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Examining the Relationship Between Corporate Governance and Financial Performance in Islamic Banks: Insights from Kenya – A Comprehensive Literature Review

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ABSTRACT

Islamic banks in Kenya play a pivotal role in economic development by facilitating financial intermediation and significantly contributing to GDP and employment. However, recent economic indicators reveal a concerning decline in their financial performance, evidenced by a 1.5% drop in Return on Assets (ROA), a 3% reduction in Return on Equity (ROE), and a 12% increase in non-performing loan (NPL) ratios of the Islamic banks, signaling heightened default risks. This study aims to evaluate the effects of board composition, board independence, and CEO duality on the financial performance of Islamic banks. Grounded in Agency, Stakeholder, and Stewardship Theories, the study employs a comprehensive literature review methodology to analyze existing empirical evidence. The findings and recommendations derived from this analysis will provide valuable insights for stakeholders, aiding in the formulation of governance strategies to enhance financial stability and performance in the Islamic banking sector.

Key Terms: Board composition, board independence, CEO duality, financial performance

1-Background to the Study

Corporate management strategies have garnered significant attention in recent years due to evolving business dynamics, societal shifts, and technological advancements. Identifying the most effective governance practices in diverse contexts—ranging from multicultural organizations to remote work environments—is critical for optimizing performance (Khan et al., 2020; Elkhwesky et al., 2022). As Fischer and Sitkin (2023) argue, corporate governance choices profoundly influence organizational outcomes, improving communication, productivity, and morale when implemented appropriately. Therefore, understanding and applying the right governance strategies has become essential for current and aspiring leaders (Asbari et al., 2020).

Effective corporate governance is vital for navigating the complexities of the global business environment (Hosseini et al., 2020). Without adequate governance structures, organizations risk stagnation and internal conflict, as highlighted by Muhammad et al. (2021). Conversely, robust governance fosters motivation and organizational effectiveness by aligning team efforts and adapting to dynamic conditions. (Asbari et al., 2020) emphasize that organizations seeking enhanced performance must continuously assess and adjust their governance models to meet evolving challenges.

The effectiveness of corporate management practices depends on situational factors and leadership approaches (Purwanto et al., 2020). For instance, centralized governance may excel in crisis scenarios requiring swift decision-making but hinder creativity in stable environments (Bömelburg & Gassmann, 2024). In contrast, participatory governance encourages innovation and employee satisfaction but may falter during emergencies (Zhiyenbayeva et al., 2022). Governance strategies should also align with team expertise; directive approaches may suit less experienced teams, while highly skilled teams often thrive under laissez-faire or delegative styles. Tailoring governance models to team dynamics and organizational needs remains key to sustained success.

2- Corporate Governance

Corporate governance provides a structured approach to channeling organizational efforts toward achieving objectives while managing risks and opportunities. Effective governance requires commitment, adaptability, and a readiness to address the unexpected (Carstense et al., 2023). Aureli et al. (2020) highlight that governance practices vary, involving prescriptive, promotional, or reorienting actions based on organizational needs. This flexibility is critical in aligning corporate management with organizational goals and addressing challenges that impact financial performance. Particularly for Islamic financial institutions, corporate governance is indispensable for navigating unique challenges posed by Shariah principles, such as the prohibition of high-interest ventures, ensuring ethical investments, and maintaining financial stability (Jan et al., 2021; Muhammad et al., 2021; Yusuf et al., 2024).

The structural elements of corporate governance, such as board activity, size, independence, and CEO duality, are pivotal in shaping organizational performance. Regular and effective board meetings enhance decision-making and strategic oversight, while independent directors contribute unbiased perspectives, boosting accountability (Ogbechie & Arije, 2023; Tejedo-Romero et al., 2023). Board size influences governance efficiency, with larger boards offering diverse expertise but potentially complicating decision-making (Khanal, 2023; Khan et al., 2023). CEO duality, where the CEO also serves as board chair, raises concerns over power concentration and its impact on risk management strategies (Athar et al., 2023). Globally, banks in regions like the UK and Malaysia have adopted innovative governance approaches, emphasizing adaptability, employee engagement, and sustainability to address regulatory and market risks, as seen in institutions like Barclays, HSBC, CIMB Group, and Maybank (Jallow et al., 2017; Saleh et al., 2022).

In Kenya, corporate governance plays a critical role in addressing the financial challenges faced by Islamic banks. Poor fiscal performance underscores the need for robust governance strategies to enhance reliability and compliance with new regulations, such as increased capital requirements introduced by the Central Bank of Kenya (Ongongo & Mang'ana, 2022; Wanyoike et al., 2022). Despite the banking sector's resilience, with assets growing from Ksh. 5.2 trillion in 2021 to Ksh. 5.6 trillion in 2022, fluctuating trends and global economic deceleration pose ongoing challenges (Elnahass et al., 2021). This highlights the importance of studying corporate governance practices in Islamic banks to understand their role in navigating economic complexities and ensuring financial stability, particularly within the Kenyan context, where research on this subject remains limited

3-Financial Performance

The financial performance of Islamic banks is a critical measure of their sustainability and success, requiring tailored metrics due to their adherence to Sharia principles. Unlike conventional banks, Islamic financial institutions operate without interest-based transactions or speculative activities, demanding a unique approach to evaluating performance (Hassan & Aliyu, 2018). While traditional indicators like Return on Assets (ROA) and Return on Equity (ROE) remain relevant, they must be contextualized within the framework of Islamic banking principles. Specific to Islamic banks is the Profit and Loss Sharing (PLS) ratio, which reflects the proportion of financing based on profit-sharing arrangements. A higher PLS ratio signifies better alignment with Islamic banking values and suggests more stable earnings. Similarly, the financing-to-deposit ratio (FDR) is a critical measure, especially in contexts like Kenya, where limited Sharia-compliant liquidity management tools challenge the maintenance of optimal liquidity levels (Central Bank of Kenya, 2022).

Efficiency and asset quality are also essential for assessing the financial health of Islamic banks. The Cost to Income Ratio (CIR) is a significant efficiency indicator, as compliance with Sharia principles often results in higher operational costs. A lower CIR signals improved efficiency. Additionally, asset quality is evaluated using the Non-Performing Financing (NPF) ratio, which assesses the performance of Sharia-compliant financing contracts, such as Murabaha, Ijara, and Musharaka, rather than traditional loans (Abduh & Azmi Omar, 2020). This study will evaluate fiscal performance in Islamic banks using key indicators like ROA and ROE, alongside metrics tailored to their unique operational model.

4-Islamic Banks in Kenya

Islamic banking in Kenya has experienced steady growth since its inception in 2007, offering Sharia-compliant financial services to Muslim and non-Muslim clients. The sector has thrived due to increasing demand for alternative banking solutions aligned with Islamic principles. By 2024, three leading institutions dominate the sector: Premier Bank, Dubai Islamic Bank, and Gulf African Bank. The Central Bank of Kenya (CBK) has played a pivotal role in this growth, introducing regulatory amendments such as the 2017 changes to the Banking Act, which recognized Islamic banking products and services. These measures have strengthened the legal framework, enhanced public trust, and ensured Islamic banks meet prudential standards similar to conventional banks.

Despite its growth, the Islamic banking sector in Kenya faces challenges such as a shortage of skilled professionals, intense competition from conventional banks, and the absence of a comprehensive Islamic financial ecosystem, including Takaful and Islamic capital markets (Hassan et al., 2022). These gaps hinder liquidity management and limit product diversification. However, significant opportunities exist for Islamic banks, including financing small and medium enterprises, supporting infrastructure development, and advancing financial inclusion in Kenya. These prospects underscore the sector's potential to contribute meaningfully to the country's economic growth and development

5-Problem Statement

Islamic banks in Kenya play a crucial role in fostering financial inclusion and economic growth by providing Sharia-compliant financial services tailored to individuals and businesses seeking interest-free banking (Simiyu, 2020). These institutions promote economic diversification through ethical investments, support financial stability, and align financial services with the ethical and religious beliefs of a significant portion of the population (Mulama et al., 2020). By mobilizing savings and channeling them into productive investments, Islamic banks contribute to broader economic development and foster equitable financial practices.

Despite their contributions, recent trends highlight the poor fiscal performance of Islamic banks in Kenya. Indicators such as Return on Assets (ROA) and Return on Equity (ROE) have shown a significant decline, with ROA dropping by 1.5% and ROE by 3% in the last fiscal year. Non-Performing Loan (NPL) ratios have risen to 12%, reflecting increased default risks (Central Bank of Kenya, 2023). Kenya's three main Islamic banks, including Dubai Islamic Bank and Gulf African Bank, have reported lower-than-average ROAs compared to conventional banks. For instance, Dubai Islamic Bank posted negative ROAs between 2017 and 2020, while Gulf African Bank reported modest ROAs of 0.6% in 2019 and 0.9% in 2018 (Kinyua et al., 2022; Umar, 2021). Furthermore, NPLs escalated to Ksh. 336.4 billion by mid-2019, up from Ksh. 308.8 billion the previous year, signaling the need for improved financial management and strategies to enhance profitability and sustainability (Kinyua et al., 2022)

6- Objectives of the Research

6-1 General Objective

To analyze the relationship between corporate governance practices and the financial performance of Kenya's Islamic banks.

6-2 Specific Objectives

The specific objectives of the study are:

a) To examine the impact of board composition on the financial performance of Islamic banks in Kenya.

b) To evaluate the influence of board independence on the financial performance of Islamic banks in Kenya.

c) To investigate the impacts of CEO duality on the financial performance of Islamic banks in Kenya

7- Justification of the Study

Commercial banks play a pivotal role in driving a nation's economic growth by facilitating capital flow and financial stability. Islamic banks, operating within a unique ethical and operational framework governed by Shariah principles, require tailored governance practices to ensure their effectiveness and alignment with financial and ethical objectives. This study is justified by the dynamic nature of the global banking environment, which has undergone substantial transformations over the past two decades, including advancements in technology, evolving regulatory landscapes, and shifts in market demands. These developments necessitate a deeper understanding of corporate governance practices that can enhance the financial performance of Islamic banks in this changing context.

Moreover, as highlighted by numerous researchers, a stable and efficient banking system is integral to financing the broader economy and promoting economic development. Islamic banks in Kenya have a dual mandate: to adhere to Shariah principles and contribute to the country's financial inclusion and growth. This study seeks to bridge gaps in existing research by exploring how governance practices—specifically board composition, board independence, and CEO duality—impact the financial performance of Islamic banks. The findings aim to inform strategies for optimizing governance structures, thereby strengthening the resilience and effectiveness of Kenya's Islamic banking sector and its contribution to the overall financial system

8-Significance of the Study

The findings of this study hold significant value for various stakeholders, including the management of Islamic banks, policymakers, and future researchers. For Islamic bank management, the insights gained can serve as a basis for evaluating and refining governance strategies to enhance financial performance. Policymakers, such as the Central Bank of Kenya, can utilize the study's outcomes to design or adjust corporate governance policies tailored to the unique needs of Islamic banks, fostering greater stability and soundness in the sector. Additionally, the research will contribute to academic literature, offering a foundation for future studies exploring corporate governance practices and their impact on financial performance in Islamic banking

9-Scope

This study will primarily assess the relationship between corporate governance practices and the financial performance of Islamic banks. The independent variables in this research include board composition, board independence, and CEO duality, while financial performance serves as the dependent variable. The study will adopt an explanatory non-experimental research design, which focuses on describing and analyzing the characteristics of a specific group or situation at a particular point in time (Kothari, 2004). It will rely on secondary data, and its foundation will be supported by Agency, Stewardship, and Stakeholder Theories, which provide the theoretical framework for examining the influence of governance practices on financial outcomes

10-Definition of Key terms

a) **Board Activity** refers to the frequency, quality, and effectiveness of board meetings, decision-making processes, and oversight functions conducted by the board of directors. This can be measured by factors such as the annual number of meetings, the number of key strategic decisions made, and the extent to which board decisions are implemented.

b) **Board Independence** refers to the presence of independent board members who do not have any financial or business connections with the bank's management. It is evaluated by calculating the ratio of independent directors compared to the total number of board members.

c) **Board Size** is defined as the total number of board members within an organization. This term will be operationalized by counting the number of seats and filled positions on the board of directors of an Islamic bank.

d) **CEO Duality** pertains to the situation where one individual simultaneously holds the position of CEO and board chair. This will be assessed by determining whether the CEO and board chair roles are combined or separated.

e) **Financial Performance** measures a bank's overall profitability, stability, and operational efficiency, typically evaluated using various financial metrics like return on assets (ROA), return on equity (ROE), and other key financial indicators.

11-LITERATURE REVIEW

11.1-Theoretical Framework

This study is guided by Agency Theory, Stewardship Theory, and Stakeholder Theory, which provide foundational insights into corporate governance and its impact on financial performance. A literature review will be conducted to examine existing research, identify gaps, and highlight key trends in the sector. The purpose of this review is to offer context for the current research, establish the theoretical framework, underline the significance of the identified gaps, and justify the need for further investigation into how governance practices influence the financial outcomes of Islamic bank

Agency Theory was introduced by Jensen and Meckling and focuses on the conflicts of interest that arise when shareholders delegate decision-making authority to agents, such as company managers. It emphasizes the need to design governance mechanisms, such as incentive structures and monitoring systems, to align the interests of principals (shareholders) and agents (managers). Fama and Jensen further developed the theory by addressing the separation of control and ownership in large organizations. Agency Theory is instrumental in shaping corporate management practices, focusing on minimizing agency costs and ensuring that managers act in the best interests of shareholders.

Stewardship Theory, introduced by Donaldson and Davis (1991), posits that executives, when given autonomy, tend to act as stewards of an organization's assets, prioritizing the organization's success over personal gain. This theory emphasizes that managers, motivated by professional satisfaction and ethical values, will naturally align their actions with the interests of the organization and its members. Davis et al. (1997) elaborated on this by arguing that a stewardship-oriented board can work cooperatively with stakeholders without excessive monitoring, fostering a mutually beneficial relationship between management and shareholders.

Stakeholder Theory, developed by Freeman (1984), argues that businesses have ethical and moral responsibilities beyond maximizing profits for shareholders. According to this theory, organizations should consider the interests of all stakeholders, including employees, customers, suppliers, communities, and the environment. Stakeholder Theory shifts the focus from shareholder-centric models to a broader perspective that integrates the needs and concerns of all parties affected by a company's decisions. It highlights the importance of balancing these competing interests to ensure sustainable and responsible business practices.

11.2 Empirical Literature

This section reviews existing empirical studies that align with the current research focus on corporate governance and financial performance

11.2.1 Board Composition and Financial Performance

Muiruri (2018) examined the impact of board composition on the financial outcomes of banks in Kenya between 2011 and 2015. Utilizing secondary data from financial statements, CBK reports, and NSE supervision records, the study found that technical expertise within the board composition positively influenced bank performance. However, the research did not explore the negative impacts of gender and board diversity, leaving a conceptual gap in understanding the underlying mechanisms. Additionally, the study was limited to Kenya's retail financial institutions, restricting its generalizability beyond this sector. In contrast, Al Farooque et al. (2020) focused on the Thai Stock Exchange, analyzing the effects of board structure, audit committee features, and ownership on market-based fiscal performance. Their findings highlighted that management ownership had a positive impact on financial performance, while other factors like board size and dual roles were also significantly correlated with fiscal outcomes. This study, however, has contextual limitations as it focuses solely on commercial banks in Thailand, limiting its applicability to other regions.

Al-Ahdal et al. (2020) investigated the influence of corporate governance practices on financial performance in India and GCC countries, finding that board accountability and audit committee features significantly affected performance. However, their study targeted only listed banks, making its results less generalizable to the broader Islamic banking sector in Kenya. George and Ukpong (2024) compared governance mechanisms and environmental disclosures in Nigeria and Ghana's oil and gas sectors, finding that board composition had significant impacts on disclosures in Ghana but not in Nigeria. Their research emphasized the need for enhanced board diversity in Nigerian firms, highlighting an area for further investigation. These studies collectively underscore the varying effects of board composition and structure on financial performance across different regions, highlighting gaps in understanding governance practices in Islamic banks

11.2.2 Board Independence and Fiscal Performance

Qadorah and Fadzil (2018) explored the relationship between board independence, meeting frequency, and overall fiscal performance in Jordanian-listed firms. Using a cross-sectional approach and Return on Assets (ROA) to measure firm performance, the study found a positive correlation between board independence and fiscal outcomes, indicating that increased board independence benefits firm performance. However, no significant link was found between meeting frequency and performance, suggesting that regular board meetings alone do not significantly impact firm achievement. Similarly, Zaid et al. (2020) investigated the effects of professional shareholders and board independence on CSR disclosures, revealing that higher board independence enhances the positive impact of external stakeholders, such as government and foreign investors, on CSR reporting.

In Nigeria, Sani (2020) examined the influence of managerial ownership and board independence on the fiscal outcomes of listed firms, finding that board independence had a statistically insignificant positive effect on performance. Al-Gamrh et al. (2020) studied the moderating impact of board independence and foreign ownership on financial performance in UAE firms, revealing that Arab foreign ownership negatively affects performance, whereas non-Arab ownership positively influences financial outcomes. Ooko et al. (2024) also explored this relationship in Kenyan firms, showing that board independence moderates the impact of ownership structures on corporate risk, with independent directors enhancing risk management effectiveness. These studies collectively highlight the significance of board independence in shaping financial and risk outcomes across different regions and contexts

11.2.3 Chief Executive Officer Duality and Financial Performance

Basahi and Muharram (2022) explored the impact of organizational governance characteristics, specifically CEO duality and gender diversity, on the financial outcomes of Swedish banks from 2017 to 2021. Using data from DataStream and yearly reports, their study employed a random effects framework and found a negative and significant relationship between CEO dual roles, gender diversity, and ROE, with little impact on ROA. Their findings align with existing research that shows board diversity can adversely affect fiscal performance, as more female board members contribute to negative results. The study recommended that commercial banks carefully manage CEO duality and gender diversity in recruitment, highlighting the financial implications of governance practices beyond ethical considerations. Furthermore, the study emphasized that board diversity can lead to conflicts and sub-group formations, which may harm firm performance.

In contrast, Dogan et al. (2023) examined CEO duality's impact on firm performance within Turkish firms listed on the Istanbul Stock Exchange during 2009-2010. Their study found a negative link between CEO duality and firm performance, supporting the agency theory that such dual roles create conflicts of interest, adversely affecting corporate governance.

Similarly, Hsu et al. (2021) investigated CEO duality in Taiwanese firms, noting that while there was no direct link between dual roles and performance, information costs played a crucial moderating role. Their research revealed that dual leadership can complicate firm performance, particularly when information expenses are high. On the other hand, Yusuf and Yahaya (2023) focused on CEO attributes such as nationality and tenure in Nigerian firms, finding that these factors significantly influenced financial outcomes. Their study provided empirical support for the agency theory, which highlights the conflicts between shareholders and managers driven by managerial decisions. These studies contribute to a broader understanding of how CEO duality and other governance characteristics impact organizational performance.

12-Analysis of Empirical Review on Corporate Governance Practices and Financial Performance of Islamic Banks

This analysis synthesizes findings from the reviewed empirical literature, focusing on board independence, board composition, and CEO duality in Islamic banks. It highlights key insights, presents limitations observed in existing studies, and provides tailored recommendations to enhance financial performance within the Islamic banking sector.

12.1 Findings

12.1.1 1Board Composition and Financial Performance

The relationship between board composition and financial performance in Islamic banks reveals mixed outcomes. Technical expertise, such as financial acumen and regulatory knowledge, has been found to positively impact financial performance (Muiruri, 2018). However, gender diversity and overall board diversity have shown inconsistent or even negative effects in some contexts (Basahi & Muharram, 2022). Key features like board autonomy, meeting frequency, and size play significant roles, though these results often vary depending on regional and sectoral differences (Al Farooque et al., 2020; George & Ukpong, 2024). The findings are often context-specific, highlighting the need for further exploration into cultural and environmental factors.

12.1.2.Board Independence and Financial Performance

Board independence generally strengthens financial performance by improving oversight and reducing agency problems. Studies show that independent boards enhance monitoring and accountability in many cases (Qadorah & Fadzil, 2018; Zaid et al., 2020). Yet, independence's impact can sometimes be statistically insignificant or vary depending on the ownership structure and governance frameworks (Sani, 2020; Al-Gamrh et al., 2020). Independent boards have also been shown to effectively moderate risks and improve decision-making processes, making them crucial for robust corporate governance (Ooko et al., 2024). The mixed results suggest that cultural differences in governance practices play a significant role.

12.1.3 CEO Duality and Financial Performance

CEO duality, where one individual holds the roles of CEO and chairman, often negatively affects financial performance due to reduced oversight (Dogan et al., 2023; Basahi & Muharram, 2022). This dual leadership structure can foster conflicts of interest and lead to poor corporate governance outcomes. The impact of CEO duality is context-dependent, influenced by factors like information costs and organizational governance frameworks (Hsu et al., 2021). The literature suggests a trade-off: while duality may promote unified leadership, it risks agency issues and governance failures.

13-Recommendations

13.1 Board Composition

To improve board composition in Islamic banks, it is essential to focus on enhancing technical expertise by appointing board members with relevant financial, regulatory, and Sharia-compliance backgrounds. Banks should also promote balanced diversity, ensuring that while gender and cultural diversity are encouraged, these efforts do not compromise group dynamics. Additionally, maintaining an optimal board size is critical to ensuring efficiency and alignment with industry standards.

13.2 Board Independence

To strengthen board independence, Islamic banks should aim to increase the proportion of independent directors to improve monitoring and accountability. It is vital to implement periodic reviews to ensure directors remain independent, incorporating tenure limits and stringent criteria for assessing conflicts of interest. Training programs for independent directors should also be provided to enhance their understanding of Sharia principles and banking practices.

13.3 CEO Duality

To mitigate the risks associated with CEO duality, Islamic banks should adopt a clear separation between the roles of CEO and chairperson. Where duality cannot be avoided, strong independent committees should be established to oversee decision-making. It is also crucial to assess the organizational context, including operational costs and governance challenges, before making leadership decisions.

14-Conclusion

The empirical literature on corporate governance in Islamic banks reveals the critical influence of board composition, board independence, and CEO duality on financial performance. Findings highlight the importance of balanced and diverse boards, clear leadership roles, and independent oversight mechanisms in fostering better organizational performance. Islamic banks must focus on tailoring governance practices to their specific context, ensuring alignment with Sharia principles while adopting global best practices. Future research should aim to bridge existing gaps by investigating these dynamics further, particularly in different jurisdictions, to enhance the effectiveness of governance frameworks in Islamic banking.

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