership has a vital indirect impact on efficiency. Transformational leaders have significant effects on employees which can lead to increasing the effectiveness of organizations. Transformational leadership has been described to influence on employees that accept responsibility for their movements, achieve rewards through self-reinforcement, and are capable of leading themselves (Kuhnert and Lewis, 1987; Bass and Avolio 1990b). A transactional leader assists workers to experience out of their particular self-interests and has the capacity to move them to work for the benefit of the association. In fact, transformational leaders could persuade followers to create more remarkable innovativeness in their working environment.
Unfortunately, numerous organizations that made efforts to bring about innovation found their attempts largely unsuccessful. Among the companies which were considered as the Fortune 500 in 1955, only 71 still have been able to remain on the list today (Collins, 2008). However, regardless of these disappointing results, companies do not have any choice but to pursue innovation in order to survive the economic downturn and attaining the quick speed of production life cycles.

Islamic vision about the socio-economic considerations emphasizes on abolishment of any interest. Individuals can lend and borrow money and invest on a risk sharing project through Islamic banking system. The Islamic banking system ensures the optimal rate and its effective usage which leads to a sustainable economic development.

Reviewing South Asia, Pakistan has recently revived its Islamic banking approach under the duel banking system. Bangladesh is considered as a follower for more solid Islamic banking policies under the increasing market and public demands. Islamic banking operations are being adopted in India and Afghanistan. Malaysia as a Southeast Asian country is considered for promoting the extensive and developed version of Islamic banking. In addition, Sudan as a country in Africa that has also adopted more pragmatic approaches to develop its Islamic banking. Islamic banking has been able to gain momentum in the United States of America and European countries as well. These countries are now challenging for more changes to their banking system so as to apply the Islamic banking approaches in their markets in order to increase their effectiveness.

1.2 Background of the Study

The purpose of this study is to concentrate on enhancing organizational effectiveness through transformational leadership. According to Bass and Avolio (1990a) a transformational leader is expected to "raise the objectives of subordinates for accomplishment and personal development, while likewise improving the organization. Beekun and Badawi (2006) describe leadership from an Islamic
perspective as having two primary roles: the servant-guardian leader; and the charismatic, strong role model leader. Servant leaders serve their followers, seek their welfare, and guide them toward what is good. Concurrently, the focus of a transformative guardian leader is on the achievement of organizational objectives as followers’ outcomes (Aabed, 2006; Beekun and Badawi, 2006; Kuhn, 2007; Ramadan, 2007).

Until the late 1990s, most of the research on transformational leadership had been conducted in the United States (Bass, 1999). More recently, research has started to examine leadership across national borders and among various cultures. However, many researches have been done in the field of transformational leadership; there is a need for more attention to the subordinates of transformational leadership and to the transformational leaders” (Bass and Riggio, 2006).

In numerous organizational behaviour studies, various factors have been found to affect innovation at different levels (Eisenbeiss et al., 2008; Jung et al., 2003; Scott and Bruce, 1994). However, even though extensive scholarly papers have been published on the subject of innovation, the field still remains theoretically and empirically fragmented. Specially, organizational behaviour researchers have encountered inevitable challenges or criticisms while studying innovation. This is because there are various endogenous variables (i.e., within an organization) and exogenous variables (i.e., outside of an organization) influencing the innovation. Since organizational behaviour researchers exclusively focus on psychological and behavioural aspects within organizations, they tend to ignore the external factors (i.e., exogenous variables), such as an organization’s position in a network of other companies (Westphal et al., 1997), information asymmetries (Jensen and Meckling, 1976), and societal impacts (Thornton and Ocasio, 2008). As a result, it is almost impossible for organizational behaviour researchers to confirm the antecedents of innovation, which involve complicated factors within and outside an organization. Given this limitation in the organizational behaviour discipline, it might be relevant to investigate psychological and/or behavioural factors that potentially affect innovation.
As the main structure of innovation is concluded in new ideas and accordingly the individuals developing and implementing them (Van de Ven, 1986), the study of what motivates individual innovative behaviour is important (Scott and Bruce, 1994). In addition, Lee (2007) argued that individual innovative behaviours in the workplace bring about an important impact on organizational innovation and effectiveness. In this study, therefore, employees’ innovative behaviour is viewed as a critical proxy variable that potentially influences organizational effectiveness.

1.3 Scope of the Study

This research focused on the effectiveness of Malaysian Islamic banking industry which includes Malaysian Islamic banks. Partial least square (PLS-SEM) is used in order to analyze the data; in this regard, the maximum number of arrows which are pointed to organizational effectiveness in the conceptual framework of the study is three. Therefore, the minimum required sample size was 124. Accordingly, Kuala Lumpur was chosen to distribute the questionnaire among the costumers of Malaysian Islamic banks; however, the respondents could also be from other states.

Kuala Lumpur is the national capital and most populous city in Malaysia. The city covers an area of 243 km2 and has an estimated population of 1.6 million. It is among the fastest growing metropolitan regions in South-East Asia, in terms of population and economy. The first Islamic bank in Malaysia, Bank Islam Malaysia Berhad (BIMB) was founded and commenced operation in Kuala Lumpur in 1983. Kuala Lumpur is one of the most appropriate places in Malaysia in terms of having customers for Islamic banks operation. Currently, besides BIMB there are other Malaysian Islamic banks such as Maybank Islamic, CIMB Islamic, and RHB Islamic.

The sampling method which was utilized in this research is purposive sampling in which a complete range of customers of Malaysian Islamic banks were surveyed. Purposive sampling is randomly selecting units from the segment of the population with the most information on the characteristic of interest (Guarte and
Barrious, 2006). Through the purposive sampling technique, the researchers take the samples that fulfill their specific purpose (Zikmund et al., 2010).

1.4 Research Gap

The constructs of transformational leadership, organizational effectiveness, employee innovative behaviour, and entrepreneurial passion have been studied by quite a number of organizational researchers in contemporary literature. These constructs have been studied in separately in relation with other variables and constructs, and in other environments and different contexts. Yet, the interrelationships between these constructs, highlighting the impact of transformational leadership on organizational effectiveness via the mediator effects of employee innovative behaviour and entrepreneurial passion have not been much explored in extant literature.

This study focuses on enhancing the effectiveness of Islamic banks in Malaysia; in this regard, in relation to increasing organizational effectiveness, this study presents employees innovative behaviour with four elements as to realize problems, create ideas, provide support for the ideas, and implement the ideas. Additionally, this study introduces entrepreneurial passion as an important factor for employees which need to be improved by managers for the purpose of enhancing organizational effectiveness. The government of Malaysia subscribes to the idea that efficient banking system is the key to stimulate savings, investments and economic growth. In Malaysia, Islamic banking system is reviewed as developed and innovative and also following standardization and the true success of the Malaysian Islamic banking system comes from serving individuals at the grassroots (Khan and Bhatti, 2008).

The orderly enhancement of the banking system is very necessary for the sustainable economic growth (Schoon, 2008). The banking approach system has significantly grown in proportion and contribution towards the world financial system and has several financial instruments which are relatively direct alternatives
to the conventional financial instruments (Ali, 2008). Islamic banking is considered as a fast developing division of the financial market which is available in both the Muslim and also non-Muslim (Van Greuning and Iqbal, 2008).

Finally, the research gap of this study is also in relation with the Tenth Malaysia Plan (2011-2015). In the light of the fact of the Tenth Malaysia Plan, there is an emphasis on both human capital development and improvements in innovation capacity (Economic Planning, 2010). Accordingly, this study attempts to improve the innovation capacity of human capital behaviour involving in Islamic banks by transformational leadership which eventually enhances the effectiveness of Malaysian Islamic banks.

1.5 Problem Statement

The Islamic banking industry in Malaysia has come a long way over the last few decades to become what it is today. For example, the early history of Islamic banking within Malaysia began with the establishment of the Pilgrims Management and Fund Board (PMFB) which represents the pioneer interest-free financial institution in the country (Ariff, 1989). The PMFB was set up in August 1969 with the main role of collecting and mobilizing saving from those who intend to go for the hajj (pilgrim) in Mecca. This request was well received by the government by establishing a steering committee to study its possibility in 1982. Consequently, the new Islamic Banking Act (IBA) was enacted in 1983. Subsequently, the first Islamic bank in Malaysia, as Bank Islam Malaysia Berhad (BIMB) was founded and commenced operation on July 1, 1983. The initial capital of BIMB was contributed by the Malaysian government, PFMB, and various religious councils and agencies (Ariff, 1989). They offer interest free banking system and ten years later in 1993 the dual banking scheme was established (Marimuthu et al., 2010). In 2001, Sukuk and capital market were founded in Malaysia and so far it has attained a notable development. Malaysia is known as the first global Sukuk centre (Khan and Bhatti, 2008b).
In Malaysia, banking industry plays a very important role in the economy of the country. For example, the importance of capital regarding economic sectors activity is still supported through banking industry in Malaysia as a developing country. Additionally regarding the importance of banking industry in Malaysia, the credit from banking sectors from 2002 to 2010 contributed in average of 90% to economic activity (Fidlizan et al, 2014). Therefore, banks and policy makers need to investigate the efficiency of the banking industry in order to enhance the economic growth of country.

Even though, Malaysia is considered as one of the most successful countries in Islamic banking, Malaysia continues to undertake necessary changes in line with global changes especially through the provision of capital economic development of the country. Research on Islamic banking efficiencies have begun to grow all around the world recently (Darrat et al., 2002; Yudistira, 2003; Hassan, 2006; Mohamad et al., 2008; Moin, 2008; Shahid et al., 2010; Ismail et al, 2013). However, there have been just a limited number of studies on the efficiency and effectiveness of Islamic banks in Malaysia (Sufian, 2006a, b; Mohd Zamil, 2007; Ahmad Mokhtar et al., 2007; Kamaruddin et al., 2008; Mohamad Noor and Ahmad, 2011; Ismail et al, 2013). In this regard, this study attempts to fill the gap in the current analysis about the effectiveness of Islamic banking in Malaysia.

There has to be greater efforts and considerations to deal with the leadership within banking industry. For instance, banking industry is highly regulated by the Government and the Central Bank of Malaysia (Wasiuzzaman and Gunasegavan, 2013). There has been a statement coming from Governor of Bank Negara Malaysia (BNM) indicating that the failure of banking system supervision had contributed to myriad of economic problem today (Fidlizan et al, 2014). Regulations and strict controlling of banking operation and higher supervisory power of the authorities are some of the measures that should be seriously undertaken by authorities’ concern. The negative effect is seen in the case of risk-taking behaviour of Islamic banks, through higher restrictions resulting in a reduction in risk taking of Islamic banks (Alam, 2013).
Furthermore, one of the most important issues within the literature about the challenges faced by Islamic banking is about the leadership framework (Nasser and Muhammed, 2013). A large number of leadership studies are highly connected to organizational studies. Accordingly, this study examines how transformational leadership is related to organizational effectiveness so that it can be managed in order to positively influence Malaysian Islamic banks.

### 1.6 Research Objectives

The primary purpose of this study is to evaluate the impact of transformational leadership on organizational effectiveness through some important organizational factors. Therefore, the objectives of this study are as follow:

1) To determine the contribution of transformational leadership on organizational effectiveness in Malaysian Islamic banks.

2) To explore the contribution of transformational leadership on employees’ innovative behavior in Malaysian Islamic banks.

3) To evaluate the impact of transformational leadership on employees’ entrepreneurial passion in Malaysian Islamic banks.

4) To study the influence of employees’ innovative behaviour on organizational effectiveness in Malaysian Islamic banks.

5) To explore the impact of employees’ entrepreneurial passion on organizational effectiveness in Malaysian Islamic banks.

6) To determine the mediating impact of innovative behavior and entrepreneurial passion on the relationship between transformational leadership and organizational effectiveness in Malaysian Islamic banks.
1.7 Research Questions

This research specifically focuses on the relationship between transformational leadership, organizational effectiveness, entrepreneurial passion, and innovative behavior with respect to the Malaysian Islamic banks. Therefore, the research questions of this study are as follows:

1) Does transformational leadership have a positive contribution on organizational effectiveness in Malaysian Islamic banks?

2) Does transformational leadership positively contribute to employees’ innovative behavior in Malaysian Islamic banks?

3) Does transformational leadership have a positive impact on employees’ entrepreneurial passion in Malaysian Islamic banks?

4) Does employees’ innovative behaviour positively influence on organizational effectiveness in Malaysian Islamic banks?

5) Does employees’ entrepreneurial passion have an impact on organizational effectiveness in Malaysian Islamic banks?

6) Do employees’ innovative behaviour and entrepreneurial passion mediate the relationship between transformational leadership and organizational effectiveness in Malaysian Islamic banks?

1.8 Contribution of the Study

Kang (2013) focused on the role of transformational leadership influencing the innovative behaviour through two mediating variables namely entrepreneurial climate and entrepreneurial passion. He attempted to identify the intervening
mechanisms between transformational leadership and innovative behaviour in an entrepreneurial context. In his findings, transformational leadership had direct impact on innovative behaviour and transformational leadership was shown to affect both firm climate and followers’ passion. However, Kang failed to find the mediating effect of entrepreneurial climate, but only found the upward influence of transformational leadership towards entrepreneurial climate. Finally, entrepreneurial passion partially mediated the relationship between transformational leadership and innovative behaviour.

The current study is an extension of Kang’s study investigating the influence of employees’ innovative behaviour on organizational effectiveness. The three factors within the investigation of organizational effectiveness are the goal approach, the systems resource approach, and the process approach. A newer approach has also emerged called the multiple constituency approach, which is a mixture of the initial three. In this study, it was investigated if transformational leadership influences on organizational effectiveness. In this regard, there would be two types of contributions namely theoretical and practical.

1.8.1 Theoretical Contribution

The current study will contribute to literature in different dimensions. For instance this study will bring about more literature between the relationships of following variables namely transformational leadership and organizational effectiveness, the relationship between transformational leadership and entrepreneurial passion, the relationship between entrepreneurial passion and organizational effectiveness, and the relationship between innovative behaviour and organizational effectiveness.
1.8.2 Practical Contribution

The outcome of this study will possess significant practical implications to Islamic banks to increase their efficiency in terms of goal approach, system approach and process approach. In this regard, it is expected that the results of this study will contribute to Islamic banks in the capability to attain their desired objectives and ability to acquire scarce resources. In fact, Islamic banks would be considered effective for customers if the processes are smooth, efficient, and goal directed.

Furthermore, the results of this study will provide Islamic banking managers effective insight in order to realize the impact of innovative behavior among employees on the effectiveness of the banks for customers. Actually, innovative behavior helps employees to recognize the problems through the operations, generate ideas for the problems, build support for in relation to their ideas, and implement their ideas accordingly.

1.9 Operational Definitions

Islamic bank- A financial institution that deals with the purpose to implement the economic and financial principles of Islam through a banking system (Haque, 2010b).

Transformational Leadership- According to Burns (1978), transformational leadership is about to a process that leaders and subordinates are cooperating with each other for higher levels of morale and motivation. This form of leadership, as suggested by Burns (1978), inspires followers to transform their self-interest toward the greater interests of the organization (Bass, 1985; Elenkov and Manev, 2009; Howell & Higgins, 1990).

Organizational Effectiveness- Considering the internal process of an organization in terms of being smoothly and efficiently, and goal directed (Chelladurai and Haggerty, 1991).
Innovative Behaviour – A multi-stage process of individuals in terms of recognizing the issues, making suggestions, bringing support for suggestions, and implementing the suggestions (Janssen, 2000; Kanter, 1988; Pieterse et al., 2010; Scott & Bruce, 1994).

Entrepreneurial Passion- “A great interest for an activity which becomes important for individuals in which they invest time and energy for it” (Vallerand et al., 2003).

1.10 Research Methodology

This study evaluated the relationship between transformational leadership and organizational effectiveness through innovative behaviour and entrepreneurial passion in Malaysian Islamic banks. This research created a theoretical model to test the hypotheses of the research. A quantitative research was completed in this study in order to test the theories and attain the objectives of the research. Therefore, this study adopted a quantitative method.

A pilot test was conducted to examine the questionnaire’s length, format, clarity, scale reliability and content validity. Collected data from pilot test was analysed and questionnaire’s was revised. Eventually, standardized questionnaire was used as a study instrument to collect the data for the current study. Purposive sampling technique was used to collect the data among the respondents of the study. Structural equation modelling (smart PLS) was applied to analyse data. Furthermore, all paths in the research model were tested to determine if they are significant.

1.11 Limitation of the Study

There are three limitations faced by the study; firstly, this study is based on cross-sectional research design. Cross-sectional studies are simple in design and are
aimed at determining the prevalence of a phenomenon, problem, attitude or issue by taking a snap-shot or cross-section of the population. These studies usually involve one contact with the study population and are relatively inexpensive to undertake.

Secondly, the respondents of this study were selected based on purposive sampling technique. It was not possible for this study to reach respondents through other sampling techniques. Thirdly, this research focused on the Malaysian Islamic banks in Kuala Lumpur state only. Along with the purpose of this study, a survey was distributed among the customers of Malaysian Islamic banks in the area that are operating in the Federal Territory of Kuala Lumpur only. Unfortunately, coverage of Islamic banks outside Kuala Lumpur would be more robust due to time constraints and other constraints faced by researcher. Nevertheless, the selection of Kuala Lumpur area could fulfil the research requirement.

1.12 Chapter Summary

This study aims at investigating the appropriate relationship among transformational leadership as the independent variable, employees’ innovative behavior and entrepreneurial passion as the mediator variables, and organizational effectiveness as the dependent variable. This study consists of five chapters; in this regard, chapter one comes up with the primary research elements such as problem statement, research objectives, and questions. Chapter two provides the literature about Islamic banking, its background and principles, what makes it distinct from conventional banking system, and Islamic banking system in Malaysia. However, chapter two brings as well. Chapter three highlights the need for quantitative analysis to cover the questions of the research, the population for research, sampling technique, and presents the principles and procedures of structural equation modelling (SEM) by Smart PLS 3 to evaluate the collected data. Chapter four discusses the data collection process, demographics and data analysis, testing the hypotheses, and eventually shows the results. Finally, chapter five brings about the findings from testing the hypotheses, the contribution of the research in theoretical
and practical terms, future research, and some concluding remarks.
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