NEW INSIGHTS FOR AGENCY THEORY IN ISLAMIC FINANCIAL INSTITUTIONS: A REAPPRAISAL*

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Abstract

This paper specifically aims at critically examining the arguments put forward by Safieddine, (2009) on the new insights for agency theory in Islamic financial institutions (IFIs) by highlighting several fundamental corporate governance issues. Safieddine, (2009) has made valuable contribution on the topic of corporate governance by providing useful and beneficial information on the agency theory in IFIs. Nevertheless, his approach is mainly influenced by the shareholders value model of corporate governance which is to certain extent contradicted with the existing literatures that advocate the stakeholders' value system as the ideal model for Islamic corporate governance. Indeed there are some areas that need further explanation and clarification particularly in term of theoretical framework of the agency theory in IFIs as well as the foundational dimension of corporate governance in Islam from the epistemological aspect.

Keywords: Corporate governance, agency theory and Islamic financial institutions.

INTRODUCTION

While there are numerous and extensive research on corporate governance from western perspective, only a few studies have been conducted as regard to corporate governance in IFIs. The survey of Siddiqi, (1981), Mannan, (1984) and Haneef, (1995), on the contemporary literatures on Islamic economic prove that there are lack of references and discussion on the topic of corporate governance in IFIs in 1980s and the earlier 1990s. Specific studies on the issue of corporate governance of IFIs can only be traced in 1989 where Abomouamer, (1989) conducted a survey on the role and function of *Shari'ah* Control in Islamic Banks and Banaga, et al., (1994) on the External Audit and Corporate Governance in Islamic Banks.

With the failure and huge amount of losses of several IFIs such as Ihlas Finance House in Turkey[1], financial scandal like in the case of Dubai Islamic Bank[2],

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closure of the Islamic Bank of South Africa[3] and Islamic Investment Companies of Egypt[4] and huge losses of Bank Islam Malaysia Berhad[5], the need for good and efficient governance system is considered as part of the crucial portion of corporate governance. In view of these governance issues which may impede the development of Islamic finance, significant number of researches on corporate governance in IFIs then were carried out by different individual, organizations and institutions. One of the most significant studies on corporate governance in IFIs is carried out by Chapra and Ahmed (2002) where they discussed the issue of roles and functions of *Shari'ah* board, auditing, accounting and general framework of corporate governance in IFIs. Other studies were conducted by Al-Baluchi, (2006) on the corporate disclosure practice of IFIs and Al-Sadah, (2007), on the corporate governance of Islamic banks, its characteristics and effect on stakeholders and the role of Islamic bank supervisors. In 2008, the IFSB published a survey on *Shari'ah* Boards of Institutions Offering Islamic Financial Services across Jurisdictions in 2008 (IFSB, 2008) and this is followed by Faizullah, (2009) where he discussed issues on governance, transparency and standardization of Islamic banks.

Despite all of the above researches, it is nevertheless found that there is lack of studies on the aspect of corporate governance theoretical foundation from Islamic perspective particularly within the context of IFIs. At this point, Choudhury and Hoque, (2004) and Iqbal and Mirakhor, (2004) deconstruct the theoretical framework of Islamic corporate governance where the former demonstrate the theory of corporate governance founded on the epistemology of *Tawhid* while the latter advocate the stakeholders' oriented value system based on the principle of property rights and contractual obligation. Safieddine, (2009) extended the existing literatures by highlighting variations of agency theory in

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[1] Ihlas finans in Turkey was closed in 10th February 2001 due to financial distress and weak corporate governance. Ali, (2007: 1-52) reported that the closure of Ihlas Finans mainly contributed by the failure of corporate governance and internal checks and balances. It is found that the bank is run without proper systems of internal control, the management was not preparing for any changing circumstances regulations and unclear scope of regulations.

[2] This refer to the fraud case in Dubai Islamic Bank involving of USD501 million. Seven individuals have been charged including two Dubai Islamic Bank former executives (Morris, 2009). In this case two DIB's personnel collaborated with five businessmen fabricated the documents and bogus transactions to obtain huge amount of financing (Za'za, 2009).

[3] The Islamic Bank of South Africa was closed in November 1997 due to lack of supervision from regulatory authority, bad management, weak risk management and numerous loans to insiders (Okeahalam, 1998: 29-48).

[4] The closure of the Islamic Investment Companies of Egypt in 1988 was due to the weak of corporate governance, irresponsible management, improper regulatory frameworks and engaged in *Shari'ah* non-compliance activities (Zuhaida, 1990: 152-161).

[5] The BIMB declared losses, totaling RM457 million in 2005 mainly due to provisioning of RM774 million as a result of bad financing and investments incurred by its Labuan branch (Parker, 2005). The composition of the board was not appropriate as there were no board members who were familiar with banking sectors as well as no sound and proper credit and debt collection (Parker, 2005).

the unique and complex context of Islamic banks. This paper specifically aims at critically examining the arguments put forward by Safieddine, (2009) and highlighting several corporate governance issues within the confinement of the agency theory in IFIs.

NEW INSIGHTS OF AGENCY THEORY IN IFIs

As pointed out by the author, companies are exposed to agency issues when the separation of ownership and control leads managers to seek their personal interests at the expense of shareholders. As a control mechanism, corporate governance hence is needed to act as a mechanism of check and balance the interests of managers and shareholders. Safieddine, (2009: 142-143) asserted three reasons of why agency relationship in IFIs is different and deserved separate examination:-

The nature of operation: IFIs are entrusted to maximize the shareholders wealth and at the same time have duty to comply with the *Shari'ah* rules and principles. IAHs are considered as quasi shareholders but without having governance rights as enjoyed by other shareholders.

(i) The tremendous growth of Islamic finance: Annual growth of 10-15 per cent. There is great opportunity for investment and further growth particularly in GCC Countries.
(ii) Lack of empirical research on the agency theory in IFIs: The existing literature has failed to address some agency theory issues in IFIs with adequate data and information.

Safieddine, (2009: 144) listed down two main characteristics of agency theory in IFIs namely the need to comply with *Shari'ah* and the rights of depositors and IAHs pertaining to the separation of cash flow and control rights. He referred to several literatures discussing mechanisms to mitigate the agency issues faced by IFIs as summarized in table 1. He further viewed that all of recommendations in the existing literatures have not been supported by empirical evidence.

Table 1: Specific Mechanism to Mitigate the Agency Issues

Agency Issues	Mechanism
The need to comply with *Shari'ah*	The establishment of *Shari'ah* board
	Access to reliable and accurate information on the *Shari'ah* board, governance structure and fatwa.
The Separation of cash flow	Role of vicarious monitoring

and control rights	
	Group of *shura* consisting representatives of the shareholders, creditors, the public, the BOD and the *Shari'ah* board
	Granting unrestricted IAHs representation on the board and involving them in the strategic management of the bank
	IAHs' representation in the audit committee or in the AGM.
	Access to reliable and accurate information and these include the duty to disclose the following:- (i) Returns on IAHs and shareholders fund (ii) the bases and percentages for the allocation of assets, profits and expenses (iv) Information on the BOD, strategies, risk factors, internal controls, performance and governance structure.

Safieddine, (2009) formulated four propositions in explaining the state of agency theory in IFIs.

(i) Proposition 1: Secular agency mitigating mechanisms may not be applied for IFIs because of regulatory conflicts between *Shari'ah* and conventional financial market (Safieddine, 2009: 148). In Bahrain, Kuwait and the UAE, the investment accounts are not secured as conventional deposits while in Saudi Arabia and Qatar, the right of IAHs is secured by imposing abidance with tighter governance practices.

(ii) Proposition 2: The conflict of agency mitigating mechanism with *Shari'ah* principles has resulted lack of adequate control over the implementation of governance in IFIs (Safieddine, 2009: 151). Table 2 summarizes the finding in this section.

Table 2: Corporate Governance Practices and the Mitigation of Agency Issues

Corporate Governance Practices	**Findings**
Commitment to governance	• 65% of IFIs adopt the BCBS and 25%, the OECD. • 58% of IFIs have developed or are planning to

	develop their own corporate governance principles • None IFIs has assigned officer to monitor the corporate governance implementation.
BOD	• Minimum number of board members is 8.5 and majority of them are non-executive directors. • Meeting and disclosure on remuneration: It generally meets the standard practice.
Shari'ah Board	• *Shari'ah* board is composed of 4 members. • Appointment: 83% of appointments were made by the general assembly and 18% by the BOD • Experience: 83% of *Shari'ah* board members have professional experience in Islamic banks and 18% in conventional. • Meeting and decision: Quarterly and majority. • Reporting Structure: 73% of *Shari'ah* boards report to BOD and Shareholders and 28% to BOD only.
IAHS	• Inconsistency between the ideal and the practice. IAHs have no governance rights either control or monitoring rights.

In view of the negative findings on the rights of IAHs, Safieddine, (2009) formulated Proposition 3 whereby he tried to examine the implications of IFIs governance practices on the mitigation of agency issues in two aspects namely audit and control and transparency and disclosure (Safieedine, 2009: 153).

(i) Audit and Control: The general practice of IFIs is in parallel with the recommendations of the AAOIFI. It is nevertheless found that IFIs do not give due consideration to the establishment of audit committees as well as fail to address the conflicts that could arise between depositors and IAHs.

(ii) Transparency and Disclosure: Lack of disclosure on investment accounts and corporate governance information.

Safieddine, (2009: 155) finally demonstrated the correlation between the corporate governance and performance of IFIs by invoking Proposition 4 whereby IFIs would operate more effectively under the governance models that balance between the protection of IAHs and compliance with the *Shari'ah*. The Proposition 4 is based on the following findings:-

(i) Well-governed IFIs have better operating and stock performance and enjoy higher valuations in the market;
(ii) IFIs with low governance index have underperformed the market; and
(iii) Investors appear to attribute higher values for the well-governance IFIs.

REAPPRAISAL ON THE ARGUMENTS OF SAFIEDDINE, (2009)

As mentioned earlier that there are other papers on the topic of corporate governance from Islamic perspective such as Chapra and Ahmed, (2002), Choudhury and Hoque, (2004) and Iqbal and Mirakhor, (2004). In addition, Nienhaus, (2007), Archer and Rifaat, (2007), Grais and Pellegrini, (2006) and Iqbal and Lewis, (2009) also provide insight on several issues pertaining to corporate governance in IFIs. Safieedine, (2009) took another approach in discussing corporate governance issues in IFIs by highlighting the distinct characteristic of agency theory framework and supporting his arguments with empirical data.

Basically, the study conducted by Safieddine, (2009) is classified as exploratory in nature. In view of the empirical data provided, undeniably, he deserves credits by expanding on the work of previous researches and enriching the studies on the topic of corporate governance in IFIs. This study provides useful source of information that may render relevant guidelines in guiding the future development of corporate governance practices in IFIs.

In term of literature review on the agency relationships in IFIs, I am of the view that the author unintentionally has neglected the discourse on the foundational dimension of corporate governance in Islam. It is very important to have solid understanding on the epistemological aspect of Islamic corporate governance before we can put forward our arguments on the agency theory in IFIs.

The author also failed to justify his arguments by providing text or evidence from *al-Quran, al-Sunnah.* Besides, he made no reference to any particular traditional *fiqhi* literatures. His arguments were only supported with the existing literatures and empirical data from the questionnaires and the interviews. In fact, the discussion will be very interesting if he could relate the agency issues in IFIs with the existing case studies such as the closure of Ihlas Finance House in Turkey, the Islamic Bank of South Africa and Islamic Investment Companies of Egypt and financial scandal as in the case of Dubai Islamic Bank.

In the aspect of methodology, the response rate of 53.3 per cent for the survey questionnaires is acceptable[6] but the interview of senior managers from only three IFIs which represent 7.5 per cent of the sample may raise validity and reliability issue. The data used in the analysis on the correlation between well-governed IFIs and performance is also inadequate as it did not reflect the actual indicators of the IFIs' performance.

There is inaccuracy as to the corporate governance regulatory frameworks in IFIs in GCC Countries. For instance, none of GCC Countries have centralized *Shari'ah* board. Higher *Shari'ah* authority or the *Fatwa* Board in the Ministry of *Awqaf* and Islamic Affairs as in the case of UAE and Kuwait can not be considered as centralized *Shari'ah* board. The author also did not elaborate and differentiate the regulatory frameworks of Dubai International Financial Centre (DIFC) as well as Qatar Financial Centre (QFC). Both centers deserve specific explanation as they have different laws and regulations.

Another debatable argument refers to the findings on corporate governance and performance of IFIs. Although, I generally agree with the Proposition 4 on the implication of corporate governance on the performance of IFIs, the findings are still questionable since there is no explanation and information on the corporate governance index developed by the author. Just by classifying IFIs into High and Low group to certain extents does not reflect the exact implications of governance on the performance of IFIs. The corporate governance index should be formulated based on international and credible corporate governance guidelines or standards which are able to provide qualitative and quantitative measure analysis. In fact, the basis of the performance analysis is only derived from two years data (2007-2008). The finding on the positive correlation between the well-governed IFIs and the IFIs' operating and stock performance based on this limited information will not reflect the effectiveness and actual contribution of good corporate governance framework.

The overall arguments of Safieddine, (2009) on the agency theory in IFIs are heavily influenced by the Shareholders value model of corporate governance. He emphasized on agency relationship of IFIs and the IAHs as quasi shareholders

[6] In view of the difficulties in getting response from the industry players and practitioners due to some inherent factors, the feedback of more than 50 per cent is considered significant and acceptable. This is affirmed by other surveys such as Chapra and Ahmed, (2002) where the response rate of the study is only 23.3 per cent (14 IFIs out of 60). A study conducted by Aboumouamer, (1996) demonstrates very minimal percentage of response rate where only 15 IFIs in 20 different countries participated in the survey. In addition, only 69 IFIs in 11 countries responded the IFSB Survey on *Shari'ah* Board of Instutions Offering Islamic Financial Services across Jurisdictions despite of getting special assistance from the IFSB full members from 15 countries (IFSB, 2008).

motivated by profit-oriented behavior. The existing literatures on the corporate governance from Islamic perspective on the other hand tend to suggest that the ideal model corporate governance in IFIs is inclined towards the stakeholders' value system. For instance Chapra and Ahmad, (2002: 13-20) emphasize on the notion of equitably protecting the rights of all stakeholders irrespective of whether they hold equity or not and Iqbal and Mirakhor, (2004) view that corporate governance model in Islamic economic system is a stakeholder-centered model in which the governance style and structures protect the interest and rights of all stakeholders rather than the shareholders per se. In this regard, the agency issues arise from the unique relationship of IFIs and IAHs as well as other stakeholders should be explored further in order to reflect the actual framework of agency theory in IFIs.

CONCLUSION

Safieddine, (2009), attempted to enhance the previous studies on the theoretical framework of the agency theory in IFIs by examining the current practice of corporate governance in GCC Countries. In presenting his ideas, he formulated four theoretical propositions derived from the existing literatures as well as the findings from the questionnaires and interviews. While most of IFIs acknowledged the importance of governance mechanism to mitigate the agency issues, Safieddine, (2009) revealed that that there are some deficiencies in the actual practices of governance in IFIs and these include:-

- (i) The establishment of governance or audit committee is not common practice;
- (ii) Clear internal audit functions are not properly established and weak supervision and monitoring;
- (iii) IAHs still lack of access to relevant information; and
- (iv) IAHs have no governance rights;

The overall arguments put forth by the author generally meet the objective of his study. Despite of this, there are some areas that need further explanation and clarification. In term of theoretical framework of the agency theory in IFIs, the author may also discuss the foundational dimension of corporate governance in Islam from epistemological aspect as well as justifying his arguments with text from *al-Quran, al-Sunnah*. Reference to traditional *fiqhi* literatures may also be made in developing the theoretical foundation of agency theory. I am of the view that there will be very lively discussion if the author could relate the agency issues with the existing corporate failure in IFIs. As regard to the accuracy of the corporate governance regulatory frameworks in IFIs in GCC Countries, some further clarification is needed particularly in the aspect of different law and regulations for DIFC and QFC as well as the issue on centralized *Shari'ah* board.

Furthermore, the findings on corporate governance and performance of IFIs will be more convincing if the corporate governance index is clearly explained. It is also found that the overall of his arguments on the agency theory in IFIs are heavily influenced by the Shareholders value model of corporate governance which is to certain extent contradicted with the existing literatures that advocate the stakeholders' value system as the ideal model for Islamic corporate governance. In whole, regardless of the above observation, Safieddine, (2009) has made valuable contribution on the topic of corporate governance by providing useful and beneficial information on the agency theory in IFIs. This motivates and triggers the need for future research to extend further discourse on the agency issues and corporate governance in IFIs.

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