

## The influence of Corporate Governance on Credit Rating in Pakistan

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### Abstract

*Credit rating agencies have great significance in the growth of the financial industry by giving confidence to borrowers and lenders through expressing their opinion on the ability of the institution to meet its financial obligation through credit ratings. Therefore, if the governance structure is weak, credit rating agencies are likely to expect poor financial position and vulnerability of the stakeholders' interests. The purpose of this study is to determine whether the corporate governance characteristics of Islamic banks influence Islamic banks' credit ratings. Data is calculated from the annual reports of 22 banks in Pakistan for 14 years from 2007 to 2014. The results show that the board size, board members' independence, CEO tenure, blockholders, foreign investors, Shariah board size, education levels of Shariah supervisors, and Shariah board expertise negatively affect credit rating when bank-specific financial variables are used as the control variables. On the other hand, credit rating is positively correlated with board independence, foreign directors, women directors, board meetings, listing shares, size of audit committee members, audit committee meetings, changes in the structure of the shariah supervisory board, and foreign shariah experts. As a result, Islamic banks in Pakistan show strong corporate governance, leading to better credit ratings.*

**Keywords:** *Corporate Governance, Credit rating, Islamic Corporate Governance, Ordered Logistic Regression, Islamic Banks.*

## **Introduction**

Credit rating by rating agencies plays a crucial role in bridging the gap between the fund issuer and buyer in the capital market by measuring the likelihood of a firm defaulting. In the evaluation process, rating agencies consider both financial and non-financial data. Due to the integrity of disclosed information, C.-M. Lin, C. C. S. Chen, S.-Y. Yang, W.-R. Wang, and Trade (2020a) find a positive correlation between governance and credit rating. This is because the knowledge asymmetry issue between management and stakeholders is reduced.

Strong governance reduces the agency problem, which benefits the organization in terms of higher credit rating. In comparison, the credit rating is a communication mechanism for stakeholders to assess a bank's solvency (Ashbaugh-Skaife, Collins, & LaFond, 2006). Extensive studies have been documented on Corporate Governance with organization performance Hossain (2022); Tseng et al. (2019), but there is minimal work completed on the Corporate Governance of Islamic banks with credit ratings (Alatassi & Letza, 2018; Hassan, Naughton, Srikanthakumar, & Schwartz, 2009).

Consequently, Islamic Corporate Governance insists on resolving stakeholder conflicts according to Shariah principles. As a result, Shariah supervisory boards ensure that all financial institution functions comply with Shariah principles (Mansoor et al., 2020). Islamic banking is based on asset-back financing and profit-and-loss sharing. In contrast, Traditional banking, on the other hand, aims to maximize shareholder profits and interest. Therefore, the Islamic banking system is considered more stable and sound in the financial industry than its counterpart (Hasan & Dridi, 2010). According to IFSB rules, the shariah supervisory board role subjugates to the issuance of a fatwa on the permissibility of a financial instrument, compliance of fatwas in operations process, calculation and disbursement of zakat, disposal on haram income, distribution of income, and expense on shareholders and investment account holders (Elasrag, 2022; IFSB, 2006). According to IFSB, the minimum size of SSB is three to six members (Malik, Ullah, & Ullah, 2020).

The fundamental purpose of Corporate Governance is value addition. Therefore, good practices in an organization help stakeholders by protecting and providing an equitable reward to shareholders for their investment, rewarding employees for their intellectual contribution and hard work, adequately rewarding and giving confidence to depositors, and compensating creditors for their resource's organization. It also gives responsibility to organizations toward society in terms of Corporate social responsibility and taxes to the government (Castrillón, 2021).

Credit rating plays a significant role in improving market efficiency in three different ways: reducing information asymmetries on rating security, mitigating agency problems by identifying the level of risk that an agent can take on behalf of the principal, lastly, in the presence of multiple debt investors, downgrading the scale helps to resolve collective action problem and monitoring performance (Naciri, 2015).

The study investigates how corporate governance characteristics of Islamic banks, including the board of directors, CEO characteristics, ownerships, audit committee, and shariah board attributes, affect credit ratings. The paper's reminder is structured as follows: a literature review, research hypothesis, conceptual framework, data analysis, findings, and discussion section of the study.

## **Literature Review**

Corporate governance plays a vital part in ensuring organizational sustainability in emerging markets. Corporate governance sets the principles and procedures on how the organization needs to operate and how the interest of the stakeholders are protected (Sarwar, Al-Faryan, & Saeed, 2022). According to C.-M. Lin, et al., (2020b), financial performance is vital to an organization's credit rating. Additionally, non-financial data like company governance illustrates how shareholders and stakeholders are related. Previous studies show that better relationships between shareholders and stakeholders reduce information asymmetry, leading to higher credit ratings through quality financial reporting.

According to Bezawada, Adaelli, and Issues (2020), The Basel Committee on Banking Regulation strongly emphasizes the necessity of good corporate governance standards in the banking sector and throughout society. A bank's corporate governance is concerned with the organizational structure that helps achieve the organization's objectives and goals. An effective board has excellent significance in monitoring and advising management. Since the global crises, Good Governance and credit risk control are becoming hot topics for researchers and practitioners. Although, less research is looking at the association between corporate governance and credit rating (Arora, 2020; Rihab Grassa, 2016; Lin et al., 2020b; M. Mansoor, N. Ellahi, & Q. A. J. I. T. J. E. M. A. S. T. Malik, 2019b; Seetharaman, Patwa, & Nagarajan, 2019).

Board composition has a critical role in managing the resources of an organization. According to Chung and Zhu (2021), It has been shown that companies with expert outside directors in China perform better than inside expert directors; the reason is that the board composition remains the same even as the environment changes. Information sharing by non-executive directors to outside directors helps them access and verify the information provided by the CEO, which allows them to perform better in corporate decision-making (Hoitash & Mkrtchyan, 2022). A board's role is to reduce the risk of failure and improve organizational performance by using organizational resources optimally. According to resource dependence theory, the corporate board's role is to arrange corporate resources and minimize the organization's environmental uncertainty. The corporate board could improve or enhance the firm performance by giving guidance and sharing valuable information with management (Mansoor et al., 2020). Chief Executive officers (CEO) are appointed to manage the organization on behalf of the shareholders and maximize their benefits. In other parts of the world, capitalism is in the hands of a few wealthy families, or the government and management work to safeguard their assets and wealth (Jones, 2004; Steier & Morck, 2005).

Agency theory by Michael and William (1976) focuses on separating ownership and control of the organization and managers' work for others (Hao, Moreira, & Haq, 2017). Agency theory gives organizations governance systems to manage agents. Despite agency theory, stewardship emphasizes teamwork and cooperation (Sundaramurthy & Lewis, 2003). Stewardship theory requires directors to serve as stewards. It guarantees they will behave in the company's best interests rather than their own. Directors require organizational goals developed by the stakeholder theory. The study explained, "Effective organizations must consider every relationship that could affect their goals. Stakeholder management is pragmatic. An effective company will manage critical relationships regardless of its goal" (Hao et al., 2017).

## **Board of Directors Characteristics**

### **Board Size**

It is generally believed that restricting the number of members on the board to a certain threshold positively influences board size and is considered a fundamental attribute of corporate governance; however, few studies discuss board size's relationship with credit rating. There is evidence of a conflicting relationship between board size and company performance. Mansoor, Ellahi, and Malik (2021) demonstrate a positive correlation between board size and Pakistan's Islamic banks' credit ratings. The Islamic financial institutions employ shariah supervisory board members as Shariah consultants to ensure Shariah conformity. They are responsible for directing, reviewing, and monitoring the actions of the IFIs.

The audit committee must include three members with experience in accounting and finance per the corporate governance rules, and the chairperson is one of the three members. The audit team must also preserve the privacy of all documents, data, and company records and report any potential conflicts of interest to the Board of Directors. Internal auditors must also adhere to professional ethics like professional independence, disclosure of information, and professionalism. Ahmadi, Nakaa, and Bouri (2018); Ali, Singh, and Al-Akra (2018) emphasized the significance of internal auditors and their independence from management for good corporate governance and credit ratings.

H1: Board Size (BS) has a positive relationship with the credit rating of Islamic banks.

H2: Shariah Board size positively impacts Islamic banks' credit ratings.

H3: Audit committee size has a significant positive impact on the credit ratings of Islamic Banks.

### **Board Independence**

There is general agreement that independent directors are fair in assessing an organization's performance and are effective in monitoring management (Guo & Masulis, 2015; Hermalin & Weisbach, 1998). The result shows that higher board independence results in a better outcome for the shareholders, for instance, higher firm value and performance and high-quality financial reporting. Moreover, independent board members are valuable because they can make good rational decisions. Karkowska and Acedański (2020) conducted an empirical study that tested how board structure and quality affected the organization's risk incentives. We formulate the following hypothesis in light of the literature mentioned above.

*H4: Board independence positively affects the credit rating of Islamic banks.*

### **Foreign Directors and Investors**

According to Bremholm (2015), foreign directors can boost corporate performance. Quintana-García & Benavides-Velasco (2016) found no correlation between foreign directors and dividend distribution arrangements in India and Korea. Assenga (2021) shows a good association between the number of foreign directors on the board, ROA, ROS, and EPS. The study confirms the resource dependency concept that foreign directors can increase organizational performance through their expertise, experience, and network connections.

This study compared local and foreign directors who are less educated about local accounting rules and management techniques. According to agency theory, having foreigners on the Board of Directors may influence how the bank is run and may even assist in reducing the bank's agency cost. In addition, there is a significant positive relationship between foreign ownership of Jordanian-listed companies and credit rating.

Quttainah, Song, and Wu (2013) discover that foreign investors encourage directors to produce quality financial statements for easy and quick decision-making. According to M. Mansoor, N. Ellahi, and Q. A. Malik (2019a), there is a positive relationship between foreign investors and the credit ratings of Islamic banks. According to the Bank Nagara Malaysia Guide, foreign investors increase the board's expertise and ability to perform their responsibilities more efficiently and effectively.

*H5: The percentage of foreign directors on the board positively impacts Islamic credit ratings.*

*H6: The percentage of foreign investors positively impacts the credit rating of Islamic banks.*

### **Women Directors**

The impacts of gender diversity and the presence of women on corporate boards of directors are subjects that have recently attracted more attention, according to research. The findings show that gender diversity and board volatility have a positive connection. Dimovski, Lombardi, Ratcliffe, and Cooper (2016), in the banking industry, suggest that board size negatively correlates with the percentage of women directors, which is more significant at small banks than at large banks. Yang, Yang, Gao, and Trade (2019) looked at the relationship between corporate social responsibility and the number of female directors on boards. It has been demonstrated empirically that there is no statistically significant difference in the proportion of female directors, the proportion of female independent directors, the educational background, or the financial pay of female directors.

*H7: The percentage of women directors on the board positively impacts Islamic banks' credit ratings.*

*H8: The women scholars in Shariah Supervisory Board positively impact Islamic banking credit ratings.*

### **Busy Directors**

The impact of dual CEO responsibilities and directorships on Malaysian company performance. They found that dual CEO responsibilities and having several directorships were linked to poor financial performance. Char-Lee and Chee-Wooi (2018) explored the impact of BDs on FP (firm performance), and it was shown that BDs had a statistically significant influence on FP. James, Wang, and Xie (2018) examined the association between busy directors and financial planning (Firm performance). James et al. (2018) studied if busy directors influence a business's performance depending on where the firm is situated in the United States.

*H9: The percentage of busy directors on the board negatively impacts the credit ratings of Islamic banks.*

### **Board meeting**

The term "board meeting" describes how many meetings the board members hold throughout a fiscal year. An effective board meeting is crucial in preventing corporate fraud and promoting good corporate governance. Regular meetings strengthen board members' organization and communication as part of the governance process Eluyela et al. (2018) examined the relationship between board meetings and business worth, and the findings indicated a positive correlation between them. Audit committee meetings are a requirement imposed by all financial regulatory agencies. Bansal and Sharma (2019) discovered a strong association between auditors' meetings and the performance of Indian enterprises. They argued that auditors could not perform better using their professional knowledge and

expertise unless there was no coordination and teamwork between auditors and the management. In this study, Ozcan (2021) investigates the influence of audit committees on corporate value. The study indicates a correlation between the dependent variable company value and the independent variables' number of audit committee meetings, members with financial expertise, and audit board size.

*H10: Board meeting positively impacts the credit rating of Islamic banks.*

*H11: There is a positive relationship between Audit committee meetings and credit ratings of Islamic Banks.*

### **CEO Duality**

This is known as CEO duality when a person serves as CEO and chairman. Similarly, it revealed that the number of voluntary disclosures made by businesses listed on the Singapore Exchange was unrelated to CEO duality. CEO duality, CEO founder, CEO tenure, the CEO being the only insider on the Board of Directors, and the CEO being the only person who signs the letter to shareholders in the annual report are just a few of the traits that have been used in previous studies to gauge CEO power (Mishra & Kapil, 2017).

*H12: The CEO duality has a significant negative impact on the Credit rating of Islamic banks.*

### **Tenure of CEO**

The status of the CEO and the power distribution on the Board of Directors are influenced by several significant factors in addition to the CEO's tenure. According to agency theory, non-executive directors on boards of directors and their oversight role as independent entities would also lessen conflicts of interest between shareholders and CEOs during board meetings. (Bigdelo et al., 2022). The influence of CEO tenure on firm performance while considering the mediating role of MTM (Members of Top Management) that govern this influence. As members of the top management team (TMT) are closest to the CEO in the firm, he examines the CEO-TMT interface as a mechanism to influence the CEO. The study shows that CEO tenure indirectly impacts performance by influencing a firm's willingness to take risks in TMT and pursue entrepreneurial initiatives.

*H13: The CEO's tenure on the board negatively impacts Islamic banks' credit ratings.*

### **CEO Founder**

The CEO makes crucial financial and investment choices that affect the company's risk and value. Due to their influence over the boards and other team members, they might affect business risk. The research claims that a CEO's ability to raise risk depends on the project's anticipated outcome. The study did a meta-analytic investigation of how institutions affect the success of the founder and professional CEO (Zaandam et al., 2021).

*H14: The CEO founder has a negative impact on the credit ratings of Islamic banks.*

### **Blockholders**

Ibrahimi and Ahmad (2020) investigated blockholder ownership and company performance and viewed it as a tool for forcing management to increase the wealth of minority shareholders. As a result, blockholders were discovered to have a positive influence on the firm's performance. The study analyzes the effect of blockholders on performance in groups with 50% or more ownership by statistically investigating the relationship between the total number of blockholders, their cumulative fractions, and the Herfindahl Index. The analysis found a negative correlation between the dependent and independent variables.

*H15: The number of blockholders negatively affects the credit rating of Islamic banks.*

### **Percentage of Listing**

The importance of corporate governance, accountability, disclosure, and transparency has increased in recent years (Aljifri, Alzarouni, Ng, & Tahir, 2014; Cheung, Chung, Tan, & Wang, 2013). Following the international financial reporting and corporate disclosure standards, Nazir and Afza (2018) studied the impact of ownership concentration, family, and foreign ownership on the performance of companies listed on the Istanbul Stock Exchange from 2005 to 2009. During 2008-2009 - when the economy was in crisis - foreign ownership concentration lost its impact on market performance, possibly due to the global origin of the crisis. Accounting data show that family and foreign ownership concentrations on firm performance diminish and may even disappear. Researchers and practitioners agree that sharing financial and non-financial information may help organizations function better by reducing agency problems.

*H16: Ceteris paribus, the percentage of listing shares has a positive effect on the credit ratings of Islamic banks.*

### **Shariah Supervisory Board Cross (Interlocking) Membership**

According to Resource Dependency Theory, directors connect corporations to the outside world. According to the RDT, the Board of Directors provides crucial resources for businesses; thus, board members who work together can supply information about other organizations' actions and policies. SSBs in Islamic banking require cross-membership because most SSB scholars serve on multiple IB boards (Rihab Grassa, 2016; Rahman & Haron, 2019). Although SSB members have access to sensitive material, some experts believe their cross-memberships may hurt the board's functioning (Salman & Nawaz, 2018). Interlocking Shariah researchers improve Islamic bank financial performance and reduce Shariah risk; interconnecting Shariah members boosted Islamic bank performance.

*H17: Board Cross-membership positively impacts Islamic banks' credit ratings.*

### **Shariah Supervisory Educational Qualification**

Since they make decisions, Shariah Supervisory Board members must have academic credentials to give sharia rules (Almutairi & Quttainah, 2019; Hamid & Ginena, 2015). The SSB's ability to evaluate an issue, have innovative ideas, and establish policies improves with education, improving the organization's success.

Credentials determine board members' quality, and qualified board members improve corporate performance. Competent people are essential assets (Ingley & Van der Walt, 2001). The Resource Dependency Theory views board members as a company's resource and vital to its competitiveness.

*H18: SSB educational qualification positively impacts Islamic banks' credit ratings*

### **Shariah Board Expertise**

Shariah Supervisory Board is not only desired not just for their sharia education but also their experiences. The efficacy of the SSB's tasks, responsibilities, and activities will be enhanced if its members meet specific competence requirements. Shariah academics evaluate the Shariah conformity of financial instruments but are unfamiliar with their intricate operating procedures. Nomran, Haron, and Hassan (2018) claimed that an untrained Shariah scholar is incapable of making sound decisions without the assistance of bankers or economists.

*H19. SSB expertise will be positively associated with Islamic banking credit ratings.*

### Shariah Board Composition

It represents the addition and deletion of new board members into the board over the year (Farag, Mallin, & Ow-Yong, 2018). Change in the board's composition is a positive sign since new members offer fresh experience, skills, and ideas and are highly self-driven to prove their capabilities. The Resource dependence theory views the makeup of the board of directors as a critical instrument for the organization's survival and development. In contrast, the AGT (Agency Theory) states that Board composition elements indicate the extent to which management controls the board. Alman (2012) investigated the concept empirically and found that annual variations in the structure of SSBs positively influence the risk-taking of Islamic banks.

*H20: The annual change in SSB composition will be positively associated with Islamic banking credit rating*

### Control Variables/firm-specific variables

Research on corporate governance and credit rating shows that numerous company-specific financial characteristics affect credit ratings (Arora, 2020; Bezawada & Adaelli, 2020; Huu Nguyen, Thuy Doan, & Ha Nguyen, 2020; Mansoor et al., 2019a; Sarwar et al., 2022). LEV, ROA, total debt, and (LSIZE). Thus, a high LEV ratio indicates a high failure likelihood, while a low ROA value indicates a low default probability (Aman & Nguyen, 2013; LaFond, Collins, & Ashbaugh-Skaife, 2006). Since scale economies in the underwriting scenario show that debt size has an inverse relationship with bond yields and a positive link with credit ratings, the log of the total liabilities issued is added. The firm's size log was also assessed because larger firms are less dangerous and have better ratings than smaller ones (Aman & Nguyen, 2013). Control variables are gathered for the years in which sample banks received credit ratings.

### Conceptual Framework

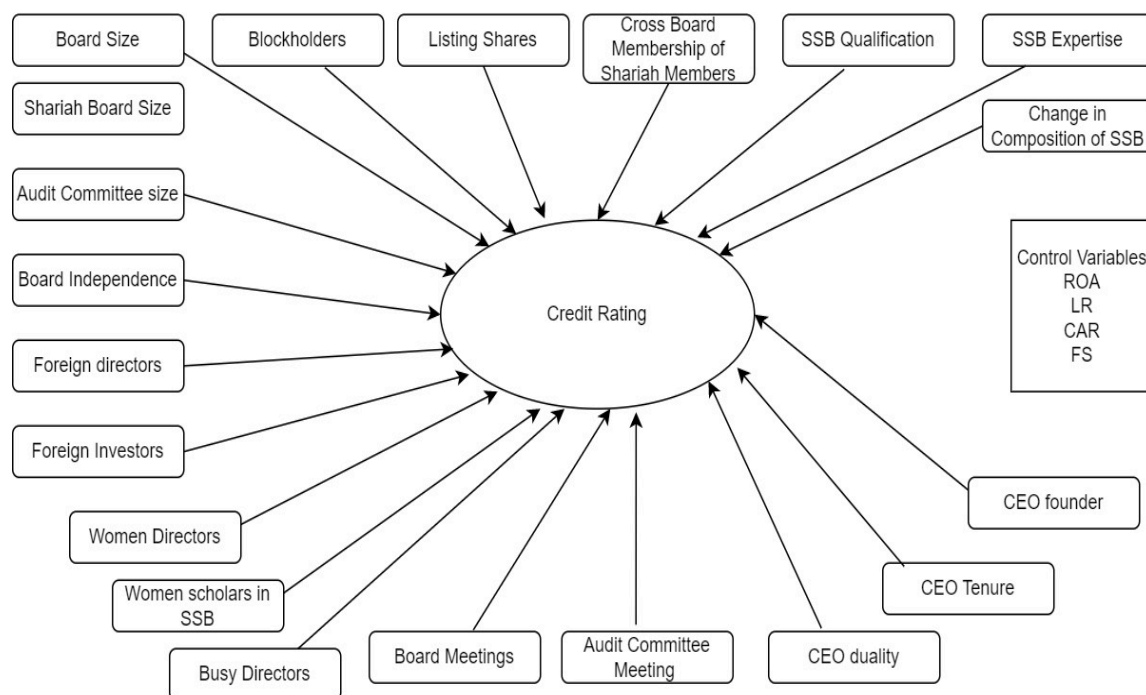


Figure 1: Theoretical Research Framework

## Methodology

The dependent and independent variables data are collected from the bank's annual reports, the State Bank of Pakistan Database, the Pakistan Stock Exchange database, and local brokerage firms like Standard Capital and investing.com. In addition, long-term crediting issued by the rating agencies is considered in this study. This study used SATA software for data inferencing. Data is collected for the last 14 years, from 2007 to 2020, with a total of 204 observations from 22 banks operating as full-fledged Islamic and Islamic windows banks in Pakistan. The descriptive statistics, a test of the significance of variables, and regression analysis using an equational model technique discuss below.

Data consists of corporate governance attributes of Islamic banks and credit ratings issued by credit rating agencies in Pakistan. Attributes of corporate governance include characteristics of the Board of Directors, CEO characteristics, ownership structure, Audit Committee, and last, Shariah Supervisory Board attributes, as shown in Table 2. Control variables represent the financial characteristics of Islamic banks. These include return on assets, leverage ratio, interest coverage (applicable on conventional banks), firm size, and debt issue size.

Table 1  
Corporate Governance Attributes-Independent Variables

### Board of Directors Attributes

Variables	Islamic banks	Definitions	References	Hypothesis
Board size	ISBS	Number of directors on the board	( <a href="#">Rihab Grassa, 2016</a> )	+
Board Independence	ISBI	% of independent directors sitting on the board of directors	( <a href="#">Aslan, 2020</a> ; <a href="#">Chakravarty &amp; Rutherford, 2017</a> )	+
Foreign directors	ISFD	% of foreign directors in BOD	( <a href="#">Assenga, 2021</a> ; <a href="#">Doğan &amp; Ekşi, 2020</a> )	+
Women directors	ISWD	% of women in BOD	( <a href="#">Hillman, Shropshire, &amp; Cannella Jr, 2007</a> )	+
Board Meetings	ISBM	No of board meetings	( <a href="#">Eluyela et al., 2018</a> ; <a href="#">Lipton &amp; Lorsch, 1992</a> )	+
Busy directors	ISBD	% of directors who are involved in more than three committees.	( <a href="#">Bezawada &amp; Adaelli, 2020</a> )	-
<b>CEO Attributes</b>				
CEO duality	ISCD	1 if CEO is also the chairman of the board, otherwise 0	( <a href="#">Tuggle, Sirmon, Reutzel, &amp; Bierman, 2010</a> )	-
Tenure of CEO	ISTC	No of years in a position	( <a href="#">Tuggle et al., 2010</a> )	-

CEO founder	ISCF	1 if CEO is also the founder of the bank, otherwise 0	( <a href="#">Mansoor et al., 2021</a> )	-
<b>Ownership structure</b>				
Block holders	ISBH	Number of block holders, where block holders are defined at the 5% ownership level	( <a href="#">Ibrahimy &amp; Ahmad, 2020</a> )	-
Foreign investors	ISFI	Percentage of shares held by foreign investors	( <a href="#">Assenga, 2021</a> )	+
Listing Shares	ISLS	Market Capitalization	( <a href="#">Alnabsha, Abdou, Ntim, &amp; Elamer, 2018</a> )	+
<b>Audit Committee</b>				
Audit Committee size	ISACZ	Number of directors on the audit committee	( <a href="#">Arora, 2020</a> ; <a href="#">Aslan, 2020</a> )	+
Audit Committee Meetings	ISACM	Number of audit meetings held in a year	( <a href="#">Arora, 2020</a> )	+
<b>Shariah Board</b>				
Shariah Supervisory board size	SBZ	Number of scholars in the SSB	( <a href="#">Mollah, Hassan, Farooque, &amp; Mobarek, 2017</a> )	+
Shariah supervisory board Cross-membership	SSBCM	% of scholars who sit in other banks too	( <a href="#">Butt et al., 2022</a> ; <a href="#">Rehman &amp; Ali, 2022</a> )	+
Shariah's supervisory educational qualification	SSEQ	% of scholars with Shariah qualification	( <a href="#">Ryu, Piao, &amp; Nami, 2012</a> )	+
Shariah board expertise	SBE	% of scholars with accounting and finance knowledge	( <a href="#">Ryu et al., 2012b</a> )	+
Change in composition of SSB	CCSSB	Dummy variable 1 for change or 0 for no change	( <a href="#">Nomran et al., 2017</a> )	+
Shariah Women Scholars	SWS	Percentage of females who are shariah scholars on the board	( <a href="#">Mansoor et al., 2020</a> )	+
Foreign shariah scholars	FSS	Percentage of Shariah scholars with foreign nationality	( <a href="#">Mansoor et al., 2020</a> )	+
<b>Control Variable</b>				
Return on assets	ISROA	Net income to total assets	( <a href="#">Arora, 2020</a> ; <a href="#">Mansoor et al., 2020</a> )	
Leverage ratio	ISLR	The ratio of total debt to total assets	( <a href="#">Grassa, 2016</a> )	

Capital Adequacy Ratio	ISCAR	Total capital over risk-weighted assets	(Irawati et al., 2019)
Firm size	ISFS	Natural logarithm of total assets	( <u>Mansoor et al., 2019</u> )

Table 2  
Credit Rating Scale-Dependent Variable

Debt rating	Rating Score	Grade
AAA	7	Investment-grade
AA+	6	Investment-grade
AA	6	Investment-grade
AA-	6	Investment-grade
A+	5	Investment-grade
A	5	Investment-grade
A-	5	Investment-grade
BBB+	4	Investment-grade
BBB	4	Investment-grade
BBB-	4	Investment-grade
BB+	3	Speculative
BB	3	Speculative
BB-	3	Speculative
B+	2	Speculative
B	2	Speculative
B-	2	Speculative
CCC+ OR CC	1	Speculative
CCC	1	Speculative
C	1	Speculative
D	1	Speculative

*Securities exchange commission of Pakistan; (Mansoor et al., 2019)*

### Data Analysis

Using appropriate statistical techniques to generate meaningful results is necessary to examine the relationship between corporate governance characteristics and credit scores. Firstly, descriptive statistics explains the characteristics of all variables selected in the sample. This study uses regression and correlation methods to test the relationship between dependent and independent variables empirically. Finally, STATA software is used to test the multicollinearity between independent variables. A high correlation between variables raises the problem of bias estimators; hence, the study suggested the value of a variance inflation factor of less than ten as an acceptable range. This study has employed four tests for data analysis, including descriptive statistics, Pearson correlation, multicollinearity, and Ordered Logistic Regression.

Table 3  
 Descriptive Statistics of Islamic Banks

<b>Variables</b>	<b>Obs</b>	<b>Mean</b>	<b>Std. Dev.</b>	<b>Min</b>	<b>Max</b>	<b>VIF</b>
ISBS	204	8.642157	1.526252	4	14	1.860
ISBI	204	0.279755	0.1162825	0	0.71	1.440
ISFD	204	0.161575	0.2642214	0	2.58	1.550
ISWD	204	0.027314	0.0527876	0	0.25	1.480
ISBM	204	6.759804	2.570418	3	15	1.890
ISBD	204	0.014461	0.0565355	0	0.6	1.570
ISCD	204	0	0	0	0	0
ISTC	204	3.813725	2.9536	1	14	1.620
ISCF	204	0.078431	0.5559579	0	4	1.620
ISBH	204	2.563725	1.619115	1	6	1.870
ISFI	204	0.091066	0.1585581	0	0.78	1.500
ISLS	204	10.65949	2.747619	0.003295	16.0347	1.750
ISACZ	204	3.740196	0.797874	2	6	1.680
ISACM	204	5.607843	3.019336	1	28	2.010
SBZ	204	2.362745	1.067101	1	4	1.860
SSBCM	204	0.823726	0.2781534	0	1	1.580
SSEQ	204	0.97152	0.0851492	0.67	1	3.600
SBE	204	0.995098	0.070014	0	1	1.060
CCSSB	204	0.166667	0.3735948	0	1	1.230
SWS	204	0	0	0	0	0
FSS	204	0.034722	0.1157398	0	0.5	4.240
ISROA	204	0.021084	0.1962087	-1.51852	1.8	1.150
ISLR	204	0.81291	0.3045561	-0.93917	0.98023	1.360
ISCAR	204	0.147587	0.0508905	0.0385	0.465	1.390
ISLNTA	204	11.71489	2.226192	6.431331	18.75245	2.430

Table 4  
Pearson Correlation Coefficient

	<b>ISBS</b>	<b>ISBI</b>	<b>ISFD</b>	<b>ISWD</b>	<b>ISBM</b>	<b>ISBD</b>	<b>ISTC</b>	<b>ISCF</b>	<b>ISBH</b>	<b>ISFI</b>	<b>ISLS</b>	<b>ISACZ</b>	<b>ISACM</b>	<b>SBZ</b>	<b>SSBCM</b>
<b>ISBS</b>	1.000														
<b>ISBI</b>	0.069	1.000													
<b>ISFD</b>	-0.032	-0.225	1.000												
<b>ISWD</b>	-0.132	0.208	0.042	1.000											
<b>ISBM</b>	-0.173	0.161	-0.325	0.020	1.000										
<b>ISBD</b>	0.097	-0.050	-0.157	0.086	-0.111	1.000									
<b>ISTC</b>	0.288	-0.055	0.144	0.000	-0.215	-0.010	1.000								
<b>ISCF</b>	0.149	0.003	0.082	-0.073	-0.138	-0.036	-0.063	1.000							
<b>ISBH</b>	0.206	-0.195	0.152	-0.180	-0.283	0.260	0.099	0.038	1.000						
<b>ISFI</b>	-0.056	0.031	0.000	0.055	-0.073	-0.074	0.017	-0.075	-0.024	1.000					
<b>ISLS</b>	-0.015	0.125	-0.005	0.216	0.008	0.029	-0.178	-0.177	-0.056	0.304	1.000				
<b>ISACZ</b>	0.073	0.085	-0.042	-0.002	0.066	0.284	0.023	-0.132	0.308	0.162	-0.079	1.000			
<b>ISACM</b>	-0.180	-0.059	-0.149	0.285	0.403	0.053	-0.114	-0.076	-0.069	-0.074	0.236	0.117	1.000		
<b>SBZ</b>	0.159	-0.010	0.228	0.249	-0.191	0.013	0.267	0.085	-0.045	0.002	-0.157	0.036	-0.058	1.000	
<b>SSBCM</b>	0.045	0.106	0.013	0.015	0.157	-0.030	-0.029	0.058	0.175	0.107	-0.188	0.091	0.075	-0.156	1.000
<b>SSEQ</b>	-0.358	-0.015	-0.322	-0.123	0.314	0.086	-0.435	0.047	0.040	0.086	0.044	0.071	0.149	-0.390	0.021
<b>SBE</b>	0.030	0.018	0.043	0.036	-0.061	0.018	0.019	0.010	-0.062	0.034	0.052	-0.023	0.038	0.090	-0.045
<b>CCSSB</b>	0.010	0.036	-0.150	-0.015	0.232	-0.035	0.127	-0.063	-0.107	0.103	-0.043	0.063	0.050	0.169	-0.114
<b>FSS</b>	0.408	-0.107	0.331	0.094	-0.296	-0.077	0.203	0.366	0.081	-0.113	-0.105	-0.231	-0.142	0.370	0.178
<b>ISROA</b>	-0.046	-0.001	0.014	0.011	-0.005	-0.012	-0.058	-0.016	0.174	-0.012	0.090	0.055	0.025	-0.077	0.034
<b>ISLR</b>	-0.135	-0.055	0.161	0.041	-0.001	-0.016	0.202	0.050	-0.029	0.150	-0.023	0.149	0.020	0.043	0.084
<b>ISCAR</b>	-0.280	0.015	-0.097	0.213	-0.092	0.002	-0.073	-0.071	-0.135	0.172	0.056	-0.011	0.059	0.216	-0.177
<b>ISLNTA</b>	0.126	0.028	-0.021	0.224	0.037	0.425	0.080	0.012	0.291	-0.085	-0.004	0.320	0.374	0.332	-0.056

Continued Table 4

	SSEQ	SBE	CCSSB	FSS	ISROA	ISLR	ISCAR	ISLNTA
<b>SSEQ</b>	1.000							
<b>SBE</b>	-0.024	1.000						
<b>CCSSB</b>	0.060	0.031	1.000					
<b>FSS</b>	-0.688	0.021	-0.135	1.000				
<b>ISROA</b>	0.020	0.004	-0.025	-0.017	1.000			
<b>ISLR</b>	-0.126	-0.021	0.023	0.121	0.114	1.000		
<b>ISCAR</b>	-0.009	0.028	0.021	-0.120	-0.041	-0.054	1.000	
<b>ISLNTA</b>	-0.121	0.131	0.089	0.097	0.156	-0.109	0.057	1.000

Table 5

Model A: Islamic Bank Corporate Governance and Credit Rating

VARIABLES	Model A-1	Model A-2	Model A-3	Model A-4	Model A-5	Model A-6	Model A-7
<b>Board of Directors Attributes</b>							
ISBS	-0.833** *	-0.468** *					
ISBI	10.89** *	7.755** *					
ISFD	0.538	-0.165					
ISWD	23.46** *	19.59** *					
ISBM	0.216*	0.295** *					
ISBD	-16.64** *	-7.147**					
<b>CEO Attributes</b>							
ISCD	-		-				
ISTC	-0.00495		-0.182** *				
ISCF	-		-				
<b>Ownership Structure</b>							
ISBH	-0.148			-0.396** *			
ISFI	-1.565			-0.304			
ISLS	0.896** *			0.591** *			
<b>Audit Committee</b>							

ISACZ	<b>0.639*</b>				0.0905		
ISACM	0.286				0.419** *		
<b>Shariah Board</b>							
SBZ	- <b>1.000**</b> *					<b>-0.455**</b>	
SSBCM	1.003					0.393	
SSEQ	-1.943					<b>-4.328*</b>	
SBE	-1.836					0.0689	
CCSSB	<b>1.869**</b>					<b>0.827**</b>	
SWS	-					-	
FSS	1.104					- <b>5.372**</b> *	
<b>Control Variables</b>							
ISROA	-1.349	0.0270	-0.239	-0.195	0.505	-0.217	0.111
ISLR	-0.354	-0.226	0.523	0.127	-0.246	0.219	0.0142
ISCAR	-10.53**	-7.647**	-2.086	-4.206	-0.986	-0.320	-0.430
ISLNTA	0.461** *	0.199**	0.163**	0.269** *	-0.0731	0.207** *	0.114*
/cut1	4.724	-1.236	-0.776	5.284** *	-0.562	-4.382	-0.543
/cut2	12.65	3.417*	2.639** *	9.704** *	2.836** *	-0.948	2.562** *
Observations	204	204	204	204	204	204	204
<b>Log-likelihood</b>	- 70.7380 48	- 128.387 86	- 167.095 46	- 135.791 98	- 166.472 06	- 168.425 71	- 181.382 19
<b>LR Chi</b>	224.86	109.56	32.14	94.75	33.39	29.48	3.57
<b>Prob &gt; chi<sup>2</sup></b>	0.0000	0.0000	0.0000	0.0000	0.0000	0.0010	0.4678
<b>Pseudo R<sup>2</sup></b>	0.6138	0.2991	0.0877	0.2586	0.0911	0.0805	0.0097
<b>Wald test Chi<sup>2</sup></b>	61.48	4.82	12.47	38.22	20.81	24.49	12.42
<b>Prob &gt; chi<sup>2</sup></b>	0.0000	0.0000	0.0523	0.0000	0.0020	0.0064	0.0145

Standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

### Finding and Discussion

The finding shows that the board of directors attributes ISBM, ISWD, and ISBI with a significant positive relationship with credit rating at 10% and 1% significance, as shown in Table 7. It shows that increasing the number of meeting boards can continuously monitor management activities and resolve issues promptly to mitigate the risk of loss. The presence of women directors on the board brings diversity which nurtures creative and innovative thinking, which benefits the organization in terms of higher credit rating. A significant positive relationship between Board independence and credit rating demonstrates that board members are independent in their decision-making, helping the banks to maintain sound

financial position and performance in Pakistan. On the other hand, ISBD shows a significant negative relationship with credit rating. It confirms that when directors are overburdened by engaging in multiple committees, it affects their performance in quality decision-making. These results are consistent with the Mansoor et al. (2019a) findings. ISCD and ISCF show no results because there is no single bank in Pakistan where the CEO is also the bank's chairman and the CEO is also the bank's founder.

CEO tenure (ISTC) negatively affects Islamic banks' credit rating. It confirms that the credit rating of Islamic banks falls with the increase in the years of the CEO position. Ownership structure, in model 4, ISLS shows a strong positive relationship with credit rating. It shows that owners can monitor and control management more effectively and prevent opportunistic behavior of the management, which benefits all stakeholders, predominantly minority shareholders and bondholders. On the opposite side, ISBH shows a strong negative relationship with credit. It shows that blockholders in Pakistan banks exert pressure on the management to take undue benefits from the management in terms of contracts, buying shares below the market price, or underwriting.

The audit committee variable includes audit committee size and meetings. Audit committee size shows a significant positive relationship with credit rating. It endorses that when the audit board size is more significant, individuals with various skills and expertise can perform better functions. From shariah supervisory board characteristics, in model 6, shariah board size (SBZ) and Shariah supervisory board education qualification (SSEQ) show a significant negative relationship with credit rating. It may be because shariah scholars who acquire shariah qualifications exercise strict shariah compliance in business operations and product development; hence, it may comprehend the bank's financial performance by restricting them from involving in non-shariah compliant products. CCSSB (change in the composition of SSB), which reflects the entry and exit of members in a year, shows a strong positive relationship with the credit rating. It justifies that the shariah board's composition brings members knowledge, experience, expertise, and motivation, enhancing its effectiveness (Al-Matari, Al Swidi, & Fadzil, 2014). The financial ratios tested in Model 7-A check the association between credit rating and the financial characteristics of the banks. The result shows ISLNTA's significant positive relationship with the credit rating at a 10% significance level. Moreover, ISROA and ISLR show a positive association with credit rating but are insignificant.

The overall fitness of the model of independent and dependent variables is tested by computing log-likelihood, chi-square value, wald chi-square test, and  $R^2$  value. In all models using the probability of chi-square, the wald test is highly significant at the 1% level, which measures how well each model's corporate governance attributes significantly measure the overall variation in the dependent variable, credit rating. Pseudo  $R^2$ , which measures the fitness of the models, represents an acceptable value of more than 0.2 in models A1, A2, and A4.

## **Conclusion and Recommendation**

The finding confirms that corporate board size and shariah board size negatively affect the credit rating in Islamic banks. It supports the results of the Mansoor et al. (2019a) study but contradicts them (Rihab Grassa, 2016). It suggests banks avoid employing extra members on their boards. It may confirm that the board size is already at its optimum regarding cost and board productivity. Board independence shows a highly significant positive impact on Islamic banks. It suggests that board directors are more independent in their decision-making in Islamic banks and foreign directors show an insignificant positive and negative

relationship with credit rating in Islamic banks. It shows there are currently fewer foreign directors on board in Pakistan banks. Bringing in more foreign directors will help improve the banks' performance with their ideas and professional expertise. Women directors' shows a highly significant positive relationship with credit rating in Islamic banks. It supports the argument that gender diversity improves the performance of the organization. Board meetings show a significant positive relationship with credit rating in Islamic banks, and busy directors show a significant negative relationship with Islamic banks.

Under CEO attributes, CEO tenure shows a significant negative relationship with Islamic banks. Our finding supports the results of (Rihab Grassa, 2016; Zhang, 2015). The CEO founder shows an insignificant negative relationship with credit rating in Islamic banks, and blockholders show significant negative relation with credit rating in Islamic banks. Foreign investors show an insignificant negative with Islamic banks. These findings support the results of Guo and Masulis (2015); Khalil and Slimene (2021) assert that foreign directors are less knowledgeable about local regulation and management practices and problems in communication with local management due to socio-cultural differences. Listing shares represents a significant positive relationship with credit ratings in Islamic and conventional banks. It confirms that corporate disclosure increases with the increase in the listing of shares, which reduces the agency problem and protects the investors. Audit committee size shows a positive relationship with credit rating in Islamic banks. Audit committee meetings show a significant positive relationship with credit rating under Islamic banks.

Furthermore, the shariah supervisory board, change in the composition of the shariah supervisory board shows a significant positive relationship with credit rating in Islamic banks. In comparison, shariah supervisors' education qualification, the shariah board size, and foreign shariah scholars show a significant negative relationship with credit rating.

Based on the study, we recommend that Policymakers like Stata Bank of Pakistan and credit rating agencies in Pakistan like PACRA and VIS devise a different methodology of credit rating for Islamic banks, which should consider the qualitative and qualitative aspects of Shariah compliance under the State Bank of Pakistan Strategic Vision 2021-2025. Second, right now, the Shariah supervisory board is being treated as a separate independent board representing their observation and finding to the corporate board for the decision. It should be further improved by giving shariah supervisory board members more opportunities to involve in different bank committees. It helps in their capacity building of shariah scholars and applying Shariah compliance more effectively and improves the confidence of stakeholders in the Islamic banking system. Third, there are currently no women shariah supervisors on the board in Islamic banks. It should be made mandatory for Islamic banks by the State Bank to further foster the growth of Islamic banking by bringing diversity to the board. Fourth, there is a dire need for Shariah Supervisory board performance disclosure in the same way as conventional banks in the banks' annual reports. Fifth, more appointed shariah scholars from different Fiqh should be on the board who have expertise in accounting and finance, financial market experience, and shariah knowledge. Sixth, the finding shows zero foreign shariah scholars in Islamic banks. Hence, a policy needs to be developed to bring foreign shariah scholars on board by the banks in Pakistan to support diversity and the international board.

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