THE IMPACT OF THE MANDATORY CORPORATE GOVERNANCE DISCLOSURES ON THE BANKING GROWTH IN UAE: ISLAMIC VERSUS CONVENTIONAL BANKS

Haitham Nobanee**, Nejla Ould Daoud Ellili***

Abstract

The aim of this paper is to measure the degree of mandatory corporate governance disclosure and examine its impact on the bank's growth using annual data for listed banks on the UAE financial markets during the period 2003-2013. Our empirical results show that the degree of mandatory corporate governance disclosure of conventional banks is significantly higher than the Islamic banks. In addition, the degree of mandatory corporate governance disclosure is significantly and positively related to the growth of deposits for both Islamic and conventional UAE listed banks.

Keywords: Corporate Governance, Mandatory Disclosures, Banking Growth, Panel Data

JEL: C33, G32, G34

** College of Business Administration, Abu Dhabi University, P.O. Box 59911, Abu Dhabi, United Arab Emirates*
Fax: +971 2 5860184
Tel.: +971 2 5015709
E-mail: nobanee@gmail.com
*** College of Business Administration, Abu Dhabi University, P.O. Box 59911, Abu Dhabi, United Arab Emirates*
Fax: +971 2 5860184
Tel.: +971 2 5015720
E-mail: nejla.ellili@adu.ac.ae

1. Introduction

It has been long established that good governance practices contribute in the Economic development (OECD, 2008)[1]. Indeed, all the companies are required to timely and accurately disclose all the matters regarding their performance, ownership structure and governance to enhance the transparency of their operations and help the investors in their proper assessment.

In the financial literature, there are many studies confirming the positive impact of the corporate governance on the corporate performance. In these studies, a certain number of corporate governance measures have been used to examine the reduction of the agency costs within the company and the alignment of the interests of the managers on those of the shareholders. These measures comprise the managerial ownership (Jensen and Meckling, 1976), the blockholders ownership (Shleifer and Vishny, 1986; Agrawal and Mandelker, 1992; Denis et a., 1995), the institutional ownership (Brickley, Lease and Smith, 1988; Cornett, et al., 2007), the board's duality ((Rechner and Dalton, 1991; Pi and Timme, 1993; Fosberg and Nelson, 1999), the board's size (Jensen, 1993; Yermack, 1996; Hermalin and Weisbach, 2003, Bhagat and Bolton, 2008).

In broader spirit of research, Gompers et al. (2003) construct a governance index including many indicators. This index construction was an effort to unify the diverse corporate governance measures and was the foundation for many other studies that used this index as a "proxy" for the governance quality of the company (Cremer and Nair, 2005; Bebchuk and Cohen, 2005; Core et al., 2006).

Despite the subsequent body of research related to the corporate governance, the type of governance indicators that may be applied to the emerging market economies located in the Gulf region are rarely discussed in the literature except the studies of Aljifri and Moustafa (2007) Hassan (2012), and Ellili (2012, 2013) in UAE and Hussainey and Al-Nodel (2008) in KSA.

Hussainey and Moustafa (2008) explore the extent to which companies listed on Saudi market publish online information regarding their corporate governance practices. Aljifri and Moustafa (2007) investigate the relationship between the governance mechanisms and the performance of the companies listed on UAE markets. Hassan (2012) constructs a disclosure index to measure the extent of the corporate governance reporting by UAE listed companies. Ellili (2012) examines the interrelations

[1] www.oecd.org/publishing/corrigenda. Electronic version: ISBN 978-92-64-05597-1

between the ownership structure and the board of directors as well as their impacts on the performance of the UAE listed companies. In the same context, Ellili (2013) analyzes the interrelations between the quality of the accounting information (measured by the discretionary accruals), the ownership structure and the board of directors as well as theirs impact on the corporate performance. Although our paper have some similarities with the latter studies regarding the corporate governance in the emerging market economies but it goes further to examine the quality of the corporate governance of the UAE listed banks and then its impact on the banking performance by differentiating between the Islamic and the Conventional banks. This is a very attractive research opportunity because in UAE, there is an emphasis on forcing all the listed companies to comply with the country's code of governance.

Against this background, we conduct this research with the aim of measuring the degree of mandatory corporate governance disclosure and then examining its impact on the banking performance by differentiating between the Islamic and Conventional banks. The three main research questions in paper are as following. First, to what extent the UAE listed banks comply with UAE code of governance requirements? Second, is there any significant difference between Islamic and Conventional banks in the compliance with the code of governance? Third, is there any significant impact of the compliance with the code of governance on the banking growth?

Our findings will help the central bank tailor corporate governance framework, supervision, and examination to address areas of vulnerabilities and capitalize on sources of strength within the banking system.

To our knowledge, there is no single research conducted in UAE about the impact of the corporate governance disclosure on the banking growth, therefore, our research provides the first insight regarding this topic.

The panel data regressions are used to analyze the impact of the degree of the mandatory corporate governance on the banking growth. The empirical results show that the degree of mandatory corporate governance disclosure of conventional banks is higher than the Islamic banks. In addition, the degree of mandatory corporate governance disclosure is significantly and positively related to the growth of deposits for both Islamic and conventional banks listed on the UAE financial markets.

These results help the banks to optimally disclose their informations and improve the quality of their corporate governance practices.

The remainder of the paper is organized as follows: Section 2 contains the literature review on the mandatory corporate governance disclosures as well as on the relationship between the corporate governance and the corporate performance. Section 3 focuses on data and the empirical methodology. Section 4 presents the empirical results and finally the conclusion in section 5.

2. Literature Review

The corporate governance disclosure is defined by the timely and accurate release of all the informations related to the corporation, including the financial situation, performance, ownership structure and governance of the company (OECD, 2008). These indicators are the major measures of the corporate governance quality because they determine the extent of the companies in complying with the good governance practices.

2.1. Corporate Governance Index and Corporate Performance

In the financial literature there are many studies seeking the construction of a corporate governance index but Gompers et al. (2003) were the pioneers in constructing an index measuring the quality of the corporate governance. In their study of the impact of the corporate governance on the firm's performance during 1990-1999, Gompers et al. (2003) create an index (GIM) including 24 anti-takeovers indicators compiled by the Investor Responsibility Research Center (IRRC) such as cumulative voting, classified board, poison pills and golden parachutes. Their empirical results show that the firms with strong shareholders' rights outperform those with weak shareholders' rights. By using the same data, Cremers and Nair (2005) construct an anti-takeover index (ATI) based on three of the provisions in the GIM index which are: the presence of the classified board, the poison pills and restrictions on the shareholders votes. Their empirical results show that the index is negatively correlated with Tobin's Q. Similarly, Bebchuk and Cohen (2005) create an "entrenchment index" (E-Index) based on six provisions (four provisions limiting the shareholder rights and two limiting the potential hostile takeovers). They find that any increase in their index (illustrating a higher entrenchment) is associated with a reduction in Tobin's Q and in abnormal returns during 1990-2003. Further, they find that the other eighteen IRRC provisions excluded from their index are unrelated to changes in firm value or stock returns. Core et al. (2006) extend the GIM's comparative investigation of stock returns and operating performance for firms with strong and weak shareholder rights. By using the GIM governance index, they find that the firms having weak corporate governance (high governance index value) are underperforming.

The construction of the corporate governance index and the examination of its impact on the firm's performance have drawn the interest of many other researchers over the world. Despite the differences in the index construction and in the performance measure, there was a strong consensus on the positive impact of the good corporate governance practices on the firm's performance (Drobetz, Schillhofer, and Zimmerman (2004) (Germany); Beiner, Drobetz, Schmid, and Zimmermann (2004) (Switzland); Black, Jang, and Kim (2006) (Korea); Zheka (2006) (Ukraine); Aksu and Kosedag (2006) (Turkey); Cheung, Connelly, Limpaphayom, and Zhou (2007) (Hong Kong); Black, Love, and Rachinsky (2006) (Russia); Kanellos and George (2007) (Greece); Chen et al. (2007) (Taiwan); Balasubramanian, Black, and Khanna (2008) (India); Hodgson, Lhaopadchan, and Buakes (2011) (Thailand)). The conclusion of all these studies is that the investors prefer to invest in companies with better information disclosure and more transparency as they can gain better understanding of the firms' current operations and future prospects, which leads to higher valuation.

2.2. Corporate Governance in UAE:

In UAE, the Hawkamah Institute for Corporate Governance was founded in 2006 by international organizations including the OECD, the International Finance Corporation (IFC), and the World Bank, as well as regional organizations such as the Union of Arab Banks and the Dubai International Financial Centre (DIFC) Authority. The role of this institute is to encourage and assist the private and the public sectors to adopt the highest standards and practices of corporate governance

In 2007, the "Security and Commodities Authority" (SCA), in order to project an image of integrity, efficiency and transparency and to comply with international standards, has issued a code of corporate governance which has been amended by the "Ministry of Economy's Decision No. 518 of 2009"[2]. This code doesn't include the non-financial institutions and requires all the UAE listed companies as well as the members of their boards of directors to comply with the UAE code of governance and they are forced to strengthen transparency by:

1. Specifying clearly the duties of the board of directors;
2. Describing the responsibilities of the chairman of the board of directors;
3. Explaining the roles of members of the board of directors;
4. Determining the audit charges, the nomination and the remuneration committees;
5. Deciding on the remuneration of the board members;
6. Creating an internal control system within their company;
7. Publishing their corporate governance report and make them available to all the shareholders; and
8. Establishing an effective framework for the protection of shareholder rights.

To enhance the compliance of the UAE companies with the corporate governance reform, the Center for Corporate Governance in Abu Dhabi was established in 2010 to promote further the economic development.

Regarding the financial institutions which are regulated by the UAE Central Bank, they are governed by the Circular Number 23/00[3] of the Central Bank. This circular provides mandatory recommendations for corporate governance structures. In the consideration of the best safety-net against risk at banks, there are recommendations about:

1. The separation between the post of Chairman and the rest of the posts;
2. The prohibition of any overlap between the Board's functions and the general management functions;
3. The proper representation of the shareholders in the Board;
4. The separation of the post of Chief Executive Officer (or Managing Director or General Manager) from the rest of posts;
5. The identification of the authorities and responsibilities of the departments, branches, and divisions as well as their reporting lines
6. The approval of the Central Bank for the appointment of the Chief Executive Officer;
7. The revision of the roles of the Internal Audit Department. In addition to its usual auditing functions, it should alarm for any overlapping work functions as well as conflict of interest cases;
8. The creation of a Credit Committee by a Board resolution with not less than 5 members. Its role is to review, approve or submit recommendations in regard to loans that exceed the value of half of one percent of capital and reserves of the bank.

In this context, Hassan (2012) is the first who explores the status and the extent of corporate governance disclosures in UAE by crafting an index blending the UAE regulations with the worldwide governance practices. His index includes four categories:

1. Ownership structure and investors' rights;
2. Management structure and processes;
3. External audit and non-audit services; and
4. Transparency disclosures.

The results of his ANOVA test show that the corporate governance index differs across the major sectors in UAE (industrial, banking, insurance and service). More particularly, the banking sector differs significantly from the insurance sector in terms of ownership structure and investors' rights, the industry sector in terms of management structure and processes as well as the transparency disclosures and the service sector in terms of management structure and processes. In addition, the results show that the banking sector publishes more governance-related information and this is because the banks follow not

[2] www.sca.ae/English/legalaffairs/LegalLaws/2009-518.doc

[3] http://centralbank.ae/en/index.php?option=com_content&view=article&id=84&Itemid=96

only the UAE Central Bank guidelines and the UAE code of governance but also the UAE regulations to comply with the Basel II standard's requirements[4] that require the publication of information related to the capital adequacy.

3. Data and Methodology

3.1. Data

The objective of our paper is to construct an index for the corporate governance disclosures and examine its impact on the bank's growth. The data was hand collected from the annual reports of all banks listed on the UAE financial markets. The annual and audited financial reports of the years 2003-2013 were obtained from the banks' websites. The final sample includes a panel of 16 banks listed on both Dubai financial market and Abu Dhabi securities market.

3.2. Methodology

The degree of the mandatory corporate governance disclosure has been measured for all banks based on the corporate governance disclosures index crafted by Hassan (2012). Similarly to the latter study, our index is based on UAE code of governance and regulations and it consists of four categories, namely: the ownership structure and investors' rights, the management structure and processes, the external audit and non-audit services, and the transparency disclosures. The process of the index construction is as following:

1. The degree of the mandatory corporate governance disclosures of each category is measured by dividing the total number of scores by the number of items in each category; and
2. The overall degree of mandatory corporate governance disclosure is measured by dividing the total number of scores by the number of items in all categories for the full sample, in the first step and then for divisions of sample according to the bank's type (Islamic or conventional).

The value of the index is ranging between 0% and 100%. The value of 0% means no mandatory corporate governance disclosed by the bank while the value of 100% means a full mandatory corporate governance disclosure. In order to compare the degree of mandatory corporate governance between Islamic and conventional banks, we conducted a Mann-Whitney test in the objective to find whether the mandatory corporate governance disclosure differs significantly between the Islamic and conventional banks.

To test the relationship between the degree of mandatory corporate governance disclosure and the growth in bank's deposits, we employed a robust generalized method of moment system estimation applied to dynamic panel data proposed by Arellano and Bover (1995) and Blundell and Bond (1998). This model controls the possible endogeneity and unobservable heterogeneity by allowing for some explanatory variables to be jointly determined with the dependent variables (Nobanee et al., 2011). This model has been run for all banks and then separately for Islamic and conventional banks.

4. Empirical Results

This section presents the results of the degree of mandatory corporate governance disclosure for all banks and then separately for Islamic and conventional banks. We constructed our index based on the corporate governance disclosures index developed by Hassan (2012) and the UAE code of governance and regulations. Table (1) reports the descriptive statistics of the overall mandatory corporate governance disclosure as well as the disclosure for the divisions of the sample by each category and bank's type. The results show a high degree of mandatory corporate discloser governance for all banks (96.55%) as well as a higher index of mandatory corporate governance disclosure for the conventional banks (97.69%) than for the Islamic banks (93.78%). Moreover, the results of the Mann-Whitney test show a significant difference of the degree of mandatory corporate governance disclosure between the conventional and the Islamic Banks.

Our findings show also that the index of the mandatory corporate governance disclosure varies between the four categories, while a full compliance of mandatory corporate disclosure by all banks in the category three "external audit and non-audit services". However, the lowest index of mandatory corporate governance disclosure was in the category two "management structure and processes" for all the banks (95.96%) as well as for the Conventional banks (96.74%), while, for the Islamic banks, the category four "transparency disclosures "index was the lowest (87.85%).

[4] http://www.centralbank.ae/en/pdf/baselII/Basel2-Guidlines.pdf

Table 1. Degree of mandatory corporate governance disclosure: descriptive statistics

Disclosure Index	All Banks		Conventional Banks		Islamic Banks	
	Mean	Std.Dev.	Mean	Std.Dev.	Mean	Std.Dev.
Category 1	.9638889	.1484173	.972549	.0921777	.9428571	.2355041
Category 2	.9596154	.0772215	.9674208	.0382346	.9406593	1293720
Category 3	1	0	1	0	1	0
Category 4	.9604167	.1074721	.9941176	.0381193	.8785714	.1646233
Overall Index	.9655797	.0582766	.9769821	.0304409	.9378882	.0921021

Table 1 reports descriptive statistics of degree of mandatory corporate governance disclosure of Islamic and conventional banks listed in the UAE financial markets during the period 2003-2013. Category 1 reports the degree of discloser of "ownership structure and investors' rights", Category 2 reports the degree of discloser of "board and management structure and processes", Category 3 reports the degree of discloser of "external auditing and audit services", Category 4 reports the degree of discloser of "transparency and disclosure", and overall index is the degree of mandatory overall corporate governance disclosure.

Table (2) reports the results of the robust dynamic panel-data two- steps General Methods of Moment (GMM) system estimation for the full sample and for divisions of the sample by bank's type. The results of the lagged dependent variable for all banks, Conventional banks and Islamic banks indicate that the bank's growth of deposits in the previous period has no effect on the bank's growth of deposits in the current period. The overall mandatory corporate governance disclosure index has shown a significant and positive effect on banks' growth of deposits for all banks, Conventional banks and Islamic banks. These findings confirm that increasing the degree of mandatory corporate governance disclosure improves the growth of deposits for UAE banks.

Table 2. Results of robust dynamic panel-data two- steps GMM system estimation

Dependent : Deposit's Growth	All Banks	Conventional Banks	Islamic Banks
Lag Dependent Variable	-.0282944	.0594271	-1.482462
Independent: Overall Index	2.59e+08*	1.15e+09 **	1.43e+08**

Table 2 reports the results of robust dynamic panel-data two- steps GMM system estimation for the relationship between the degree of mandatory corporate governance disclosure of Islamic and conventional banks listed in the UAE financial markets during the period 2003-2013. Dependent variable and independent variables are in the form of first difference.
* Significant at 90% confidence level, * *significant at 95% confidence level.

5. Conclusions

In this study, we construct the index of the mandatory corporate governance disclosure and examine its impact on the bank's growth using annual data for listed banks on the UAE financial markets during the period 2003-2013. The results show a high degree of mandatory corporate governance disclosure of all banks and the index average is 96.5% as well as a higher degree of mandatory corporate governance disclosure for the conventional banks comparing to the Islamic banks. In addition, the Mann-Whitney test shows also a significant difference of the degree of mandatory corporate governance disclosure between the conventional banks and the Islamic Banks. The results of the robust dynamic panel-data two- steps General Methods of Moment (GMM) system estimation show a significant and positive effect of mandatory corporate governance disclosure on the growth of deposits for all banks, conventional banks and Islamic banks. These findings confirm that increasing the degree of mandatory corporate governance disclosure improves the growth of deposits for UAE banks.

One of the limits of this research is the omission of other disclosures channels. In this study, the annual reports have been used as the only source of data while it could be extend it in the future researches by examining other disclosures channels such us the press releases and the banks' websites. Indeed, these latter channels could help the banks in improving their compliance to the good corporate governance practices and enhancing their transparency.

References

1. Agrawal A. and Mandelker, G. Shark Repellent and the Role of Institutional Investors in Corporate Governance. Managerial and Decision Economics 13 (1992), pp. 15-22.
2. Amit, R. and Villalonga, B. How do family ownership, control, and management affect firm value? Journal of Financial Economics 80 (2006), pp. 385– 417.
3. Arellano M. and Bover, O. Another look at the instrumental variable estimation of error-components models. Journal of Econometrics, 68 (1995), pp. 29-51.
4. Balasubramanian, B. N. Black, B. S. and Khanna, V. S. Firm-Level Corporate Governance in Emerging Markets: A case Study of India. SSRN Working Paper.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=992529 (2008).
5. Bebchuk, L, and Alma Cohen. The costs of entrenched boards. Journal of Financial Economics 78 (2005), pp. 409-433.
6. Beiner, S., Drobetz, W., Schmid, M. M. and Zimmermann, H. An Integrated Framework of Corporate Governance and Firm Valuation - Evidence from Switzerland. ECGI l Finance Working Paper 34 (2004), pp. 1-59.
7. Bhagat, S. and Bolton B. Corporate Governance and Firm Performance. Journal of Corporate Finance 14 (2008), pp. 257-273.
8. Black, B. S., Jang, H., and Kim, W. Predicting Firms' Corporate Governance Choices: Evidence from Korea. Journal of Corporate Finance 12 (2006), pp. 660-691.
9. Black, B. S., Love, I., and Rachinsky, A. Corporate Governance Indices & Firms' Market Values: Time Series Evidence from Russia. Emerging Markets Review, 7 (2006), pp. 361-379
10. Blundell, R. and Bond, S. Initial conditions and moment restrictions in dynamic panel data models. Journal of Econometrics, 87 (1998), pp. 115-143.
11. Cheung, S.Y. J. Connelly, T., Limpaphayom, P. and Zhou, L. Do investors really value corporate governance? Evidence from the Hong Kong market," Journal of International Financial Management and Accounting 18 (2007), pp. 86-122.
12. Core, J. Guay W. and Rusticus T. Does weak governance cause weak stock returns? An examination of firm operating performance and investors' expectations. Journal of Finance 61 (2006), pp. 655–687.
13. Cornett, M. Marcus, A., Saunders, A. and Tehranian, H. The Impact of Institutional Ownership on Corporate Operating Performance. Journal of Banking and Finance 31 (2007), pp. 1771-1794.
14. Cremers, M.K.J. and Nair V.B. Governance mechanisms and equity prices. Journal of Finance 60 (2005), pp. 2859–2894
15. Denis, D. Denis, D. and Sarin, A. Performance Changes Following Top Management Dismissals. Journal of Finance 50 (1995), pp. 1029-1057.
16. Drobetz, W., Schillhofer, A., & Zimmermann, H. Corporate Governance and Expected Stock Returns: Evidence from Germany. European Financial Management, 10 (2004), pp. 267-293.
17. Ellili, N. The Ownership Structure, the Board of Directors and the Corporate Performance: Complementarity or Substitutability? Evidence from Companies Listed On Abu Dhabi Stock Exchange'. Corporate Ownership and Control 9 (2012), pp. 276-287.
18. Ellili, N. The Ownership Structure, the Board of Directors and the Quality of Accounting Information'. Corporate Ownership and Control 10 (2013), pp. 420-433.
19. Fosberg, R.H. and Nelson M.R. Leadership Structure and Firm Performance. International Review of Financial Analysis 8 (1999), pp. 83-96.
20. Hassan M. K. A disclosure Index to Measure the Extent of Corporate Governance Reporting byUAE Listed Corporation. Journal of Financial Reporting and Accounting 10 (2012), pp. 4-33.
21. Hermalin, B. and Weisbach M. S. Boards of Directors as an Endogenously Determined Institution A Survey of the Economic Literature. Economic Policy Review 9 (2003), pp. 7-26.
22. Hodgson, A., Lhaopadchan, S. and Buakes, S. How informative is the Thai corporate governance index? A financial approach. International Journal of Accounting and Information Management, 19 (2011), pp. 53-79.
23. Jensen, M.C. and Meckling, W. H. Theory of the Firm, Managerial Behavior, Agency Costs and Ownership Structure. Journal of Financial Economics 3 (1976), pp. 305-360.
24. Jensen, M.C. The Modern Industrial Revolution, Exit, and the Failure Of Internal Control Systems. Journal of Finance 48 (1993), pp. 831-880.
25. Kanellos, T., & George, T. Corporate Governance and Firm Performance: Results from Greek Firms. MPRA_paper_6414, (2007), http://mpra.ub.uni-muenchen.de/6414/
26. Nobanee, H., Abdullatif, M., AlHajjar, M. Cash conversion cycle and firm's performance of Japanese firms. Asian Review of Accounting. (2011), pp. 147-156.
27. Pi, L., and Timme S.G. Corporate Control and Bank Efficiency. Journal of Banking and Finance 20 (1993), pp. 515-530.
28. Rechner, P.L. and Dalton, D.R. CEO Duality and organizational performance: a longitudinal analysis. Strategic Management Journal 12 (1991), pp. 155–160
29. Shleifer, A. and Vishny, R.W. Large shareholders and corporate control, Journal of Political Economy 94 (1986), pp. 461-479.
30. Yermack, D. Higher Market Valuation of Companies a Small Board of Directors'. Journal of Financial Economics 40 (1996), pp. 185-202.
31. Zheka, V. Does Corporate Governance Predict Firms' Performance? The Case of Ukraine. 2nd Annual Conference on Empirical Legal Studies Paper, CERT Discussion Paper No. DP06/05(2006).