



Corporate governance and the global performance of Islamic banks

Performance of
Islamic banks

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Abstract

Purpose – The purpose of this paper is to study the operation of Islamic banks and the elements which determine their performance.

Design/methodology/approach – In order to ensure the respect of *Shari'a*, religious committee of monitoring exists within the Islamic bank to take care of the conformity of the activities and banking products with the *Shari'a*. This paper supposes that corporate governance of Islamic banks imposes an important constraint on Islamic banks operations. Furthermore, the directors of the Islamic banks are subjected to the governorship exerted by the board of directors and the *Shari'a* board.

Findings – The findings of this paper are that the performance of an Islamic bank – as a company based on principles of Islam – is affected not only by the internal variables of quantitative nature (for example financial ratios) but also by the internal qualitative variables like the managerial variables. Moreover, the performance of an Islamic bank and a conventional bank should not be measured in the same way because of their divergence on the level of the objectives. The *Shari'a* member must have a qualification in finance and commerce to ensure better quality of supervision and consultation.

Research limitations/implications – The findings of this paper are based on case studies from one country only (Bahrain).

Practical implications – This paper implies that in practice, members of *Shari'a* Board must have stature to give the bank credibility *vis-à-vis* the stakeholders and the depositors.

Originality/value – The original contribution of this paper is that it shows that the members of *Shari'a* board were a serious handicap for the directors of the Islamic banks. Directors and members of *Shari'a* board did not speak the same language. The members of the *Shari'a* board were not very specialized in the fields other than *Shari'a* and contrary the directors in *Shari'a*.

Keywords Islam, Banks, Organizational performance, Corporate governance, Ethics, Bahrain

Paper type Research paper

Islamic banking principles

Islamic banks have grown recently in the Muslim world but are a very small share of the global banking system. We indicate the basic elements of the Islamic banking structure which will make it possible to include/understand the problems of our research which will be developed in the next section.

The central feature characterizing the Islamic banking system is the absolute prohibition of the payment and receipt of interest in any transaction. Islam prohibits Muslims from taking or giving interest (*riba*) regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged. To be sure, there have been attempts to distinguish between usury and interest and between loans for consumption and for production. It has also been argued that *riba* refers to usury practiced by petty moneylenders and not to interest charged by modern banks and that no *riba* is involved when interest is imposed on productive loans, but these arguments have not won acceptance. Apart from a few dissenting opinions, the general consensus among Muslim scholars clearly is that there is no difference between *riba* and interest. In what follows, these two terms are used interchangeably.



The Islamic ban on interest does not mean that capital is costless in an Islamic system. Islam recognizes capital as a factor of production but it does not allow the factor to make a prior or predetermined claim on the productive surplus in the form of interest. This obviously poses the question as to what will then replace the interest rate mechanism in an Islamic framework. There have been suggestions that profit-sharing can be a viable alternative (Kahf, 1982a and b). In Islam, the owner of capital can legitimately share the profits made by the entrepreneur. What makes profit sharing permissible in Islam, while interest is not, is that in the case of the former it is only the profit-sharing ratio, not the rate of return itself that is predetermined.

As mentioned earlier, Islam does not deny that capital, as a factor of production, deserves to be rewarded. Islam allows the owners of capital a share in a surplus which is uncertain. To put it differently, investors in the Islamic order have no right to demand a fixed rate of return. No one is entitled to any addition to the principal sum if he does not share in the risks involved.

Islamic banking has the same purpose as conventional banking except that it claims to operate in accordance with the rules of *Shari'a*, known as *Fiqh al-Muamalat* (Islamic rules on transactions). The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of *ribā* (interest). Amongst the common Islamic operations used in Islamic banking are profit sharing (*Mudharabah*), joint venture (*Musharakah*), cost plus (*Murabahah*) and leasing (*Ijarah*).

Musharakah (*joint venture*)

This concept is normally applied for business partnerships or joint ventures. The profits made are shared on an agreed ratio, while losses incurred will be divided based on the equity participation ratio. This concept is distinct from fixed-income investing (i.e. issuance of loans).

Mudharabah (*profit loss sharing*)

Mudharabah is an arrangement or agreement between a capital provider and an entrepreneur, whereby the entrepreneur can mobilize funds for its business activity. Any profits made will be shared between the capital provider and the entrepreneur according to an agreed ratio, where both parties share in profits and only capital provider bears all the losses if occurred. The profit-sharing continues until the loan is repaid. The bank's profit comes in the form of a floating-point profit rate that is pegged to the debtor's profits.

Murabahah (*cost plus*)

This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of assets (such as real estate or a vehicle), with a fixed rate of interest determined by the profit margin. The bank cannot charge additional interest on late payments), however the asset remains in the ownership of the bank until the loan is paid in full.

Ijarah Thumma Al Bai' (*hire purchase*)

There are two contracts involved in this concept. The first contract, *Ijarah* contract (leasing/renting) and the second contract, *Bai'* contract (purchase) are undertaken one

after the other. For example, in a car financing facility, a customer enters into the first contract and leases the car from the owner (bank) at an agreed rental over a specific period. When the lease period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed price. In effect, the bank sells the product to the debtor, at an above market-price profit margin, in return for agreeing to receive the payment over a period of time; the profit margin is equivalent to interest earned at a fixed rate of return.

Corporate governance in Islamic banks

According to Chapra and Ahmed (2002, p. 13) corporate governance is the “set of relationships between a company’s management, its board, its shareholders and other stakeholders” (OECD, 1999, p. 2). They criticize that is a “value neutral definition ... [that] does not indicate the objective of corporate governance”. They sympathize with a definition given by World Bank President Wolfensohn, according to which “the objective is to ensure ‘fairness’ to all stakeholders to be attained through greater transparency and accountability” (Chapra and Ahmed, 2002, p. 13). Most Western contributors would hardly agree with such a broad definition (“fairness to all stakeholders”) but would probably limit the objective of corporate governance to “corporate management and control in order to achieve long-term value. The core elements comprise investor relations, as well as relationships to stakeholders (staff and employees, customers and clients, suppliers, public interest groups such as trade unions).

The objective is to improve the efficiency of management and supervisory structures in publicly quoted companies and increase the market capitalisation of listed stocks by means of a transparent and prospective information policy.” (German Industry Association and Pricewaterhouse Coopers, 2002, p. 6).

This paper cannot cover the subject in its full scope. It must be selective. Two issues have been picked up for a critical analysis:

- (1) First, it focuses on attempts to strengthen the role of investment depositors who share profits and losses with Islamic banks. The proposal of a depositors’ representative in corporate bodies is discussed. Investment depositors are seen in a special situation in Islamic banks compared to depositors in interest-based banks.
- (2) Second, it tests the effect of *Shari’a* Board on the corporate governance of Islamic bank. Our objective is to study how *Shari’a* Board influence the performance of Islamic bank.

The investment account holder and the corporate governance in Islamic banks

Islamic banks mobilize funds mainly on the basis of the *Mudaraba* (profit-sharing) form of contract. Islamic banks offer investment account. The type of investment account raises a set of issues concerning the contractual relations between the bank and the holders of such investment accounts. These issues may be addressed from the perspectives of Agency Theory, as we will do in this paper. In particular, we focus in an imbalance between management and attributed control rights.

In this paper, we will discuss the problem of corporate governance in Islamic banks and his influence on the global performance of Islamic Bank.

Further, the structure used to deal with investors funds, normally a profit-sharing *mudaraba* contract, imply a high degree of fiduciary duty on the part of an Islamic bank, which should be, but it is not always, reflected in its corporate governance.

In these banks, the Board of Commissioners (BOCs) substitutes the traditional role of a Board of Directors (BODs). However, decision-making is constrained by a *Shari'a* Board that sanctions or rejects any proposals in the light of Islamic law. This supervisory board comprises eminent religious scholars who, although appointed by BOCs, are independent and have authority to reject any proposals deemed to be against the Islamic law.

Management of business operations rests in the hands of a Board of Directors (BODs), headed by a President Director who is directly responsible for BOCs, the *Shari'a* Board, and a Board of Auditors. Financial monitoring of the organization is the responsibility of the Board of Auditors, which comprises a team of auditors, with at least one member being a member of BOCs, and is appointed by the BOCs.

Almost all theoretical models of Islamic banking are based on *Mudaraba* or *Mucharaka* or both. Moreover, the concept of profit and loss sharing (PLS) is theoretically superior to conventional banking for different reasons. See, for example, Khan and Mirakhor (1987). However, in practice things seem to be different.

Our concern here is this latter aspect. In the last decade, the PLS problem have begun to show up. In the following paragraphs we will try to discuss the origin of these difficulties.

But the question which arises in this case is, why the Islamic banks do not much use the contracts of "*Mudaraba*" and "*Mucharaka*" (PLS)?

As we have already said, the PLS contract is formulated in a principal-agent arrangement, where the borrower (agent) supplies the human capital (expertise) needed for the success of the enterprise while the lender (principal) provides capital, becomes a partner and bears some part of the risk. This arrangement is crucial since it places human capital on par with financial capital, eliminating any guaranteed fixed returns.

The Islamic contracts "*Mudaraba*" and "*Mucharaka*" used by the Islamic banks represent an agency relation, in the one hand, between the depositors and the Islamic bank and in the other hand, between the Islamic bank and the companies in the case of *Mucharaka* contract. Our goal is to see how the agency problem influences the performance of Islamic banks?

The form of *Mudaraba* contract used by the Islamic banks may be seen as involving a complex agency problem (Archer and Karim). The bank's management acts as an agent for the shareholders, while the bank as *Mudarib* acts as an agent for the investment account holders. This enhances the possibility of conflict of interest facing the bank's managers, not just in their dealings with the shareholders and in those with the investment account holders, but also between the interests of the two categories of investors (shareholder and investment account holder).

As we described, investment account holder (IAH) does not have the right to interfere in the management of their funds which is the sole responsibility of the *Mudarib*, i.e. the Islamic Bank. However, the corporate governance of Islamic banks does not give IAH any power to appoint the management, the SSB or the external auditor. In addition, the capital of IAH is at risk, the IAH does not have control over the management and they are not in position to enforce monitoring measures on the management. This situation raises the issue of possible conflict of interest between IAH and the Islamic banks, a problem that also exists in the principal-agent relationship in conventional firms.

The restrictive role of shareholders (investors) in management makes them non-participant in nature, which allows a sleeping partnership.

The practice of some Islamic banks is a perfect example of such a non-participant PLS. The *Mudaraba* contract issued by the Islamic banks does not give voting rights to IAH, and hence no annual general meeting is called.

Therefore, *Mudaraba*, a major Islamic mode of financing, provides limited control rights to IAH and shareholders, thus creating an imbalance in the governance structure of PLS as proposed in Islamic banking and finance. This is an important reason for lack of PLS on the assets of Islamic banks. Thus, a consistent and complementary management and control system is essential for steady functioning of Islamic banking and finance.

The modern use of *Mudaraba* as a mode of financing obviously requires more than such preliminary specification of rights and responsibilities.

There is a need for construction of standardized PLS contracts, in the light of the legal frameworks of Muslim countries. A prominent feature of these bylaws should be definition of the rights and obligations of various officers or groups within the organizational structure. Similar bylaws should delineate the clauses related to performance of the borrowing firm compared with other firms in the same sector and, possibly, other firms.

Proposals for organizational structure of Islamic banks

Islamic banks are set up as private limited companies or as mutual organizations. If set up as private limited companies, their owners will not be shareholders from the general public; rather large institutions and entrepreneurs may provide initial capital.

On the other hand, Islamic banks choosing mutual organizational form will have more democratic character enabling their depositors to enjoy some ownership rights. Alternatively, a mix of these organizational forms may prove useful. The lack of liquidity as posed by PLS on the liabilities side may be tackled by encouraging pension funds, insurance companies and other such organizations to invest in Islamic banks. As organizations aim at long-term growth, and not short-term capital gains, Islamic banks will not be much vulnerable to unexpected withdrawals or liquidity crises. Long-term investment or strategic development, audit, compensation, and nominating may have marginal effect (Klein, 1998).

Public confidence in PLS can only be established if ownership and management of Islamic banks show their own commitment to this principle. An important step in this direction will be introduction of profit-related pay for managers and employee share ownership plans (ESOPs). This is expected not only to have a positive effect on the productivity of management and other employees, but will send a healthy signal to the general public indicating commitment of the owners and managers to the principle of PLS.

Proposals for growth of PLS on assets

Banking regulations need serious overhauling. In most Muslim countries, banks are either prohibited from taking controlling rights in corporations (regulated so that taking control blocks would be costly) or structured so that managers of the borrowing firms control their decision-making. These laws, along with hostile attitude of the *Mudaraba* contract towards capitalist, have been a major hindrance in the adoption of PLS by Islamic banks. Hence reforms in banking regulations are required to balance the management and control rights between Islamic banks and managers of the companies they invest in.

We propose an organizational structure based on Venture Capital (VC). Venture Capital is a form of equity financing in which the investor actively participates in the venture being financed.

According to Suwailem (n.d.), once a venture capital fund has been established, the venture capitalist must identify investment opportunities, arrange deals with entrepreneurs, monitor the investments, and ultimately achieve some return on his capital. The venture capitalist usually invests in recipient companies in the form of convertible preferred stock; that is, preferred stock that can be converted into common stock. The financing process is done in stages, and the amount of capital given at each stage is sufficient only to reach the next stage. Venture capitalists take an active role in the recipient companies through membership on Boards of Directors. To avoid losses, venture capitalists form a portfolio by investing in several companies at one time.

Sharing has important consequences. One is that it creates incentives for the capital provider to monitor and assist his partner (Davis, 1992, p. 265). Given the venture capitalist's stake in the venture, the better the quality of assistance he provides to the entrepreneur, the better the likelihood that the venture will succeed, and therefore, the higher the expected value of his stake. One venture capitalist writes, "A venture capitalist is not merely a money manager for investors' funds but also a full partner with the entrepreneur, sharing a mutual goal of creating a valuable company" (Kunze, 1990, p. 3).

Based on a survey obtained from a sample of venture capitalists, Gorman and Sahlman (1989) found that venture capitalists spend about half their time monitoring and assisting their portfolio investments. They also found that venture capitalists provide three critical services in addition to providing money:

- (1) building the investor group;
- (2) reviewing and helping to formulate business strategy; and
- (3) filling in the management team.

As Suwailem (n.d.) indicates, such a degree of involvement by venture capitalists would be inconceivable from traditional financiers. Combining harmony of interests with monitoring and assistance, we see how venture capital structure helps to overcome the high risk and informational asymmetries associated with typical ventures.

The venture capital provides a balance of power between management and other owners who have a financial stake in the firm. The shareholders are not passive capitalists but share decision-making with the management when it comes to running the organization. The value creation by a "VC" will be much better than other organizations. Sapienza (1992) founds that the average value-added by venture capitalists, as perceived by both venture capitalists and entrepreneurs, is significantly positively related to the level of innovation pursued by these companies.

Managers, who also hold shares in the "VC", will be more productive as they possess private information about the projects because perhaps they already have been professionally associated with the ventures. In addition, joint ownership between managers and other shareholders will result in alignment of interests between them, mitigating the agency problem. Furthermore, in a VC, strategic controls will replace financial controls because all the shareholders (managers, Islamic banks and institutional investors) will be intimately involved in managing the company and

making key decisions. These controls encourage long term investments in projects, which influence the firm's value.

In a VC, information sharing will be less costly, quickening the pace of decision-making. Involvement of the institutional investors serves a positive monitoring function. Institutional investors in a VC will closely monitor managerial actions, thus reducing agency costs.

Corporate governance and *Shari'a* board

From its nature, a bank conducting Islamic finance is subject both to those forms of regulation which apply to conventional banks (banking supervision, financial reporting standards and external audit), with due regard to the characteristics of Islamic banks, and also to the review of its compliance with Islamic principles and rules by the *Shari'a* board, which constitutes a key organ of governance in an Islamic bank. The *Shari'a* board of a bank is part of the corporate governance framework.

Islamic banks offer Islamic banking products and services (IBS banks) are required to establish *Shari'a* board/consultants to advise them and to ensure that the operations and activities of the bank comply with *Shari'a* principles.

Each Islamic bank will have a *Shari'a* board which reviews both proposed new products of the bank, and the types of transactions into which that bank has entered, to ensure that they are *Shari'a*-compliant. New products will not be introduced until they are in a form acceptable of *Shari'a* board.

Shari'a board in the past has been composed of *Shari'a* scholars, some of whom had little knowledge of modern banking and who often could not understand the language in which transactions were documented. This could be a significant handicap to the progress of Islamic finance and the development of new products. There is currently a move to recruit *Shari'a* board members with more experience of banking and this can only be welcomed.

In this paper, we suppose that the role and function of *Shari'a* board, in both the development and the enhancement of Islamic banking are very important. Their contributions has been a great spur to the success of Islamic banking, not only in winning the confidence of shareholders and the public, but also in innovation resulting in products suitable for modern and prudent banking activities. The board's responsibility has been generally perceived as both supervisory and consultative in ensuring that Islamic banking adheres strictly to *Shari'a* rules and principles and their banking operations.

Shari'a board and performance of Islamic banks

The Islamic system imposes important constraints on operation of Islamic banks and their directors. In fact, added to the governorship exerted by the board of directors, undertaken very conventionally, the directors of the Islamic banks are subjected to a second governorship, that of the *Shari'a* board. In theory, the Islamic bank should not seek the profit at any price because this last is not an end in itself.

Unlike the directors of the conventional banks, the directors of the Islamic banks are subjected to important constraints as they do not have a margin of rather broad work. In an Islamic bank, the director does not have the autonomy to deploy their resources in any activity or any sector.

Unlike conventional banks, Islamic banks do not have many instruments on the secondary market. Also Islamic banks do not have an inter-bank deposits market to make the excess of short-term liquidity profitable or to meet immediate requirements

in liquidity. In general, they cannot use derived products and even less the financial lever. Additionally, the leaders can make only ethical decisions and which ensure the legitimacy and the acceptability of the organization.

The role of an Islamic bank director is to ensure profit in compliance with Islamic law. In addition the governorship of an extremely demanding of board directors with regards to the financial performance, which remainder it is not easy to reach under such conditions, are subjected to the strict control of the *Shari'a* Board which is laid out to approve only the compliance of the banking transactions with the rules of *Shari'a*, without consideration of the dimension profit required by the leaders.

Which role does the *Shari'a* board play in the operation of Islamic banks? And what influence does it have on the performance of these banks?

To answer this question, we will have to examine the role played by Islamic bank directors within their organizations. The role of Islamic bank director will, primarily, consist of reconciling the apparently contradictory requirements of these two systems of governorship. He should sensitize the *Shari'a* board to shareholders' concerns (profit) necessary for the survival of the organization and he should sensitize personnel to the importance of ethics on the organization generating legitimacy of the bank.

The Islamic bank director must realize profit for the shareholders and ensure that requirements of *Shari'a* are obtained and he must respect ethical standards which are essential. There, a new mechanism of governorship, the ethical governorship, was included on the corporate governance of Islamic bank.

The governorship of Shari'a board

As we previously mentioned, the main objective of an Islamic bank is to offer banking services according to Islamic law. Therefore, the presence of *Shari'a* board is so essential to control bank transactions.

Legal role. In fact, *Shari'a* compliance is the very essence of Islamic bank and its banking business. Thus, the *raison d'être* and role of *Shari'a* advisers acting as a supervisory council are crucial, because the responsibility to ensure *Shari'a* compliance is vested in these advisers. For the Governance Standard for Islamic Financial Institutions no. 1, *Shari'a* Supervisory Board issued by AAOIFI contains the following definition:

A *Shari'a* Supervisory board is an independent body of specialized jurists in *Fiqh al – mu'amalat* (Islamic commercial jurisprudence). However, the *Shari'a* supervisory board may include a member other than those specialized in *fiqh al – mu'amalat* but who should be an expert in the field of Islamic financial institutions and with knowledge of *fiqh al mu'amalat*.

The *Shari'a* Board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic banking to ensure that they are in compliance with Islamic *Shari'a* rules and principles.

It has been observed, however, that the *Shari'a* advisers in Islamic banking were individuals who enjoyed a good reputation in their society because of their general knowledge of Islam and their significant role in that society. In other words, they are scholars whom their society accepted and recognized as reputable though they are not academically trained in Islamic commercial law and related disciplines. However, Islamic banks need for specialized jurists in Islamic commercial law who are more able to apply *Shari'a* rules and principles to modern and actual cases in the banking sector to grow rapidly in the modern financial environment and to realize a good performance on the market.

As banking and financial activities are very specialized in character, the requirement for *Shari'a* member to have a qualification in finance and commerce is very important to ensure better quality of supervision and consultation. However, *Shari'a* programs in education and training must include positive law as well as finance and accounting treatments. This phenomenon could contribute significantly to the quality of *Shari'a* supervision. Ideally, a *Shari'a* adviser must be able to understand not only *Shari'a* issues but also issues pertaining to law and economics, because such issues in many cases are overlapping.

Moreover, members of *Shari'a* board must have had notoriety to give the credibility of the bank *vis-à-vis* the stakeholders and the depositors.

Tacit role. The *Shari'a* board plays a role of double governorship. The first is relating to the conformity of the commercial transactions approved by the directors, with the principles of *Shari'a*. The second is relating to the respect of *Shari'a* by the bank directors.

To guarantee a good image and a good reputation for the bank, a monitoring of the ethical character of the banking commercial transactions and development of products are not enough. The behavior of the directors and frameworks of the organization is also implicitly supervised by the *Shari'a* board.

Shari'a board and profit

The Islamic doctrines encourage man to adopt a positive attitude in regard to the profit; Islam encourages the true profit as an output of the entrepreneurial effort and the financial capital. According to the Islamic definition, a true profit, i.e., conforms to *Shari'a*. For the *Shari'a* board, the organizational performance is measured by the respect of the principles of Islamic law by the bank directors. Therefore, profit must be generated with full respect of *Shari'a* rules. The bank directors do not have, therefore, any interest to present transactions which generate incomes coming from Riba. As it has been observed, *Shari'a* and profit are quite compatible. These directors of Islamic bank had called upon the specialists in Islamic jurisprudence to help them to develop financial products and single investments not only adapted to ensure the needs of the extremely demanding and increasingly sophisticated clients, but also compatible with the prohibition of the interest.

In this division of competence, economic calculation and the profit concerns are allocated to the directors and the appreciation of the licit character of this profit is allocated to the *Shari'a* board. The members of *Shari'a* board are increasingly conscious of the challenges and pressures to which the leaders are subjected.

It has been observed, that in the early stages of Islamic banking, the membership of *Shari'a* board was a serious handicap for the directors of the Islamic banks. Directors and members of *Shari'a* board did not speak the same language. The members of the *Shari'a* board were not very specialized in the fields other than *Shari'a*, which was contrary the directorship in the *Shari'a*.

Therefore, having regular periodical meetings between the *Shari'a* supervisory board and the management of the bank is preferred not only by the *Shari'a* advisers but also by the management of the bank. It could be that in this way, the bank will only present the cases that they think require deliberation. In other words, the bank can shortlist the issues of discussion. This could be very problematic if the bank management fails to disclose cases of practices that they think to be non-*Shari'a* compliant in their banking operations. The other possible reason that is perhaps the most likely is that many, if not most, of the *Shari'a* advisers are not full-time *Shari'a* advisers to the bank.

Conclusion

This paper treats the effect of corporate governance of Islamic banks on its performance. The practice of Islamic bank discussed here indicates that the Islamic bank must have *Shari'a* advisors board with a good knowledge in finance to help the management of the bank to develop a new products in accordance with *Shari'a* rules. In order to achieve better corporate governance in Islamic banks, it has been proposed to broaden the scope of IAH represented in the board of the bank. Because, IAH share risks so they should have a seat in the board.

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