Does anti-corruption disclosure affect banking performance?

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Abstract

Purpose – This paper aims to test the levels of anti-corruption disclosure and its implication on the banking performance of both conventional and Islamic banks listed on the Abu Dhabi Securities Exchange and Dubai Financial Market.

Design/methodology/approach – The authors have used the content analysis to identify the levels of anti-corruption disclosure in the banks' annual reports. They have also used the two-steps generalized method of moments (GMM) regression applied to dynamic panel data analysis to examine the effect of the anti-corruption disclosure on the banking performance.

Findings – The empirical results show that the anti-corruption disclosure is at low levels for all banks and conventional and Islamic banks samples. The results also show no significant differences in the anti-corruption disclosure between Islamic and conventional banks. The results of the two-steps GMM regression applied to dynamic panel data analysis show a negative and significant impact of the levels of anti-corruption disclosure on the bank's performance for both all banks and conventional banks; the results of the dynamic panel data analysis show an insignificant impact of anti-corruption discloser for the Islamic banks' sample.

Practical implications – The findings recommended a comprehensive framework of anti-corruption disclosure to the central banks and financial market regulators to enhance anti-corruption practices within the financial institutions to increase transparency and enhance their performance.

Originality/value – Fighting against anti-corruption is essential for financial institutions. This paper is the first study that examined the extent of anti-corruption levels and their effect on banking performance for both Islamic and conventional banks operates in the UAE. The findings help in enhancing reporting practices in terms of anti-corruption to improve transparency and performance in the banking sector.

Keywords Performance, Islamic banks, Content analysis, Conventional banks, Anti-corruption disclosure

Paper type Research paper

1. Introduction

Since 2003, the United Nations (UN) set an annual alarm on the Ninth of December to remind individuals, institutions and governments around the world about the importance of anti-corruption. Both advanced and developing countries are experiencing corruption and paying valuable efforts and continuous improvements to fight corruption (Nguyen and van Dijk, 2012). Corruption defined is by International Transparency as "the abuse of entrusted power for private gain". Furthermore, the UN recognizes that the scope of the phenomenon of corruption

JEL classification – C33, G32, G34

Journal of Financial Crime
Vol. 27 No. 4, 2020
pp. 1161-1172

1359-0790
DOI 10.1108/JFC-04-2020-0047

has moved from the local to the global sphere, which has necessitated international collaboration and led to the formation of an integrative approach and the comprehensive program towards corruption prevention (UN report, 2004, p. 5; Cao *et al.*, 2018).

The above developments have prompted researchers and policy-makers to examine the effect of corruption on both firms and countries. Their findings highlighted the consequences of corruption for economic growth and prosperity and the integrity of the social structure. For example, Karhunen and Ledyaeva (2012) examined the relationship between corruption and foreign ownership structure in Russia and documented that corruption exerted an impact on the entry style of foreign investors into the Russian market. Foreign investors have chosen a strategy of joint venture participation rather than full ownership of projects because the benefits from exploiting the resources and connections of local partners exceed the joint venture cost in terms of control. Other studies highlighted further negative consequences of corruption on several aspects of economic activity. First, corruption negatively affects the flow and allocation of resources (Issa and Alleyne, 2018). Second, corruption represents a vital impediment to economic growth and sustainability (Halkos and Tzeremes, 2010). Third, corruption influences the unemployment rate (Habib and Zurawicki, 2002). Forth, bribery overestimates the global cost of project budgeting due to legal cases by about US$2.6tn (Issa and Alleyne, 2018).

Other studies set out to investigate the relationship between corruption and financial performance at the firm level. They documented a positive impact of corruption on firms' financial performance due to incurred bribes and other illegal contributions as necessary costs to enter existing markets and "grease the wheels". Bribes are the cost of joining the market late and create an opportunity to gain market share (North, 1990). Further, some studies pointed out the beneficial role of corruption in timesaving and overriding bureaucratic obstacles, thereby enhancing firm growth and financial performance of firms (Lui, 1985; Vial and Hanoteau, 2010). De Jong *et al.* (2012) argue that the cost of corruption may be seen as an investment in networking and has a positive influence on the ability of firms to access new markets or sectors. Thus, corruption may be a short-term objective of firms, which aim to increase their cash flow and build their networking for further use in the future. In contrast, other studies documented an adverse effect of corruption on the financial performance of firms. They described corruption as sand in the wheels. As corruption cripples the business in many ways; it raises the cost of operation, exposes reputation to risk, reduces business growth and transforms business culture (Van Vu *et al.*, 2018). In more detail, Rose-Ackerman (1997) argues that bribes could delay transactions and proven unhelpful in reducing transaction time, as corruption beneficiaries tend to delay the conclusion of transactions to evoke more bribes. Moreover, corruption behavior shifts firms' effort from enhancing their productivity and efficiency to relying on dishonest mediation for carrying out their operation, thereby adversely affecting their competitiveness and survival in the long term (Murphy *et al.*, 1993).

International developments on the incidence of corruption have put pressure on firms to improve their transparency, which requires *inter alia* disclosing anti-corruption activities and policies. Two hundred non-governmental organizations around the world formed an initiative, titled "Publish what you pay", that induces firms in the oil, mining, and gas sectors to disclose payments made to the government (Saenz and Brown, 2018). The initiative has stressed that there few studies available that measure the impact of anti-corruption disclosure on the financial performance of firms.

Our paper contributes to this effort, by designing examining the effect of anti-corruption disclosure on the financial performance of banks in the UAE. The analysis focuses on both conventional and Islamic banks. We use manually collected data from the UAE banks' annual reports during the period 2003-2013. The results show that anti-corruption disclosure

is at low levels for all banks including the conventional and Islamic banks, with no significant differences in the level of anti-corruption disclosure between Islamic and conventional banks. Also, we found a negative and significant impact of the levels of anti-corruption disclosure on the bank's performance for both all bank's sample and conventional bank's sample, while Islamic banks have an insignificant impact of anti-corruption on the performance.

Our paper contributes to the literature in several ways. First, it focuses on individual firm behavior and analyses the effect of corruption on the financial performance of banks, which belong to a business sector that has rarely been explored in the literature regarding the Middle-east region. Bank lending decisions are very important for corporate finance and economic growth. Second, our study examines the corruption effect in both conventional and Islamic banks. Very few studies exist that focus on the incidence of corruption in Islamic banks (Arshad and Rizvi, 2013). We believe that our findings will aid domestic bankers and policy-makers in becoming properly aware and developing proper anti-corruption policies.

The paper is structured as follows: Section 2 analysis the local context of banking activities and provides a brief literature review of the association between corruption and performance; Section 3 describes the data and the empirical methodology; Section 4 analyzes the results and finally, Section 5 offers conclusions.

2. Related literature and hypothesis development

2.1 The UAE context

The Corruption Perceptions Index (CPI) reported by Transparency International (TI) indicates that the UAE rank improved from 37 out of 133 countries in 2003 to 21 out of 180 countries in 2019. The UAE has been observing an improvement in the CPI rank over the past sixteen years. The rank improvements are due to the UAE Government's outstanding efforts to combat corruption. The federal law 4/2002 on anti-money laundering and other federal anti-bribery rules and regulations were enacted following the recent global financial crisis. In 2008, UAE established the Abu Dhabi Accountability Authority (ADAA), which aims to combat financial and administrative corruption. The ADAA is responsible to ensure that public institutions efficiently manage resources, produce reliable financial reports, investigate corruption cases and enhance ethical, accountability and transparency values (Al-Tamimi and Co., 2015). The UAE published many cases of corruption, including high-level corruption episodes, such as the case of the former Governor of Dubai International Financial Centre (DIFC).

However, in a 2015 survey conducted in Dubai, TI documented that 66% of corporate executives expressed negative feedback on the efficiency and effectiveness of anti-bribery and corruption legislation in the UAE. In general, the UAE needs more action to combat corruption. The 2015 directive of Sheikh Mohammed bin Zayed Al Nahyan to establish a new anti-corruption unit, aiming to control compliance with corporate governance and transparency, is a positive development. Workshops were carried out to enhance the awareness of the public and encourage whistleblowing regarding suspected corruption cases concerning public or private institutions. However, a 2015 PWC report documented that about 12% of fraud and corruption cases in the UAE were discovered by sheer chance. The PWC indicated that 48% of respondents did not perform a fraud risk assessment and believed they would suffer from fraud and corruption in the subsequent years. Moreover, they confirmed that their firms lost between US$ 100,000 and US$5m due to corruption and fraud (PWC, Economic crimes in the UAE, 2015).

Previous studies discussed the differences between conventional and Islamic banks. Islamic banking operates following Islamic rules, which prevent making money from money

and using the interest rate as a return on money while allowing profit generation from investing in assets and devising profit and loss sharing mechanisms between lenders and borrowers (Bougatef, 2015). The UAE banking sector in 2019 contains 22 conventional and Islamic banks, with total assets AED 2894.9bn and gross credit AED 1675.1bn (UAE central bank report, 2019). In 2019, KPMG reported that Islamic banks become more acceptable in the global financial market by offering Sukuk instruments. The value of Sukuk issued by Islamic banks during the first half of 2018 were $44.2bn globally, Bougatef (2015) confirmed the KPMG report and argued that Islamic banking is achieving noticeable growth in market share, with an average of 17% in 2013. The World Economic Forum added that UAE Islamic banks control 14.6% of the global Islamic financing assets (World Economic Forum, 2015). These trends justify a focus on the Islamic banking sector in the UAE concerning corruption activity.

2.2 Corruption disclosure and performance

Many studies recognized corruption disclosure as an essential element in enhancing firm performance. Hess (2009) showed the positivity impact of a firm's corruption disclosure on its ability to achieve both internal and external objectives. He justified his argument by pointing out that corruption disclosure increases public awareness and enhances the firms' accountability. The latter is crucial for improving its ability to set policies and procedures as well as improve the effectiveness of internal control against corruption activity. Accordingly, corporate managers become aware of their direct responsibility to disclose corruption activities to the public, as part of their accountability toward the firms' stakeholders and society. Moreover, firms are called to handle the responsibility of their employees' behavior to promote their ethical standards and therefore improve the organization's reputation (Joseph *et al.*, 2016).

In contrast, Day and Chambers (2011) examined the corruption disclosure in 20 corporate annual reports and documented that firms do not believe in any responsibility to the public regarding cases related to bribery and corruption, as well as no evidence of corruption disclosure. Wilkinson (2006) argued that corruption is confident, complicated and sensitive. Therefore, firms always try to hide corruption activities and avoid or weaken corruption disclosure. Gordon and Wynhoven (2003) found that only 43 firms out of hundreds of nonfinancial firms listed on the website of a UN conference disclosed anti-corruption information on their websites. Healy *et al.* (2014) reached similar results after exploring the use of the transparency index-scoring framework by 480 firms regarding efforts to combat corruption in their operation. They highlighted the important anti-corruption role of enforcement effectiveness, the corporate board's independence and the quality of external audit. In a report carried out to explore anti-corruption disclosure practices of firms, KPMG (2005) found that only 18% of 1,600 annual reports included anti-corruption information and 61% of the reports included corporate governance information.

Osuji (2011) studied the relationship between the firms' anti-corruption disclosure and their reputation and concluded that the incidence of corruption mainly exists in the firms that operate in a few corrupt countries. Everett *et al.* (2007) identified 16 most common corruption activities of firms, including bribery, embezzlement, cheating, extortion and money laundering. Chandler and Graham (2017) emphasized the concerns of management regarding the role of social reputation in corporate performance and survival in the competitive market place. Many studies indicate the high possibility of firms paying bribes and committing fraud to enter new markets. They added that management must continuously communicate with stakeholders about combat corruption to sustain corporate reputation. Corporate managers willing to invest abroad must pay attention to the general

attitudes of investee societies towards corruption. Kolsi and Attayah (2018a) measured the impact of honest activities and ethical standards on earnings management and the quality of financial reports and found that the firms' ethical and social commitment improves the quality of reporting

Further, Xu and Yano (2017) argued that the possibility of corruption adversely affects firms' ability to innovate. Murphy *et al.* (1991) noted that corruption increases business risk, transaction costs and negatively affects innovation activities. Paunov (2016) further argued that the innovator's value chain involves the relevant authorities and corruption could negatively affect the innovation process because of regulatory capture. Public officials may ask for bribes or other gains to grant patents or other official certificates. In such cases, the innovative spark may slow down, due to the innovators' feeling of having their effort unappreciated and of being extorted in the process of documenting their innovations. Xu and Yano (2017) note that corruption may grant innovator efforts to competitors, or slow down the expected innovation returns due to the difficulties and challenges facing innovators in commercializing their innovations. Murphy *et al.* (1991) added that firms with innovation capabilities engage in tradeoffs between renting ideas or innovating themselves and found that corruption in China often induces firms to rent out their ideas rather than developing them by themselves.

The efficient combat of corruption is the most trustworthy solution against asset expropriation. This also applies in the provision of innovation finance (Himmelberg and Petersen, 1994; Stiglitz and Weiss, 1981; Berkowitz *et al.*, 2015; Al-Suwaidi and Nobanee, 2020; Neaime, 2012). The effective anti-corruption policy provides a better environment for entrepreneurs and innovative businesses, improves economic conditions, enhances market fairness and reduces market risk and transaction costs. It also improves the opportunities of a firm to obtain needed finance at a lower cost.

Further, the efficient combat of corruption improves the general economic situation and encourages the inflow of foreign investment (Wei, 2000; Javorcik and Wei, 2004). Habib and Zurawicki (2002) documented the negative impact of corruption on foreign direct investment, regardless of the origin of corruption between the home or host states. They added that the level of FDI flow is associated with the level of government efficiency and the degree of corruption in countries. McArthur and Teal (2012) analyzed the relationship between corruption and firm performance in Africa. They concluded that corruption has a significate negative effect on firm performance, which amounted to a 20% reduction in labor productivity of corrupted firms and a general 70% reduction of performance of firms operating in highly corrupt countries. Faruq *et al.* (2013) documented that corruption negatively affects the firms' labor productivity. Finally, Gaviria (2001) documented that firms in Latin American countries have lower sales growth if they are engaged in corruption activities.

Particularly, the previous researches conducted focused on the effect of corruption on the banks' performance, but no researches investigated the anti-corruption disclosure to the bank sector. Corruption in the banking sector is harmful to the economy and causes unstable financial sector investment. Murharsito *et al.* (2017) documented a negative effect of corruption on the financial performance of banks. Other researchers pointed out the implication of corruption in the performance of banking sector, Park (2012) pointed that corruption reduces the allocation of fund efficiency, which significantly affects the profitability of the bank operation and reduces the safeguard of banks fund; and negatively affect the economic growth. While James *et al.* (2018) stated that information sharing between banks decrease the corruption and reduce the lending risks. Based on the arguments above, we have developed the following research questions:

RQ1. Do UAE listed banks disclose adequate anti-corruption information in their annual reports?

RQ2. Are there significant differences in the disclosure of anti-corruption information between UAE listed conventional banks and listed Islamic banks?

RQ3. Is there a significant impact of anti-corruption disclosure on bank performance?

3. Data and methodology

We obtain data from the annual reports of all banks listed in the UAE exchanges and classify them between Islamic and conventional banks. We collected the data manually from the audited annual financial statements, which cover 11 years, 2003-2013. Our final panel sample includes 176 firm-year observations of banks.

The outcome variable of our analysis that measures bank performance is the bank's return on equity (ROE). We obtain the data for ROE for the bank's financial statements. The independent variables include the size of the bank, measured by the first difference of logarithm of the bank's total assets; the degree of a bank's leverage, measured by the first difference of total liability to total assets ratio; and an index of the bank's anti-corruption disclosure policy measured by the first difference of the computed index value.

We calculate our anti-corruption disclosure index using the method suggested by Joseph *et al.* (2016). The composite index consists of six groups of disclosure variables that include 38 sub-disclosure items. The first group includes 12 disclosure items on accounting for anti-bribery; the second group includes seven items on the disclosure of firms' board and senior management responsibility to combat corruption; the third group includes four items of human resources disclosure to fight against bribery; the fourth group includes nine items of responsible business relationships; the fifth group includes three items of external verification and assurance of anti-corruption, and finally, the sixth group includes three items related to the applicable codes of conduct.

We apply content analysis on the banks' annual reports. Each disclosure sub-item takes the score of 1 if the item is fully disclosed and 0 otherwise. We construct our overall anti-corruption index by adding the disclosure scores of the sub-items in each group and subsequently the disclosure scores of all groups and then dividing the resulting sum by the total number of items. The values of the anti-corruption disclosure index are within the range of 0 to 100%, where 0% indicates no anti-corruption disclosure and 100% indicates full anti-corruption disclosure. We use the Mann–Whitney statistic to test for significant differences in anti-corruption disclosure between Islamic and conventional banks (Verschoor, 1998; Md Nasir *et al.*, 2018). Furthermore, we use the one-way *t*-test to test the significance of anti-corruption disclosure of both Islamic and conventional banks.

We use the two-step generalized method of moments (GMM) estimator proposed by Arellano and Bover (1995) and Arellano and Bond (1991) for dynamic panel data analysis to estimate the effect of anti-corruption disclosure on bank performance. This estimator allows us to control for possible endogeneity and unobservable heterogeneity (Nobanee *et al.*, 2011). This estimation system also applies the finite sample correction proposed by Windmeijer (2005). We examine the validity and consistency of the GMM system estimator by employing the Sargan and Hansen tests (Sargan, 1958; Hansen, 1982). We also report the autocorrelation tests (AR1, and AR2) to check for the presence of first and second-order autocorrelation (Law *et al.*, 2018). Our estimation model leads to the following estimation equation:

$$ROE_{it} = \alpha + \beta_1 ROE_{it-1} + \beta_1 LGTA_{it-1} + \beta_1 TLE_{it-1} + \beta_1 INDEX_{it-1} + \varepsilon_{it} \quad (1)$$

In our models, ROE_{it-1} is the differenced lagged dependent variable; $LGTA_{it-1}$ is the control variable of bank size, measured by the first difference of logarithm of total assets. $TLEe_{it-1}$ is the control variable of leverage measured by the first difference of total liability to total assets, $INDEX_{it-1}$ is the first difference of the anti-corruption disclosure index; and ε_{it} is the composite error term that comprises both the country and year error terms.

4. Analysis of results and discussion

Table 1 presents the descriptive statistics of our variables. The results show small differences between banks. Indeed, the average value of the anti-corruption disclosure index is 12.5% for all banks, 12.4% for the conventional banks and 13% for the Islamic banks, all of which are at low levels. The average value of bank performance is 12.7% for all banks, 12.9% of conventional banks and 11.9% of Islamic banks. This result confirms previous research conducted to measure the scope of firms' anti-corruption disclosure, Issa and Alleyne (2018) research revealed that the GCC firms have weak anti-corruption disclosure. Blanc *et al.* (2017) identified the importance of anti-corruption disclosure in fighting corruption and it has a positive impact on reducing corruption practices on the firms' level.

Table 2 presents the results of the one-way *t*-tests, used to test the hypothesis that the anti-corruption disclosure level is significantly lower than 50%. The results show that the anti-bribery disclosure levels for all banks and conventional and Islamic banks are significantly lower than 50%. These results are consistent with those reported in Table 1. They are also consistent with those of previous studies about the effect of anti-bribery disclosure in the UAE (Nobanee and Ellili, 2020). Moreover, the results are also relevant to those of Joseph *et al.* (2016), who documented that the anti-corruption disclosure effect was low in both Malaysian and Indonesian corporations. Issa and Alleyne (2018) studied the anti-corruption disclosure practices of what in the Gulf Cooperation Council (GCC), and found that banks in the region are characterized by low disclosures and generally, they are not mature enough concerning anti-corruption disclosure policies.

Table 3 reports the results from applying the Mann–Whitney test to check the significance of differences in the anti-corruption disclosure between Islamic and conventional banks. Given the Islamic rules and recommendations for financial transactions to be straightforward, deal ethically, and commit to integrity, we expected to find significant

Means	Anti-corruption index	Bank performance (ROE)	Bank size	Bank leverage
All banks	0.1257143	0. 1265693	7.558025	5.898095
Conventional banks	0.1242857	0.1292533	7.574154	5.309905
Islamic banks	0.1300000	0.1191046	7.514528	7.515619

Table 1. Descriptive statistics

Sample	Obs.	Std. Err.	Mean	Ha: mean < 0.5
All banks	140	0.0148972	0.1257143**	Pr (T < *t*) = 0.0000
Conventional banks	105	0.0170764	0.1242857**	Pr (T < *t*) = 0.0000
Islamic banks	35	0.0308629	0.1300000**	Pr (T < *t*) = 0.0000

Note: The symbol ** implies significant at the 99% confidence level

Table 2. One sample *t*-test of anti-corruption disclosure during 2003-2013

differences between the Islamic and conventional banks. Our results show no significant differences between the two bank types, which is in line with the result of Nobanee and Ellili (2018) research, which found no significant differences in the anti-money laundry disclosure between Islamic and conventional banks. Our ability to compare our findings with other researches is limited as no previous research investigated the anti-corruption disclosure impact on the conventional and Islamic banks' performance.

Finally, Table 4 reports the results from applying the two-step GMM system estimator. The results show a negative and significant association between the anti-corruption disclosure index and bank performance for all banks and conventional banks, as well as an insignificant association between the anti-corruption disclosure and the performance of the Islamic banks. These results are consistent with the previous findings regarding the effect of anti-financial crime disclosure on bank performance in the UAE (Nobanee and Ellili, 2018). Table 4 also shows a significant positive impact of lagged bank performance and a significant negative impact of bank size on current bank performance, which is also consistent with previous findings (Kolsi and Attayah, 2018a). Thus, the smaller the size of the bank, the higher the average performance of all banks and conventional banks. The effect of leverage ratios on current bank performance is significant and positive for all banks on average and significant and negative for conventional banks, while it insignificant for Islamic banks. The latter result is reasonable given the role of Islamic values on the banks' decision to assume leverage. Finally, the values of the autoregressive 1(AR1), autoregressive 2(AR2), Hansen and Sargan statistics, confirm the validity of the variables and instruments used in the GMM model.

5. Conclusion

Most previous studies analyzed the role of non-economic factors, such as social responsibility and environmental disclosure policies, for the performance of firms, focusing on earnings quality and financial performance (Verschoor, 1998; Lopatta *et al.*, 2017; Kolsi and Attayah, 2018b). This paper focuses on a different non-economic factor, the extent of anti-corruption disclosure and examines its effect on the financial performance of banks in the UAE. A novelty of the analysis

Table 3.
Mann–Whitney test of anti-corruption index of UAE conventional and Islamic banks

Mann–Whitney	Unadjusted variance	Adjustment for ties	Adjusted variance	Z value
Coefficient	43181.25	−2460.61	40720.64	0.109

Table 4.
Results of the dynamic panel-data two-steps GMM system estimation

ROE	All banks	Conventional banks	Islamic banks
LAGGED ROE	0.1628**	0.3286**	−3.4508
SIZE	−0.2835**	−0.1528**	???
LEVERAGE	0.0009**	−0.0047**	−0.0326
INDEX	−0.2479**	−0.0746**	−1.1547
AR(1)	−1.6	−1.79	0
AR(2)	−1.58	−1.44	−0.82
Sargan value	11.02	20.08	10.29
Hansen J value	13.82	7.1	0

Note: The symbols * and ** imply significant at the 95 and 90% confidence level, respectively

is the distinction between conventional and Islamic banks. Jizi *et al.* (2014) and Álvarez Etxeberria and Aldaz Odriozola (2018) argued that the banking sector has strong governance mechanisms and therefore banks would engage in strong disclosure of their anti-corruption activities, with a positive impact on their performance. Higher anti-corruption disclosure in the annual reports would provide new information to the users of these reports, with the effect of improving the banks' reputation and trust in the marketplace, thereby enhancing their financial performance. In contrast with this prediction, we found a negative effect of anti-corruption disclosure on bank performance in the UAE. More specifically, the impact on Islamic banks was negligible. These results may reflect the overall weak state of anti-corruption disclosure practices in the country and the lack by local banks and market analysts of proper disclosure evaluation experience. It may also be the case that such disclosures do not represent sufficient material risk to warrant more careful consideration. Our results contribute to the literature on bank disclosures and raise questions for future research regarding the role of non-economic disclosure on firm performance in the country and the region. They also provide an incentive to bank managers interested in improving the reputation of the local banks in the market place and having better integrated into the global market.

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Further reading

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