



Corporate governance and Issues, and Challenges of Displaced Commercial Risk (DCR) of Islamic Banks

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Abstract: Islamic banks (IBs) operating in a dual banking system face various risks due to high competitive pressure between IBs and conventional banks (CBs). This research review mainly focuses on the theoretical discussion of the potential issues behind displaced commercial risk (DCR) in IBs. Precisely, this study focuses on the profit-sharing investment account (PSIA). As the basis on the Mudarabah deposits, the profit is shared between the PSIA as the fund provider and IB as Mudarab (entrepreneur) and any losses will be borne by the PSIA except if the losses are due to the negligence or misconduct made by the IB. In this contract, IB acts as a financial intermediary between the PSIA (depositors) and borrowers (the clients of IBs), but using and managing this task is critical. This is one of the key issues in IBs, how IBs measure and manage the sharing of returns and risks between shareholders and PSIA holders. Any variation in the assets' rate of return that is funded by the PSIA from the market rate of return benchmark may result in risk shifting from PSIA (depositors) to the banks' shareholders to avoid PSIA withdrawing their funds into another bank and this action is known as the DCR. To protect the interest of shareholders and stakeholders from such risk, IB needs to apply some risk management strategies like setting up specific prudential reserves, diversifying their traditional and normal income, capital adequacy ratio, and hiring an expert board of directors to avoid the occurrence of DCR and at once to strengthen the trustworthiness and creditworthiness.

Keywords: Islamic banks; Displaced Commercial Risk; Performance, PSIA, Murabahah, risk management strategies.

1. introduction

Islamic banks (hereinafter referred to as IBs) have experienced rapid growth in the last 20 years and have become another form of banking in the world. This is due to the need of Muslim investors to invest their surplus income in the Islamic Shariah products such as bonds (Sukuk), Islamic shares, and other Islamic investments (Ramasmy et al., 2010). IB has become an alternative source of funds in the majority of Islamic countries and many non-Muslim countries (e.g., UK, South Africa, Hongkong, and Luxembourg) (Alawode and Iqbal, 2015). Thus, nowadays many non-Muslims becomes also the customer of IBs.

Although many are believed that IBs could safeguard and prosper their investments (wealth) in the premise products that are being offered in compliance with Shariah precepts. However, Islamic Shariah products are still in their infancy stage and they are surrounded by many risks. From an Islamic perspective, the risk is highly linked with the degree of uncertainty which is known as "*gharar*" (Badawi, 1998). AL-Saati, (2003) pointed out that the Shariah scholars classified *gharar* into three types namely, slight, intermediate, and excessive. According to the author, there is consensus among Shariah jurists that excessive *gharar* affects the validity of contracts; therefore it is prohibited, while slight *gharar* has no impact on the validity of the contracts. In addition, AL-Saati (2003) explained that the wide difference among the jurists of Shariah is the determinant of the intermediate cases, where it is difficult to measure the degree of *gharar* whether to be slight or excessive. Thus, avoiding excessive *gharar* is required since

the protection of possessions is one of the Shariah objectives (Maqasid Al-Shariah). Therefore, failure to protect possessions from any type of risk is unacceptable from an Islamic point of view.

In this regard, Oldfield and Santomero (1997) classified risk in financial institutions into three types, (1) risk that can be eliminated, where it has minor negative effect on the performance of the enterprise, (2) risk that can be transferred to others such as the systematic risk that to reduce its negative effects on the performance of the firm, and (3) risk should be managed, since this risk is accompanied to the nature of the business.

Managing risks has at the heart of any bank's activity. Managing risk aims to maximize the value and profitability of the bank and to ensure its stability (Abedifar 2013; Mollah et al., 2017). Since in the majority of the countries over the world, the IBs operate in parallel with traditional banks (dual banking system), with the intense competition, IBs have to do a lot to maintain their profitability and credibility, by ensuring that all of their products offered, operations, processes are Shariah complained at all time. The main distinguishing feature between IBs and conventional banks (CBs) is the use of IB's profit and loss sharing (PLS) paradigm as one of the sources of funds and prohibited interest rate. The PLS contracts could affect both sides of the statement of financial position of IBs; assets and liabilities where both sides are dependent on the condition of PLS between shareholders, borrowers, and depositors (Chong and Liu, 2009).

This study aims to narrow the scope of discussion of IBs by focusing on the risk of *Mudarabah* deposits as according to Sundararajan (2011), over 60% of IBs' funds derive from *Mudarabah* deposits. Furthermore, in Indonesia the biggest Islamic country according to Islamic Banking Statistic (Dec, 2020), the *Mudarabah* deposit is the dominant deposit in the IBs which contributed up to 50% to the total deposit. Thus, the *Mudarabah* deposit is the main source of the funds raised by IBs. Therefore, this study focuses on the *Mudarabah* deposit account because it has a significant impact on IB's soundness and economic capital requirements. To be more precise, the focus of this conceptual review research is on the specific risk of *Mudarabah* deposit that is known as displaced commercial risk (hereafter, DCR).

The DCR is a risk result from the management of unrestricted *Mudarabah* which the profit-sharing investment account (PSIAs) holders act as fund providers (depositor) and the IB acts as a fund manager (entrepreneur). DCR arises in the case the actual rate of return on deposits under *Mudarabah* is lower than the expected rate of return in the market (Toumi and Viviani, 2013). If the actual rate of return is low, PSIA holders may want to withdraw funds and then shift them to other institutions that provide better returns (Aysan et al., 2017). As a result of massive withdrawal, banks' commercial position as well as the financial system stability will be affected and may face systematic risk. Under the competition, to avoid the risk of withdrawal, IBs and their shareholders may be forced to forego part or entire of their profits and add it to the profit of PSIA (depositors) to pay them the comparable and competitive market rate of return. This may be resulting shareholders of IB bearing losses in cases the returns fall short. IBs may use this payment mechanism to meet market expectations. This phenomenon is known as the DCR.

A review of the past literature shows that there is not much research on the concept of DCR and how the corporate governance mechanism mainly the expertise directors may affect it. This study attempts to bridge this gap by highlighting the concept of DCR and the expected effect of the existing expertise board of directors in mitigating the DCR effects. This study seeks to answer the question: To what extent the directors' expertise would reduce the DCR. The remainder of the paper is organized as follows: Section 2 provides the outlines discussion background of the study and reviews the past literature. Section 3 presets the DCR risk management strategies, then Section 4, which discusses the strong corporate governance. Finally, in section 5 the conclusion is provided.

2. Background of the Study and Literature Review

IB's financing mode, whether based on markup contracts, lease contracts, or profit and loss sharing contracts, is not a loan contract like in the CBs. The framework of these types of financing modes is complex, and the standardization of IBs products is more difficult to achieve due to the multiplicity of their potential financing products (Cihak and Hesse, 2008). Generally, risks are caused by many factors, such as the huge development of the financial sector; increased market volatility; and sudden changes in the regulatory environment (Iqbal and Mirakhor, 2007). Besides, the nature of IB is different from CB in form and substance. IBs do not pay or charge interest. IBs pay rate of return to the capital providers (depositors) via their saving deposits either based on the debt (mark-up) contracts, leasing (Ijarah) contracts, or based on PLS contracts. Due to that, IBs have to deal with additional types of risks besides the general risks as in CBs.

IB may create mark-up based contracts such as *Murabahah* (cost of sales with markup) as well as *Istisna* with a fixed and predetermined rate of return, but, in these contracts, the degree of adverse selection, as well as the moral hazard problems, is very high (Khan and Ahmed, 2001). In the case of

Murabahah, the credit risk is high, as the IB should deliver the asset to the client immediately, but the payment must be deferred and the client may not pay the deferred installments on the due date (Iqbal and Mirakhour, 2007). Moreover, Sundarajan and Errico (2002) emphasized that, in contracts such as Salam and Istisna, commodity price risk is high due to the period between the date of delivering the subject matter and the payment, where the payment will take place immediately while the delivery of subject matter should be in a specific time in the future. In Ijarah contracts, the transfer of ownership will not take place until the end of the Ijarah period, so IBs have to bear all the risks during the Ijarah period such as the cost of periodic maintenance and damage to the underlying assets. Khan and Ahmad (2001) empirically emphasized that IB faces additional risks due to the adoption of PLS and markup-based contracts. Here, the majority of the bankers believe that the unique risks of IBs are more harmful than the risk faced by conventional financial institutions. By using PLS as the mode of financing, IB may record losses from its business operations and that means, the principal and the expected return are both exposed to risk (Dar and Presley, 2000).

IB represents the profit-sharing investment account (PSIA) holders, invests PSIA funds as *Mudarib*, and is based on IB's right to share the profits (not losses) of the *Mudarabah* contract. In the *Mudarabah* contract, the earned profits are shared between IB and PSIA depositors in a pre-agreed ratio and any losses' records are to be borne by depositors if there is no misconduct, negligence, or breach of the contracted terms by the IB (AAOIFI, 2015a). Practically, PLS financing mode has two familiar contracts namely *Musharakah* and *Mudarabah*. *Musharakah* contracts are marked by PLS, while *Mudarabah* contracts are marked by profit sharing and loss bearing. DCR is one type of financial risk and it arises in the case the actual rate of return on PSIA (*unrestricted Mudarabah*) deposits is lower than the expected rate of return of PSIA holders who might expect to earn the current market rate of return offered on an alternative investment with the same conditions of risk (Toumi and Viviani, 2013).

If the actual rate of return is low, PSIA holders may withdraw their funds and then transfer them to other institutions that provide better returns (Aysan et al., 2017). As a result of massive withdrawal, banks' commercial position as well as the financial system stability will be affected and may face systematic risk. Under the competition, to avoid the risk of withdrawal, IBs and their shareholders may be forced to forego part or entire of their profits and add it to the profit of PSIA depositors to pay them the comparable and competitive market rate of return. This may result in shareholders of IB bearing losses in cases the returns fall short. Supervisors may require also a profit payout mechanism to PSIA that provides some protection to avoid systematic risk. IB may use this payment mechanism to meet market expectations. This is a portion (or all) of the risk of assets managed by IB, because *Mudarabah* is managed by IB on behalf of PSIA as fund providers.

IFSB (2005) described DCR as an exclusive risk for IBs as a result of the rate of return risk when IBs should pay a rate of return higher than the rate of return that agreed in the contracts of unrestricted *Mudarabah*. Therefore, DCR occurs when IB faces competitive pressure, which makes the rate of return paid by IB higher than the rate of return payable under the term of the *Mudarabah* contract. AAOIFI (1999) explains that equity-holders of IBs expose to risk that comes from transferring part of their profits to investment account holders (IAH) that dissuade them from withdrawing their deposits. In some cases where the withdrawal risk is very high, banks' management may deviate from PLS principles by paying competitive market returns to IAH regardless of realized performance. This will raise the DCR (Obaidullah, 2005). Haron and Hock (2007) pointed out that, DCR occurs when investing funds in long-maturity investments like *Murabahah* or Ijarah which has a long maturity period. This is because the return on long-term investment may not be competitive with alternative investments. Therefore, IBs should increase the rate of return on deposits to smooth the income of PSIA depositors. However, to avoid transferring the risk to shareholders, IBs may set up two specific prudential reserves profit equalization reserve (hereafter, PER) and investment risk reserve (hereafter, IRR). Shortly, DCR is the subsequent result to the rate of return risk; therefore, it expects to affect the profitability of IBs negatively.

The DCR adds considerable challenges to the regulation of IBs in terms of assessing that the actual DCR should be borne by the shareholders. Despite the efforts of IFSB that were published in 2011 regarding the determination of the DCR measurement framework, most of the frameworks of the jurisdictions are still rare. The IFSB mechanism to measure the DCR in IBs is reflected in the alpha α coefficient in the supervisory discretion formula of calculation of the capital adequacy ratio CAR for IBs (IFSB-2, 2005; IFSB-GN 4, 2011). The alpha " α CAR" coefficient represents the proportion of the risk-weighted assets funded by PSIA to be displaced from PSIA holders to shareholders. To measure alpha " α CAR", IFSB suggests using the ratio of actual exposure to DCR to the maximum exposure to DCR (IFSB-GN 4, 2011).

The formula used to measure the DCR and the alpha " α CAR" are calculated based on the variability of returns of the shareholders on equity given by the standard deviation measure of variability (or variance).

Thus, the alpha “ α CAR” has a positive relation with actual exposure to DCR. This means with high actual returns smoothing on PSIA, it implies high actual risk transfer to the shareholders, alpha “ α CAR” that the highest value is 1. However, based on some jurisdictions, the value of alpha “ α CAR” is subjected to the discretion of supervisory and does not consider the specification of each IB’s practices in terms of smoothing (Toumi and Viviani, 2013).

According to Toumi et al., (2019), the estimation of DCR as well as coefficient alpha “ α CAR” which is recommended by the IFSB presents some weaknesses. First, it is mainly because it is based on a simple formula of risk measurement which is based on the standard deviation (or variance) of the shareholders’ equity returns, thereby measuring the volatility of returns relative to their mean. Using this simple volatility formula will highlight two disadvantages. On the one hand, the average return may not represent the true mean of the return distribution. On the other hand, the problem is related to the arbitrary choice of the length of the historical returns (Saita, 2007).

Secondly, the measures recommended by the IFSB ignore the extreme situations that may occur when PSIA holders suffer losses and their investment returns are negative. This issue is particularly important in jurisdictions when depositors are highly protected by the government and central bank for strategic reasons. The capital adequacy ratio for IBs is highly sensitive to changes in the value of DCR and alpha “ α CAR”. Therefore, any inaccurate assessment of IB's capital adequacy ratio may result in a serious shortage of IB's capital, because IB's CAR is highly sensitive to changes and may threaten financial stability.

On the contrary, placing too much capital may impair the ability of IB to compete (Daher et al., 2015). Capital is a key resource for shareholders as well as managers who have interested in a bank’s ability to survive and offer an attractive return to shareholders. At the same time, the head of the financial system hopes to maintain the stability of the financial system by reducing the risk of bank failures, thereby controlling the amount of capital (Berger et al., 1995). Therefore, in banking systems where the DCR is a significant factor, the volume of PSIA deposits is vitally important and thus raises questions on the role of BoD expertise in measuring and reducing the effect of the DCR on the return of shareholders and PSIA.

3. DCR Management Strategies

This section presents a review of DCR risk management strategies that banks might adopt to mitigate and manage the DCR.

3.1. Profit Equalization Reserve and Investment Risk Reserves

To avoid DCR (transferring the risk from depositors to shareholders), IBs have to set up and manage specific prudential reserves, the Profit Equalization Reserve (PER) and Investment Risk Reserves (IRR), as these reserves are recommended by the IFSB (2005) and AAOIFI (2015b). In general, the purpose of using the PER and IRR is similar to the purpose of establishing conventional revenue reserves, to smooth dividend payout to shareholders. Before distributing profits between shareholders and PSIA holders, IB must deduct the amount of PER, which will reduce the actual profits that must be distributed to shareholders and PSIA depositors. More precisely, when earnings decline (but positive earnings), the PER will stabilize the profit distribution of PSIA holders and shareholders. However, IRR deducts from the profits attributable to PSIA holders, after deducting the bank's profit share. This is because, the IRR services are only used to mitigate any losses (negative returns) attributable to PSIA holders that might cause from time to time (Toumi et al, 2019).

The discretion of PER and IRR retained in each period is positively correlated with the total return generated by assets funded by PSIA funds (Sundararajan, 2007). This is confirmed by Farook et al. (2012). They found that there is a significant positive correlation between the scale of IB's profit distribution management and the discretion of PER and IRR reserves. The percentage of PER should be stated in the contract of the investment and get the approval of the capital provider. The Board of directors of the IBs has the right to set the conditions and the percentage of IRR. Ismail and Shahimi (2006) study the creation of PER and they find that the decision of establishing PER should be based on the future expectations regarding the possible losses and give considerations to the price of finance. Taktak et al. (2011) study the smooth of income in a sample of 66 IBs in 12 countries over the period 2001-2006. They documented that 49 banks (75 percent) have shown smooth in their income and they claimed that this smoothing was achieved by using PER and IRR rather than through using loan loss provisions (LLPs). Under regulatory pressure and commercial pressure, earnings may be smoothed by using reserves. This is because, in several jurisdictions, regulators have a view that IBs should not allow their fund providers (PSIA) to suffer from losses or decreases in their return below the market benchmark (Archer and Karim,

2009; Mejia et al., 2014). The regulators could assimilate PSIA holders as the depositors in CBs who bear free risk or as partially risk bear instead of dealing with them as investors who bear all risks voluntarily. Considering these practices, in the case the accumulated PER and IRR are insufficient to smooth the returns of the PSIA, IBs should do adjustments to its Mudarib share if obliged, and reduce it below the pre-agreed rate in the contract.

3.2. Management fee (Non-Traditional Activities Income)

With the reform of the global economic and financial sectors, banks and financial institutions are diversifying their traditional income and normal income. Generally speaking, banks can diversify their income by adopting traditional financial intermediation operations and non-traditional activities. The banking industry has a lot to do with non-traditional banking as an important income resource. Therefore, diversification of income in the banking industry becomes important in terms of increasing non-interest incomes in the net operating income of a bank. Non-traditional activities (NTA) in the banking industry can take place by combining conglomerate activities such as underwriting activities, insurance, securities, custodial services, trading commercial banking, and other financial services (Baele et al., 2007; Shahimi et al., 2006). In short, banks can increase revenue diversification by adopting fee-based services, and those banks that already have strong fee-based services can expand their businesses into trading activities (Elsas et al., 2010).

Overall, Barth et al. (2004) revealed that diversification of non-traditional activities income has a positive effect on the stability of banks. In the IBs industry, the operations of IBs are Shariah compliance, thus IBs are restricted to expanding their business activities as CBs do (i.e. derivatives) to generate additional income instead of relying on generating income from loans (on the assets side in the statement of financial position). Shahimi et.al (2006) measured the management fee activities of IBs in Malaysia. Their findings indicate that through NTA engagement; IBs generate income from alternative resources, thereby increasing their assets level and core deposits. This shows that as the level of assets and core deposits increase, IB can manage to pay high returns to the PSIA, which may restore PSIA's confidence in IB. By paying high returns, the risk of deposit withdrawal can be avoided, as well as the competition between IBs and CBs can be enhanced (Hamza and Saadou, 2013).

Muneer et al. (2016), income diversification has a positive effect on the performance of commercial banks in Pakistan; however, in the case of IBs, there is no significant effect of income diversification on the performance. Acharya et al. (2006) found that in industries with less competition, banks cannot take full advantage of the benefits of income diversification, but overall, due to income diversification, bank returns can be improved. The effect of income diversification on risk has been investigated by Reichert et al. (2008). They found that, while allowing for diversified operations, the risks of the non-banking business sector have been reduced, and the potential returns have increased. Consistently, Rogers and Sinkey (1999) investigated the determinants of NTA in the US commercial banks. They found that with a larger NTA, banks have more sources of income and can reduce risk.

DeYoung and Torna (2013) examine whether income from NTA contributed to the failures of commercial banks in the U.S. during the financial crisis. They found that NTA, such as securities brokerage and insurance sales were contributed to the decline of the probability of distress in the banks. Nepali (2018) studies the impact of income diversification of 20 commercial banks in Nepal on risk-return tradeoffs. His research results show that NTA such as non-interest income is positively correlated with risk-adjusted returns. Consistently, Ferreira et al., (2019) study the impact of bank revenue diversification on banks' risk and return in Brazil. By using the dynamic panel data GMM, the results show that non-interest income has a positive correlation with the return of the sample banks studied over the period 2003 to 2014.

Gueyie et al., (2019) examine the impact of non-interest income of the biggest chartered banks in Canada over the period from 1982 to 2018 on the banks' risk and performance. Their findings show that the expansion into NTA had slightly decreased in the risks while their performance has got significant improvement benefiting from income diversification. In short, through the above discussion, by diversifying income, banks can increase earnings and pay high yields to depositors and shareholders, which will decrease withdrawal risk and DCR.

3.3. Capital Adequacy Ratio (CAR)

CAR is defined by Ebhodaghe (1991) as a stage in which losses can be absorbed through adjusted capital, and fixed assets can be made up with sufficient balance to face current operations and expected expansion. In 1988, BCBS introduced an agreement called "Basel Capital Accord" (also known as "Basel Accord I") that merges between "Capital Measurement" and "Capital Standards. According to the Basel Accord

(Basel I), banks must hold 8% of their capital as a capital ratio requirement, which means that banks must hold at least 8% of capital to deal with the risks of their loans.

However, banks have two options, either to increase capital or to focus their business on less risky investments such as government securities. For example, the growth of the loans in Malaysia has ranged between 3 to 4 percent during the period of the Asian financial crisis in 1997. This figure refers to the preference of Malaysian banks, which fear that loans will be defaulted and withdrawn during the crisis (Abdul Wahab, et al. 2014). The Bank of Korea has adopted this strategy, reducing the supply of loans and increasing government securities investment in Korean banks (Berger and Udell, 1994).

The purpose of the capital adequacy ratio regulatory requirements is to encourage the bank manager to reduce risky lending (Vanhoose, 2007). Furthermore, Zhang et al. (2008) confirmed the relationship between the theoretical model of CAR and risk. As the capital increases, the proportion of risky assets will decrease. In other words, banks with higher capital are less induced to invest in a risky portfolio (Jeitschko and Jeung, 2005). However, due to various factors, such as information asymmetry, moral hazard incentives, competitiveness, agency problems, and deposit insurance, this theoretical expectation may not always be achievable. According to Basel I, banks must measure credit risk as 8% of the minimum capital standard by the end of 1992 (Lessambo, 2013). Basel I focuses on credit risk here to meet the clear requirements for on-balance sheet and off-balance sheet positions, while other types of risk are the responsibility of the local regulatory agency in the country (Balthazar, 2006). However, this approach has received banks criticized from the beginning due to the lack of risk sensitivity, thus, later; this led to a revised framework of Basel Capital Accord to come out with new capital adequacy (Basel II) in June 2004.

Basel II is a new method, not completely dependent on the capital adequacy ratio as Basel I, but created based on its three-pillar concepts, minimum capital ratio, regulatory review, and market discipline. Basel II emphasizes the importance of maintaining a capital ratio of 8% as a measure of credit risk. This is the first pillar of Basel II. Pillar two of Basel II is the banks' supervisory review, a system of risk management and its requirements that the majority of banks have to adopt. The third pillar focuses on market disciplines, such as developing and adopting disclosure standards. Adopting and revising Basel II is still continuous, but after the recent global financial crisis, Basel Committee on Banking Supervision (BCBS) decided to incorporate more rigorous measures to improve and support Basel II's three pillars. Thus, responding to the issues that represent the causes of the recent global crisis, BCBS launched Basel III in December 2010.

BCBS released Basel III in 2010 as a comprehensive reform measure to strengthen the supervision, and control of banking risks. Under Basel III, the world's financial institutions have to use a common regulatory framework, although each financial institution may manage its operational risk in different ways from each other. In the context of IBs, BCBS issued Basel III without giving any consideration to the specifications of IBs. Although Basel III did not ignore the three basic pillars introduced by Basel II, a series of adjustments were made to it. There is a significant positive relationship between CAR and the profitability of commercial banks. This means banks with high CAR; generate high profitability (Ahmed et al. 2015).

Hossain and Islam (2017) examine the effect of CAR on absorbing the shocks arising from the financial and economic stress of Al-Arafah Islami Bank Limited in Bangladesh. By using the OLS regression model to study the relationship between profitability and capital adequacy requirements the study result shows that there is a significant positive relationship between CAR and the return on assets (ROA). This means if the ratio of capital adequacy is increased, the ROA would be increased too. This is a good indication that with a higher ROA, IB can manage to pay high returns to their PSIA which may restore the confidence of PSIA in IBs and avoid the risk of deposit withdrawal (Hamza and Saadoui, 2013).

4. Strong Corporate Governance is the solution

BCBS has long emphasized the importance of financial entity governance mechanisms. In September 1999, and then February 2006, BCBS called for the strengthening of corporate governance of bank companies through a structure composed of a board of directors and senior management. However, the global financial crisis has shown that the governance mechanisms of banks are still weak, and the impact of scholars and policymakers on bank risk exposure is unclear (Kirkpatrick, 2009). BCBS believes that with good corporate governance, banks can increase the efficiency of monitoring as well as guarantee a sound financial system, hence, a country's economic development (Andres and Vallelado, 2008). Banks' governance is defined by Zingales (1998) as multiple mechanisms that have to adopt by stakeholders to make them ensure the resources of the corporation are managed by directors efficiently.

However, the nature of the banking industry and the complexity of its business increase the challenges of governance mechanisms such as existing information asymmetry, and the limitation of stakeholders to monitor bank managers' decisions. The problem of information asymmetries exists in all sectors, but the problem is arising for financial intermediaries such as banks due to the complexity of their business (Levine, 2004). The complexity of banks' business is related to the idiosyncratic nature of the banking industry, making it difficult for stakeholders to monitor their banks. Banks' complexity can take the form of the quality of loans not given clearly due to for example the absence of critical standards of credit rating of perceived, absence of transparent of financial engineering, complicated of proving financial statements, the capability of modifying risk of investment (Levine, 2004).

Hence, banks' business complexity is one of the reasons that aggravates the banks' governance problem, thus banks need a board of directors has not only had to monitor the efficiency of managers but also have to provide valuable advice to the manager to run the bank (Andres and Vallelado, 2008). The assumption is that banks can overcome the complexity of their business by hiring directors with extensive experience in the field so that they can provide valuable advice and monitor the behavior of management.

4.1. Board of directors

The Board of directors represents the company's shareholders (Adams and Mehran, 2012). However, the role of the board of directors is monitoring the management and identifying the risk. This role has received much attention and become under the scrutiny of researchers after the last global financial crisis in 2007. Furthermore, the board of directors has a function to supervise, establish the risk control system, and advise the management and all these are the key elements of the governance mechanisms. In prior literature, the role of the strong board of directors in terms of its size, the fraction of the independent board of directors, experts, and qualification of its members are received much debate (Mamatzakis et al., 2017), but the evidence for the beneficial effect of boards' structure on bank risk-taking has remained far from convincing. This was confirmed recently by Mamatzakis et al. (2017). Therefore, this paper has the objective to highlight the expected role of the board of directors with an emphasis on the expertise of directors on the reduction of DCR.

4.2. Board of directors expertise

Directors who have experience from their previous work as executives or directors in other companies that work in the same industry can provide useful resources in terms of know-how pertaining to the firm's products and services (Charitou, et al. 2016). Faleye et al. (2014) believe that directors with industry expertise can provide better investment in decision-making strategies. This is because they have a deeper understanding and rich information about the field of industry. In addition, the existence of financial expertise in the composition of the board of directors is important, because the lack of financial expertise of the board of directors may be one of the reasons for exacerbating the financial crisis (e.g. Kirkpatrick, 2009; and Walker, 2009).

A board with financial proficiency allows them to identify risks early and report them to senior management through some scientific advice. Alternatively, hiring financial experts can identify the beneficial risk to the stakeholders in normal times and do recommendations to management to pick up the opportunity of these types of risk. This is in line with resource dependence theory (RDT). According to the RDT, corporate board experts are an important contribution to the firm resource (Hillman and Dalziel, 2003). This contribution is, for example, to gather the diverse experiences of board members (Abdullah and Valentine, 2009).

Sekyi and Gene (2015) studied the effectiveness of the internal control system of Spanish-listed banks from 2004 to 2013. They examine the effects of board size, board independence, and board expertise as elements of internal control system on bank credit risk. They measure the board's expertise as the ratio of the board of directors with banking or finance background to the total board members. Research shows that the proportion of board expertise has a significant positive impact on bank credit risk. Thus, the rising question here is the existence of financial experts in the composition of the BoD is contributed to high returns and overcomes the risk-taking increase in the value of shareholders. Harris and Raviv (2006), argue that financial experts in the structure of BoD have lower costs and the ability to acquire any type of information associated with the risk of a certain transaction, and that enables them to efficiently monitor senior management.

Nomran et al.,(2017) examine the effect of Shariah supervisory board characteristics such as board size, cross-membership, qualification, reputation, and experience on performance. They use a sample of 15 listed IBs in Malaysia over the period from 2008 to 2015. The results of the study show that

the experience of SSB has a positive impact on performance and prove that SSB with financial experience can provide valuable advice to management. After the global financial crisis in 2007 and exacerbated the accounting scandal, regulators called for more financial experts on the supervisory board (Güner et al., 2008). The reason for this is that directors with extensive experience and a better understanding of the finance industry will be able to exercise their supervisory role in risk aversion.

Trinh et al., (2020) investigate the impact of BoD busyness (i.e. multiple directorships of outside board members) on the profitability and stability of CBs and IBs in 14 countries for the period 2010 - 2015. The results of the study show that CBs with a busy board and excellent financial expertise can improve their profitability and financial stability. However, this is less pronounced in IBs. This result may be attributed to the complexity of IBs' governance structure as well as the uniqueness of IBs' financial products that require additional effective monitoring. Experienced directors can provide industry insights and the needs of customers and suppliers and they have a significant impact on the firm's value or performance, as well as the experienced director can contribute to handling industry shocks and shorten cash conversion cycles (Obado, 2017). Liu and Sun (2021) investigate the effect of independent directors' legal expertise on banks' risk-taking (proxy by total risk, idiosyncratic risk, systematic risk, and insolvency risk) and performance in a sample of 273 bank-year observations for 2011 to 2013 in the USA. The result of regression shows that independent directors' legal expertise facilitates reducing all types of risks for banks. Besides the result show, independent directors' legal expertise affects the idiosyncratic risk negatively but was insignificant. This finding suggests that with more independent directors who have legal experience, more constrain of systematic risk than other directors. Regarding the effect of board members' financial experience, the result shows independent directors' financial expertise is negatively related to insolvency. Based on the previous studies and the discussions above, it could be said that the majority of empirical findings refer to the positive effect of the board of directors' experience on the performance and risk in the banks. This fact means that banks with a high level of ROA, will pay a high return to their PSIA and avoid the withdrawal risk.

5. Conclusion

In the dual banking system, due to the competitive pressure between IBs and traditional banks, IBs face multiple risks. This theoretical discussion focuses on the underlying issues behind the scene of the IBs, specifically on the profit sharing and lost bearing paradigm, the *Mudarabah* concept. According to the *Mudarabah* contract, the profit is shared between fund provider (*rabulmala*) and IB as Mudarab while the losses will be borne wholly by the funds' providers except to the negligence or misconduct made by the IB, thus depositors expect to collect the high rate of return from their investment. IB's role in this contract is to act as a financial intermediary (asset financing) between depositors and borrowers, but the task of utilization and management is critical. If the rate of return of assets funded by Mudarabah is lower than the market benchmark interest rate, the depositors can withdraw their *Mudarabah* funds from that particular IB and then transfer them to another bank. Therefore, to avoid withdrawal risks, IB must follow market benchmarks and pay the same rate to its fund providers. However, if the *Mudarabah* outcome is underperformance, IB's shareholders may force forgoing portion or might pay their entire *Mudarabah* profit share to fund providers to avoid them from withdrawal their *Mudarabah* deposit, and this action knows DCR.

IB management has to work to protect the interest of both, the shareholders and stakeholders, and that need to adopt good risk management strategies that may enhance the profitability of IB, which will reflect on improving the return of shareholders as well as depositors. IB may set up specific prudential reserves such as PER and IRR, diversifying their traditional and normal income like underwriting activities, insurance, securities, custodial services, trading commercial banking, and other financial services, follow the requirements of capital adequacy ratio and hiring expertise board of directors that who can provide useful resources in term of know-how pertaining to the bank's products and services to avoid the occurrence of DCR and simultaneously to strengthen the trustworthiness and creditworthiness. Perhaps, this theoretical study could be further examined to gather empirical evidence about the impact of the BoD expertise on DCR involving IB in future research.

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