Islamic Financial Institutions and Corporate Governance: New Insights for Agency Theory

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ABSTRACT

Manuscript Type: Empirical
Research Question/Issue: This paper takes a theory building approach to highlighting variations of agency theory in the unique and complex context of Islamic banks, mainly stemming from the need to comply with Sharia and the separation of cash flow and control rights for a category of investors.
Research Findings/Results: The paper provides insights that agency structures in the context of Islamic banking might give rise to trade-offs between Sharia compliance and mechanisms protecting investors’ rights. Alternative models of idiosyncratic governance might be effective in balancing the two cornerstones of the agency dynamic. In practice, the paper finds that most of the surveyed Islamic banks appear to recognize the value of governance and institute some basic mechanisms. Nonetheless, some governance flaws relating to audit, control, and transparency are observed, a situation further exacerbated by the fact that investment account holders are not represented on the board, and are not granted control or monitoring rights. This leads to a discussion on the tradeoff between the costs and benefits of such a practice.
Theoretical Implications: This study contributes to the agency theory literature by providing theoretical propositions highlighting challenges to this theory whereby mechanisms with the purpose of mitigating agency problems might lead to a divergence from Islamic principles of Sharia.
Practical Implications: The paper motivates Islamic banks to improve governance practices currently in place. It alerts policymakers to the need to tailor the regulations to safeguard the interests of all investors without violating the principles of Sharia.

Keywords: Corporate Governance, Board Evaluation, Board of Director Issues, Gulf States, Agency Theory

INTRODUCTION

Awareness of the potential drawbacks of agency problems has grown enormously over the past decade. By now it has become widely accepted that companies are exposed to agency issues whereby the separation of ownership and control leads managers to seek their personal interests at the expense of those of shareholders (Fama and Jensen, 1983a). To mitigate these issues, governance was adopted (Beasley, 1996; Bebchuk, Cohen and Ferrell, 2004). These lead to improved mechanisms that align the interests of managers and shareholders and institutional control is increasingly performed for corporations (Gompers, Ishii and Metrick, 2003). However, agency relationships and governance settings become more complex when corporate structures deviate from their conventional forms (Dharwadkar, George and Brandes, 2000; Kapopoulous and Lazaretou, 2007; Hu and Izumida, 2008).

The paper attempts to explore the agency issues in the special context of Islamic financial institutions and further develop the discussions on the relationship between Islamic finance operations and agency. We argue that the agency problems at Islamic financial institutions deserve separate and particular examination for a number of reasons. The first is directly related to the nature of their operations, which distinguishes them from conventional corporations and widens the issue of separation of ownership and control underlying the agency theory. The key sources of distinction arise from the observation that managers of Islamic banks are not only entrusted by shareholders to maximize the value of their investments, but have a more compelling duty to achieve these objectives in a Sharia-compliant manner (Archer, Ahmed and Al-Deehani, 1998). Furthermore, the

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contracts created between the Islamic banks and investment account holders (IAHs) allow the banks to share in profits and not in risks or losses and forbid IAHs from intervening in the management of their funds. Thus, managers of Islamic banks are presented with opportunities to extract personal benefits at the expense of IAHs’ interests (Abdel Karim, 2001; Abdel Karim and Archer 2002, 2006). Consequently, structures where the cash flow rights of IAHs are separated from their control rights are created.

Second, the study of the agency dynamics in Islamic financial institutions becomes of paramount importance in light of the tremendous growth rates the industry is experiencing. Islamic banks expanded to more than 50 countries and even beyond Muslim countries. Hassoune and Volland (2004) reported that “the growth rate of Islamic banking services outpaced that of conventional banking during the past decade, making it one of the most dynamic areas in international finance.” In 2004, Islamic banks controlled approximately $250 billion in assets and they are expected to grow at an annual rate of 10 per cent to 15 per cent (El-Hawary, Grais and Iqbal, 2007). This study focuses on the Gulf Cooperation Council (GCC) region where the growth rate has been outstanding in comparison with other parts of the world (Hassoune and Volland, 2004; Grais and Pellegrini, 2006a). The Islamic finance industry in this region is expected to attract 4.50 times the funds to be invested in conventional assets in the near term. In 2007, the United Arab Emirates alone issued 52.70 per cent of the global Sukuk (Islamic bond) (Kuwait Finance House, 2007; Global Investment House, 2008).

Third, while the previous literature sheds light on a number of issues faced at Islamic financial institutions and recommends possible mitigating mechanisms, little, if any, research has tackled the issue from an empirical angle. Prior research hints at the exacerbated agency issues at Islamic banks (Choudhury and Hoque, 2006), but does not address the challenges to the theory. Furthermore, to our knowledge, no research has specifically tackled the agency dynamics of Islamic financial institutions operating in developing countries or the GCC. The paper thus takes a theory building approach and attempts to fill the gap in the literature by highlighting how agency theory is different in Islamic financial institutions. It explores the peculiar governance issues facing Islamic banks in five countries of the GCC – Saudi Arabia, Kuwait, Qatar, Bahrain, and United Arab Emirates – and their effectiveness in mitigating agency problems. Through a thorough analysis of the operations of Islamic banks and examination of the practices in place, the paper builds theoretical propositions that tackle the challenges to the agency theory in the context of Islamic banking. It also investigates the impact of a set of governance practices on performance.

The rest of the paper is organized as follows. The next section reviews the literature and explores the variations of the agency theory in Islamic banks. Then the paper presents an overview of the research methodology and the sample. The paper proceeds with a section that summarizes the governance environment and the regulatory framework in the GCC countries and then discusses the findings and presents a set of theoretical propositions. The last section includes our concluding remarks.

LITERATURE REVIEW

Agency Theory in Different Corporate Contexts

It is widely argued that the contract structure of organizations separating ownership from control gives rise to agency problems resulting from the fact that the agents or managers do not bear the risks or the “wealth effects of their decisions” (Fama and Jensen, 1983a; 1983b). Managers would be consequently tempted to diverge from their fiduciary duty of maximizing shareholder wealth. The development of the agency theory has resulted in the proposition and implementation of governance structures whereby the control of decisions is separate form the management of these decisions (Fama and Jensen, 1983a). The reinforcement of the role of the board of directors and the tightening of audit and control mechanisms came to serve this purpose. The concept of corporate governance as “a set of relationships between a company’s management, its board, its shareholders, and other stakeholders,” has quickly emerged, fueled by the desire to mitigate recurring incidents of agency problems (OECD, 2004).

The research on agency theory has expanded beyond conventional contractual structures between shareholders and managers. Hu and Izumida (2008) and Kapopoulou and Lazaretou (2007) tackle the issue of ownership structures and their implications for the emergence of agency problems. Kapopoulou and Lazaretou (2007) highlight the issue of conflicting interests between strong blockholders and weak minority shareholders in family-controlled firms in Greece and find that the greater the degree of ownership concentration, the more effective the control mechanisms. Dharwadkar et al. (2000) also study the agency theory in a unique governance setting by exploring the issues that encounter privatized firms in emerging markets. They argue that the traditional agency problems are exacerbated, and issues relating to the expropriation of minorities’ rights are created. They attribute this to the transfer of ownership and the weak internal and external governance contexts.

Bebchuk, Kraakman, Reinier and Triantis (2008) address the agency costs of corporate arrangements separating the cash flow and control rights such as the dual class share structures. They find that as the size of cash flow rights held decreases, the size of agency costs increases. Their findings also suggest that the separation of the two rights could create agency costs in an order of magnitude larger than those associated with controlling shareholders.

The Unique Agency Relationships in Islamic Financial Institutions

The governance of the banking industry in general has also caught the attention of scholars and regulators. Hagendorff, Collins and Keasey (2007) concentrate their research on the banking sector backed by the argument that it requires a separate agency analysis. The uniqueness of the agency relationships at banks stems from the managers’ duty to safeguard the funds of all capital providers, including depositors (IFQ, 2007). The opaque nature of many of the banks’ main activities, the role of regulation in the industry (Basel Committee on Banking Supervision, 2006; Hagan-
The Need to Comply with Sharia. Islamic banks must adhere to both the regulations set by the supervisors and the Islamic principles of Sharia (Archer et al. 1998). Sharia prohibits *riba* (interest), *gharar* (speculation), and the trading of money, and it calls for alternative modes of trading where the underlying products are real assets or services. A large percentage of capital providers – shareholders and investors – to Islamic financial institutions are extremely concerned that their funds are invested in a Sharia-compliant manner (Chapra and Ahmed, 2002). Thus, while agency problems in conventional companies arise when managers deviate from their duty to maximize shareholders’ wealth, any divergence by managers of Islamic financial institutions from placing all supplied funds in Sharia-compliant investments creates an additional source of agency problems.

The Rights of Depositors and IAHs – The Separation of Cash Flow and Control Rights. The prohibition of interest poses agency problems that extend beyond the issues of complying with Sharia law. In contrast to interest-bearing saving accounts in conventional banks, an Islamic savings account grants the Islamic bank the discretion to pay the depositors a return that depends on the bank’s overall profitability. Thus, a risk of a potential manipulation of the depositors’ return that depends on the bank’s overall profitability creates an additional source of agency problems.

Instead of earning a fixed rate of return on investments, the Sharia principles call for contracts based on equity participation, profit-sharing (*Mudaraba*), and profit- and loss-sharing (*Musharaka*) arrangements, which create IAHs (Aggarwal and Yousef, 2000). An investment account is an instrument of neither pure debt nor pure equity. Depositors at conventional banks enjoy a certain level of deposit insurance, and do not share in risks, while in a *Musharaka* (equity participation contract), the profits and losses are shared between the bank and the investor. In the case of a *Mudaraba* (trustee finance contract), which is the riskiest type of contract, the bank is entitled to manage the capital of investors and has complete freedom therein. The profits are shared in a mutually agreed-upon proportion. Any financial loss is completely borne by the capital owner or IAH, unless it was the result of a proven misconduct or negligence on the part of the bank (Aggarwal and Yousef, 2000; IFQ, 2007). The contracts do not give IAHs the right to intervene in the management of the funds. Grais and Pellegrini (2006a) view IAHs as “principals entrusting their resources to an agent, the financial institution’s management – with the significant difference that, in their case, the agent is appointed by another principal, namely, the shareholder.” Consequently, IAHs are not granted the monitoring and control rights that shareholders enjoy and their cash flow rights are separated from the rights to control the investments. The agency issues thus do not solely arise from the separation of ownership and control for shareholders but also from the separation of cash flow and control rights for depositors and investors.

With such contractual structures, it would be more likely for managers to exploit opportunities to put less effort into managing the funds, report lower profits, or extract private benefits at the expense of IAHs (Ahmad, 2000; Dar and Presley, 2000). Moreover, some contracts, the unrestricted investment accounts for instance, do not restrict bank participation in certain types of investment fund activity and permit managerial discretion in commingling depositors’ funds with shareholders’ funds for investment in the same portfolio. This eliminates operational transparency and creates potential conflicts of interest with respect to the potential divergence of risk appetite between the two types of capital providers (Abdel Karim and Archer, 2002).

The implications of the divergence between cash flow and control rights become more serious when the discretion granted to managers of Islamic financial institutions in the administration of investment accounts and the financial reporting, including the return smoothing and the reporting of unrestricted IAHs’ profits or losses, are considered. For instance, some contracts allow the creation of a profit equalization reserve, a smoothing technique that sets aside some of the bank’s profits and reduces the returns of both shareholders and IAHs. These practices impede the transparency and reliability of financial information, and hinder the ability of investors to assess the bank’s actual performance (Abdel Karim, 2001; Grais and Pellegrini, 2006b).

Abdel Karim (2001) argues that Islamic banks adopt different accounting treatments for investment accounts. While some report these treatments as equity or liabilities, others report them as an off-balance sheet item, which permits them to hide any negative information related to investment accounts, such as losses because of misconduct or negligence (Abdel Karim, 2001). In addition, a number of researchers argue that the financial reporting rules set by the International Accounting Standards and the Generally Accepted Accounting Principles do not reliably reflect the true performance of Islamic banks. For example, financial reporting standards do not cover the spectrum of Islamic financial operations. The Accounting and Auditing Organization for Islamic Financial Institutions standards were introduced to fill these gaps (Abdel Karim and Archer, 2002; Grais and Pellegrini, 2006a).

Furthermore, an additional impediment to transparency and monitoring is represented in that Islamic banks do not adequately disclose investment account revenues and expenses (Archer et al. 1998).

A global look at the previous literature and a deep examination of the operations of Islamic banks suggest that the Islamic principles underlying the contracts result in unique agency relationships. Particularly in the case of Islamic financial institutions, the traditional agency problems resulting from the tendency of managers to divert from their duty...
to maximize shareholders’ wealth are surmounted by a potential tendency to divert from managing the funds in a Sharia compliant manner and by a separation of cash flow and control rights for depositors and IAH. Similarly to Bebchuk et al. (2008), who find that the agency costs of corporate arrangements separating the cash flow and control rights are larger, we argue that the agency structures and relationships at Islamic financial institutions are more complicated than those faced by conventional corporations and thus deserve special and separate analysis. Consequently, the governance mechanisms that aim at safeguarding the interests of shareholders in conventional corporation structures might not be sufficient in the setting of Islamic financial institutions. We highlight below the mechanisms that are suggested to mitigate the agency issues pertinent to Islamic banks.

**Corporate Governance at Islamic Financial Institutions**

Previous research and publications by international organizations recommend a number of mechanisms, on top of the standard governance mechanisms (board of directors, committees, etc.), to mitigate the unique agency issues faced at Islamic financial institutions. In relation to compliance with Sharia, scholars, researchers, and international organizations have all stressed the importance of a Sharia supervisory board (SSB), which can reassure stakeholders that the institution’s activities comply fully with Sharia law (Abdel Karim and Archer, 2002; Islamic Financial Services Board, 2005b). The role of the SSB covers other responsibilities, which are listed in Table 1, along with the responsibilities of other important governance instruments.

Specific mechanisms have also been suggested to bridge the gap between the cash flow and the control rights of IAHs. Archer et al. (1998) highlight the role of “vicarious” monitoring that shareholders can carry out on behalf of IAHs to prevent management from exposing funds to intolerable risk levels. These shareholders are driven by their desire to attract more investment accounts and to increase their own returns. Asri and Fahmi (2004) propose a governance framework consisting of a group of *shura* (consultants), including representatives of the shareholders, creditors, the public, the board of directors, and the SSB. Grais and Pellegrini (2006b; 2006c) propose that the rights of shareholders be extended to unrestricted IAHs by granting them representation on the board; enabling them to discuss their demands and concerns; and involving them in the

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**TABLE 1**

**Basic Roles of Governance Bodies in Islamic Financial Institutions**

The table lists the basic roles and responsibilities of the key governance organs of Islamic financial institutions: the Board of Directors; Sharia Supervisory Board; Internal Control; Internal Audit; External Audit; and Audit, Compensation and Remuneration Committees.

<table>
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<tr>
<th>Governance Organ</th>
<th>Role</th>
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| **Board of Directors**       | • Set and approve overall policy and strategy  
                                • Monitor progress toward corporate objectives  
                                • Ensure accountability of the management  
                                • Protect Shareholders and Investment depositors rights |
| **Sharia Supervisory Board** | • Set Sharia-related rules and principles  
                                • Provide a clearance of Sharia compatibility of all products  
                                • Oversee compliance and its verdict as to create confidence with respect to compatibility with Sharia |
| **Internal Control**         | • Ensure management oversight  
                                • Recognize and assess risks  
                                • Detect problems and correct deficiencies |
| **Internal Audit**           | • Ensure that the policies set by the board are followed by the management |
| **External Audit**           | • Ensure the accuracy of the quality and quantity of information  
                                • Ensure that the financial statements are prepared according to the accepted reporting standards  
                                • Ensure that the profit has been derived without the violating the teachings of Sharia |
| **Audit Committee**          | • Review and supervise the financial reporting  
                                • Provide oversight of internal and external auditors |
| **Compensation Committee**   | • Monitor the compensation policy of senior management and key personnel |
| **Nomination Committee**     | • Provide assessment of the Board of Directors’ performance  
                                • Replace board members |

Sources: Chapra and Ahmed (2002)
strategic management of the bank. Archer et al. (1998) recommend that IAHs be represented in the audit committee or in the annual general assembly, while keeping their rights limited. Grais and Pellegrini (2006b, 2006c), and Chapra and Ahmed (2002) also suggest the possibility of granting unrestricted IAHs rights similar to the deposit protection granted to debt holders. Unfortunately, the adoption of these mechanisms may face constraints or create additional conflicts or Sharia-related issues that would need to be addressed separately (Chapra and Ahmed, 2002; Grais and Pellegrini, 2006b; 2006c).

It is also argued that shareholders and IAH must have access to reliable and accurate information, and Islamic banks must strictly control the financial reporting system and the regular disclosure of pertinent information. In this way, a well-functioning audit committee with internal audit departments is genuinely needed for Islamic banks to ensure the reliability of the financial information. It is also imperative that the audit committee apply the standards of financial reporting that address the specific issues of Islamic banking (Abdel Karim and Archer, 2002; Chapra and Ahmed, 2002).

The Accounting and Auditing Organization for Islamic Financial Institutions and the Islamic Finance Supervisory Board recommend that Islamic banks accurately disclose the returns on IAH and shareholder funds, the bases and percentages for the allocation of assets, and profits and expenses in a way to enhance transparency and enable investors to monitor the performance of their investments. Additional disclosures could include information on the board of directors, its committees, the SSB strategies, risk factors, internal controls, performance, fatwas (legal pronouncements or opinions), and information on the governance structure (Abdel Karim and Archer, 2002; Sundararajan and Errico, 2002; Islamic Financial Services Board, 2005b; Grais and Pellegrini, 2006a).

Prior studies show that agency problems in different contexts are mitigated by the incorporation of sound corporate governance practices that align the interests of managers with those of principals. This is evidenced by superior stock performance, reflecting the consequences of poor transparency as indicators of sound corporate governance (Pi and Yermack, 1993; Yermack, 1996; Accounting and Auditing Organization for Islamic Financial Institutions, 1997; Anderson, Mansi and Reeb, 2004; Brown and Caylor, 2004).

In the case of Islamic financial institutions, Chapra and Ahmed (2002) observe that agency problems may affect a bank’s credibility, as well as its ability to attract investors. They provide evidence that almost 86 per cent of depositors in Bahraini Islamic banks and almost 95 per cent in Sudanese Islamic banks are prepared to withdraw their funds if those banks failed to operate in accordance with Sharia. Also, 30 per cent of the Bahraini depositors and 87 per cent of the Sudanese depositors would withdraw their funds if there were rumors of poor managerial performance, reflecting the consequences of poor transparency. Al-Deehani, Karim and Murinde (1999) find that increases in profit-sharing investment accounts are associated with increases in the value of the bank’s shares. Consequently, Chapra (1992) suggests that without effective corporate governance, it will be impossible for Islamic banks to rapidly strengthen and expand. In fact, the failures of several Islamic banks can be attributed to governance weaknesses, including the collusion of the board with management, auditing failures, the lack of consideration for minority shareholders’ interests, and the pursuit of excessive risks (Grais and Pellegrini, 2006a).

To our knowledge, prior research does not go beyond mere suggestion and recommendation of governance principles and it falls short in investigating the mechanisms being actually practiced by Islamic financial institutions or in empirically examining the impact of the recommended best practices of corporate governance, or lack therein on performance. This paper attempts to fill this gap by examining the implications of the practices of Islamic financial institutions on the mitigation of the traditional and unique agency issues as well as on the operations and performance of Islamic banks.

**METHODOLOGY AND DATA**

**Methodology**

In order to shed light on the actual governance practices of Islamic financial institutions and their effectiveness in mitigating agency issues, a survey of 43 questions was prepared and sent to 75 Islamic financial institutions that operate in five of the GCC countries of Saudi Arabia, Kuwait, Qatar, Bahrain, and the United Arab Emirates. The final sample of respondents consists of 40 Islamic financial institutions.

The questions of the survey tackled traditional, as well as unique, practices, including awareness of corporate governance principles, board of directors’ effectiveness, SSB effectiveness, rights of IAHs, audit, and control over the financial reporting and transparency.

In addition to the survey, we interviewed senior managers from three Islamic financial institutions, in order to gauge their insights into corporate governance practices at Islamic banks.

For the examination of the impact of corporate governance on performance in Islamic financial institutions, the paper takes a similar approach to the G-Index by Gompers et al. (2003) and the Gov-Score by Brown and Caylor (2004) to create a quantified index of corporate governance. The index takes an aggregate value of a number of criteria: (1) separation of the CEO and chairman positions; (2) existence of an audit committee; (3) existence of a corporate governance or nomination committee; (4) existence of a corporate governance code; (5) separation of the internal control and internal audit departments; (6) public disclosure of information; (7) reporting lines of the external auditor to shareholders; (8) representation of IAHs on the board; (9) SSB appointment by the shareholders; and (10) reporting lines of the SSB to shareholders. These criteria are identified in previous literature as indicators of sound corporate governance (Pi and Timme, 1993; Yermack, 1996; Accounting and Auditing Organization for Islamic Financial Institutions, 1997; Anderson, Mansi and Reeb, 2004; Brown and Caylor, 2004; Islamic Financial Services Board, 2005a; Grais and Pellegrini, 2006a).

The sample consists of 29 Islamic financial institutions. These include the publicly listed banks for which corporate governance and financial data is available. For each Islamic
financial institution, one point is added to the index for each available criterion of corporate governance. The Islamic financial institutions are split into two groups at median values. The banks in the High governance group have the highest corporate governance index values and those in the Low group have the lowest values. Several measures of performance are calculated for each group of Islamic financial institutions in order to examine the link between corporate governance and performance. The measures include indicators of size and operating performance (Number of Employees, Total Assets as of end of 2007, Total Revenues for the year ended 2007, Revenue Growth over 1 year, Net Profit for the year ended 2007, and Net Profit Growth over 1 year), as well as indicators of stock performance and valuation (Market Capitalization, 12 months index-adjusted returns, 6 months index-adjusted returns, Price to Earnings ratio, and Price to Book ratio). Table 2 presents the bi-variate correlations between the independent variables.

**Descriptive Statistics**

Table 3 displays a summary of the descriptive statistics of the sample. It shows that the survey was completed by members of the board of directors (40 per cent) or by senior managers (60 per cent). Twelve (30 per cent) of the respondent banks operate in Kuwait, nine (23 per cent) in Bahrain, and eight (20 per cent) in the United Arab Emirates. These three countries have introduced the most advanced regulations to govern the operations of Islamic financial institutions and have developed separate Islamic banking laws. Thirteen and 15 per cent of the surveyed institutions operate in Saudi Arabia and Qatar, respectively.

In addition, the table shows that 32 (80 per cent) of the surveyed banks are publicly held institutions. They are generally large companies, if benchmarked to the national scale of the industry. In fact, the sample captures the largest Islamic financial institutions in each of the five countries. The sample has a mean number of employees of 797, mean book value of assets of $4.64 billion, and mean net profits of $0.2 billion.

**NEW THEORETICAL INSIGHTS**

**Islamic Regulations and Corporate Governance**

Hassoune and Volland (2004) attribute the reluctance of conventional banks in the GCC to invest aggressively in Islamic banking to uncertainties in the legal and regulatory environment. Choudhury and Hoque (2006) and Zaher and Hassan (2001) stress the role of banking supervisors and the importance of policies and regulatory frameworks that recognize the unique nature of Islamic banks. Thus, before examining the governance structures of Islamic financial institutions in the region, this part of the paper elucidates the degree of development of the governance standards set by the regulatory bodies in the GCC and assesses the differences among the regulations imposed by each of the countries and their effectiveness in mitigating the agency issues. Table 4 lists the regulations that currently govern the operations of Islamic banks in each of the GCC countries.
Differences in the approaches adopted by the central banks of the GCC to mitigate agency issues and protect IAHs are noted. Two models could be particularly discerned – some GCC central banks appear to be focusing on imposing regulations that safeguard the returns of IAHs, while others are focused on providing a range of flexibility for Islamic banks to operate.

In Saudi Arabia and Qatar, a separate law for Islamic banks does not exist. The Islamic financial institutions must comply with the general laws applicable to all banks. Additional guidelines and rules are imposed when necessary. It is interesting to note that the regulations suggest that Qatar and Saudi Arabia seek to protect the interests of IAHs and mitigate the unique agency issues that they face by imposing on banks the requirement to secure the returns on IAH investments. A close examination of these regulations opens the door for interesting insights on the interaction between agency problems and Islamic finance operations. In these countries, IAHs are granted a high level of security, making them approach more a level of depositors in conventional banks than to that of investors. In Saudi Arabia, only restricted investment accounts are allowed and these are required to earn safe returns. The Qatari authorities require Islamic financial institutions to treat unrestricted IAHs in a manner similar to those of conventional deposits by paying them a steady rate of return.

This unveils regulatory conflicts between Sharia law and conventional financial markets, mainly represented by the fact that Sharia law prohibits the earning of fixed or interest like returns on money. Thus, while such regulations might be effective in avoiding a manipulation of the rights of IAHs, they might cause Islamic banking to divert from its very core principle of sharing risks and returns and suggest the possible prevalence of discrepancies between principles and practice. Indeed, previous literature and evidence suggest that the actual practices of Islamic banks often diverge from the principles of Islamic Sharia itself (Aggarwal and Youssef, 2000; Rammal, 2006; Chong and Liu, 2009) whereby Islamic banks are reported to be offering interest-bearing instruments disguised sd mark-up or fixed payment arrangements (Murabaha, or cost-plus financing, and Ijara, or lease). This becomes more serious as the regulations relating to the SSB, whose role is to promote credibility and trust in relation to the compliance with Sharia, are not duly developed in Saudi Arabia and Qatar as reflected in Table 4, thus calling into question the compliance with the Sharia principles. Taking into perspective these observations suggests that the operations of Islamic financial institutions pose challenges to the agency theory, whereby the regulations set by central banks to secure the returns of IAHs and avoid agency issues may cause Islamic banks to divert from the mere reason for their existence and central mission of operating in a Sharia-compliant manner. This leads to the following theoretical proposition:

**Proposition 1:** Because of regulatory conflicts between Sharia law and conventional financial markets, secular agency mitigating mechanisms may not apply for Islamic financial institutions.

Bahrain, Kuwait, and the United Arab Emirates adopt a somewhat different model for regulating the industry. It could be noticed that Bahrain is the GCC country that has contributed the most to regulating the industry. The Central Bank of Bahrain has introduced a separate law that specifically applies to Islamic banks and tackles their unique aspects. In general, these regulations correspond with the guidelines proposed by the Accounting and Auditing Organization for Islamic Financial Institutions. The Prudential Information and Regulatory Framework was established to license, regulate, and supervise Islamic banks (Hassoune and Volland, 2004).

The central banks of Kuwait and the United Arab Emirates have also demonstrated progress in this respect. Islamic banks in both countries are required to comply with a separate Islamic banking law, based on a higher Sharia authority that exists at the national level (Chapra and Ahmed, 2002). Although the role of each bank’s SSB and its composition are specified in Kuwaiti and United Arab Emirates law, the Emirati laws grant the banks the discretion to determine other factors.

In these countries (Bahrain and Kuwait, and to a lesser extent the United Arab Emirates), the investment accounts are not secured as conventional deposits. In Kuwait,
The table lists the regulations that are imposed by each of the GCC countries (Saudi Arabia, Kuwait, Qatar, Bahrain, and the United Arab Emirates). These cover the banking laws in place, the treatment of Investment Account Holders, disclosure, accounting, and capital adequacy principles, regulations relating to the SSB, committees, and directors of the board.

<table>
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<tr>
<th></th>
<th>Saudi Arabia</th>
<th>Qatar</th>
<th>Kuwait</th>
<th>Bahrain</th>
<th>United Arab Emirates</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of Banking System</strong></td>
<td>Dual*</td>
<td>Dual*</td>
<td>Dual*</td>
<td>Dual*</td>
<td>Dual*</td>
</tr>
<tr>
<td><strong>Banking Law</strong></td>
<td>Islamic banks operate within the laws that govern all banks.</td>
<td>Separate regulatory system, but no separate Islamic banking law; Islamic banks operate within the laws that govern all banks.</td>
<td>Separate Islamic banking law developed.</td>
<td>Separate Islamic banking law developed.</td>
<td>Separate Islamic banking law developed.</td>
</tr>
<tr>
<td><strong>Unrestricted Investment Account Holders (UIAH)</strong></td>
<td>Only restricted investment accounts are allowed with low risk asset allocation, producing safe returns.</td>
<td>Islamic banks are under some kind of an obligation to maintain the capital of unrestricted investment account holders intact, and also to pay the account holders a steady rate of return similar to that paid on conventional deposits. The bank must obtain the Central Bank's prior approval on the profit rates on the different deposits.</td>
<td>Participate in the profits and losses from the bank's business in proportion to the amounts of their participation in the investment and pursuant to the contracts in place.</td>
<td>No obligation to maintain the capital of the unrestricted investment account holders intact or to pay them a return on their investment if no profit has been earned. However, such practices are considered bad banking practices by the supervisor who exercises surveillance over the Islamic banks in order to avoid situations where such practices might occur.</td>
<td>Unspecified.</td>
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<tr>
<td><strong>Disclosure Requirements as to Investment Accounts</strong></td>
<td>No disclosure requirements developed.</td>
<td>No disclosure requirements developed.</td>
<td>Yes. Disclosed in totals as depositors' accounts in the Balance Sheet and as income to depositors in the Income Statement</td>
<td>As per the requirements of Financial Accounting Standard (FAS1): Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions issued by AAOIFI</td>
<td>No disclosure requirements developed.</td>
</tr>
<tr>
<td><strong>Accounting Standards</strong></td>
<td>AAOIFI are set as Guidelines by the Monetary agency; but the IAS are officially required.</td>
<td>Issued accounting standards based on both AAOIFI's standards and the IFRS.</td>
<td>IAS</td>
<td>AAOIFI standards are Mandated, (for products and activities not covered by AAOIFI, IAS must be followed).</td>
<td>IAS</td>
</tr>
<tr>
<td><strong>Capital Adequacy</strong></td>
<td>Unspecified.</td>
<td>Unspecified.</td>
<td>Set by the Board of Directors of the Central Bank.</td>
<td>The regulations are consistent with the approach recommended by the BCBS and IFSB for capital adequacy. As the Basel Committee guidelines may not address specific characteristics of the various services offered by Islamic banks, the Central Bank has adopted a risk-based approach and has tailored the regulations to address the specific risk characteristics of Islamic banks.</td>
<td>Unspecified.</td>
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<tr>
<td>SSB terms of Reference</td>
<td>Saudi Arabia</td>
<td>Qatar</td>
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<td>Verify compliance with Sharia and submit to the General Assembly a report comprising its opinion relating to the compliance of the bank’s operations with the Islamic Sharia principles and any comments it may have in this respect.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Verify compliance with Sharia and submit to the General Assembly a report comprising its opinion relating to the compliance of the bank’s operations with the Islamic Sharia principles and any comments it may have in this respect.</td>
</tr>
<tr>
<td>SSB Composition</td>
<td>Unspecified.</td>
<td>Unspecified.</td>
<td>No less than three Qualified Muslim members.</td>
<td>No less than three members.</td>
<td>No less than three.</td>
</tr>
<tr>
<td>SSB Decision Making</td>
<td>By majority.</td>
<td>Unspecified.</td>
<td>By majority.</td>
<td>Unspecified (To be decided by shareholders).</td>
<td>Unspecified (To be decided in the articles of association of the bank).</td>
</tr>
<tr>
<td>SSB Appointment and Dismissal</td>
<td>Unspecified</td>
<td>Appointed by the Board of Directors and approved by the General Assembly.</td>
<td>Appointed by the Board of Directors and approved by the Central Bank of Kuwait (CBK) and the General Assembly.</td>
<td>Appointed by Shareholders. Dismissal is proposed by Board and approved by shareholders (According to AAOIFI standards).</td>
<td>A centralized SSB exists</td>
</tr>
<tr>
<td>SSB Fit and Proper Criteria</td>
<td>Unspecified</td>
<td>Unspecified</td>
<td>Subject to best practice – possibly AAOIFI standards</td>
<td>Conflict of interest and competence clauses (According to AAOIFI governance standards).</td>
<td>Unspecified</td>
</tr>
<tr>
<td>Centralized SSB (higher Sharia authority at the national level)</td>
<td>A centralized SSB does not exist</td>
<td>A centralized SSB does not exist</td>
<td>Yes (with a role to standardize the Sharia Practices)</td>
<td>A centralized SSB does not exist</td>
<td>A centralized SSB exists</td>
</tr>
<tr>
<td>Compensation Committee (Required versus Encouraged)</td>
<td>Encouraged</td>
<td>Encouraged</td>
<td>Encouraged</td>
<td>Encouraged</td>
<td>Encouraged</td>
</tr>
<tr>
<td>Nomination Committee (Required versus Encouraged)</td>
<td>Encouraged</td>
<td>Encouraged</td>
<td>Encouraged</td>
<td>Encouraged</td>
<td>Encouraged</td>
</tr>
<tr>
<td>Independent and Non-Executive Board Members (Required versus Encouraged)</td>
<td>Not Required</td>
<td>Not Required</td>
<td>Not Required</td>
<td>Not Required</td>
<td>Not Required</td>
</tr>
</tbody>
</table>

unrestricted IAHs participate in the profits and losses from the bank’s business pursuant to the contracts in place. In Bahrain, there is no obligation to maintain the capital of the unrestricted IAHs intact or to pay them a return if such return is not earned, although the occurrence of such incidents would be considered a malpractice.

Thus, a model different than that adopted in Saudi Arabia and Qatar seems to be in place. Under this model, the regulations appear to preserve the nature of Islamic finance, but they do not grant IAHs a minimum rate of return. Nonetheless, due consideration of the other regulations imposed by these central banks suggests that they are attempting to secure the rights of IAHs by imposing an abidance by tighter governance practices. For instance, Islamic banks in Bahrain and Kuwait are required to abide to some standards of disclosure in relation to investment accounts, a requirement that is non-existent in Saudi Arabia and Qatar. The same is observed for the capital adequacy requirements. In relation to the SSB, it could be implied that in Bahrain, Kuwait, and the United Arab Emirates these bodies are expected to exercise a more binding and stringent role in ensuring abidance by Sharia relative to those in Saudi Arabia or Qatar, as their terms of reference and rules for appointment and proper fit are addressed by the regulations. In essence, the central banks of Bahrain, Kuwait, and the United Arab Emirates appear to be imposing some idiosyncratic mechanisms of corporate governance. These aim at protecting IAHs from an abuse of their rights by managerial misconduct while at the same time preserving the concept of Islamic finance that prohibits the earning of interest and calls for profit and loss sharing. These observations bring us to the next theoretical proposition:

**Proposition 2:** Because of the principles underlying the Sharia law, some idiosyncratic approaches to corporate governance allowing Islamic financial institutions to cope with moral hazard issues seem to substitute or at least alleviate the need for agency mitigating mechanisms that trigger conflict with Sharia principles.

Additionally, Table 4 shows that none of the GCC countries requires Islamic banks to establish audit, compensation, or nomination committees, although some of them do encourage it. The absence of such regulations still keeps some room open for agency problems that result from a lack of adequate control over the implementation of governance standards, the appointment of directors and managers and their remunerations, and the financial reporting processes. Furthermore, the regulatory bodies do not require Islamic financial institutions to have independent and non-executive directors on their board. During his interview, Mr. Mohammad Al-Qahtany, CEO of Al Aman Investment Company, highlighted the fact that enforcement of corporate governance issues is the responsibility of the central banks or stock exchanges, and further action needs to be taken by them in order for companies to comply and implement corporate governance in their institutions.

### Corporate Governance Practices and the Mitigation of Agency Issues

#### Commitment to Governance

According to the Islamic Financial Services Board (2005b), a governance policy framework that fits the nature and characteristics of Islamic financial institutions should be adopted so that the practices by Islamic financial institutions do not give rise to agency problems. The answers to the survey demonstrate that the majority of banks are aware of the importance of incorporating sound governance practices. Sixty-five per cent and 25 per cent of the surveyed banks adopt the Basel Committee on Banking Supervision or the Organization for Economic Cooperation and Development principles, respectively. Fifty-eight per cent of banks either have developed or are planning to develop their own principles of corporate governance. Unreported segment findings suggest that two banks do not follow clear principles of governance. For example, these two banks failed to adopt any international guidelines or to develop standards of their own. All of the surveyed banks recognize that the primary role of corporate governance is to protect the interests of all stakeholders.

The results suggest that the majority of banks have instituted strong principles of corporate governance; however, the means of ensuring compliance with the standards are not in place. The responses reveal that 45 per cent of Islamic banks do assign the role of monitoring to an incorporated governance committee; however, none of the banks has assigned a corporate governance officer to take responsibility for this task. Fifty-five per cent of these institutions assign this responsibility to internal audit functions and internal committees, suggesting that they have not established a governance committee or a position for a corporate governance officer. The absence of a governance committee in particular, does not meet the recommendations of the Islamic Financial Services Board (2005b), which places special attention on the establishment of such a committee, with pre-defined roles and composition. Eighty-five per cent of the surveyed banks believe that governance could be improved through internal mechanisms that pertain to the participation of shareholders, the role of the board of directors, and internal control groups.

Moreover, the responses indicate that most banks have not given the requisite effort to instituting a culture of “good corporate governance” throughout the organization or to spreading awareness of governance issues. Sixty per cent of the banks do not train key employees in corporate governance issues. This does not meet the requirement of the Basel Committee on Banking Supervision (2006), which mandates that board members have a deep understanding of their role in corporate governance. It is this specific issue that Mr. Mohammad Al-Qahtany, CEO of Al Aman Investment Company, stresses during his interview. According to Al-Qahtany, “The Islamic banks recognize the importance of incorporating sound governance practices and most of them have proceeded with implementing a governance code.” He points out, however, that “[t]he lack of training aimed at enlightening directors and executives on their roles in promoting corporate governance would prevent them from performing their responsibilities effectively.” The consequences of this failure are reflected in the lack of clarity or at least lack
of consistency in relation to the main responsibility of the board of directors. The majority of Islamic banks (58 per cent) view a director’s main role as ensuring compliance with rules and regulations. Eighteen per cent consider a director’s primary role to be caring for shareholder interests, while another 18 per cent believe that a director’s primary role is to manage conflicts of interest between management, directors, and shareholders. None of the banks considers the strategic role of the boards in setting the overall direction, mission, or vision, and only 8 per cent consider that directors are primarily responsible for supervising management. Considering that exercising oversight over management, protecting shareholders and IAHs, and setting the overall strategic policy are extremely important responsibilities of the boards of Islamic financial institutions (Chapra and Ahmed, 2002; OECD, 2004), the low (or even null) percentage of this response may reflect a problem with the way the boards of directors perform their roles in such banks.

Board of Directors. The complexity of the operations of Islamic financial institutions involving different stakeholders and creating multifaceted relations among them and the structures of contracts granting managers some range of discretion places a greater monitoring responsibility on the board of directors. The qualifications of board members, the way their roles are structured, and the frequency of board meetings imply that Islamic banks comply with the basic requirements of governance and therefore allow the board to exercise its fiduciary duties effectively. For the entire sample, the minimum number of board members is seven and the mean is 8.50 – the majority of whom (average = 6.90) are outside directors. It is widely agreed that outside or non-executive directors do a better job of ensuring independence of governance decisions from management’s influence, and in protecting the interests of investors (Chapra and Ahmed, 2002). Generally, Beasley (1996) finds that the independence of the board is associated with a decrease in financial fraud. Additionally, the respondents to the survey revealed that all Islamic financial institutions have adequate experience and knowledge to exercise their positions of responsibility. All of the surveyed banks regularly hold meetings and are committed to publicly disclosing the compensation of the directors. Together, such practices suggest that the surveyed Islamic financial institutions have boards of directors that are well equipped to contribute to decision-making processes that can avoid agency problems.

Sharia Supervisory Boards. Adherence to Sharia principles is the primary distinguishing attribute of Islamic financial institutions. Investors entrust Islamic banks with investing their funds in compliance with Sharia law. Thus, it is imperative for Islamic banks to have appropriate mechanisms and procedures that allow the SSB to exercise its role in ensuring compliance of the banks’ products and compliance with Sharia.

All respondents have an independent SSB that is composed of four members. This is considered good practice, in line with the Accounting and Auditing Organization for Islamic Financial Institutions requirement of having at least three SSB members. The SSB members are appointed by the general assembly in 83 per cent of the banks, a move toward ensuring independence of the SSB (Grais and Pellegrini, 2006a). In 18 per cent of the surveyed banks, the board of directors appoints the SSB members.

Eighty-three per cent of the respondents report that SSB members have professional experience in Islamic banks, while 18 per cent report that they have professional experience in conventional banks. This is also considered good practice: Grais and Pellegrini (2006a) recommend that the Sharia scholars be knowledgeable about Islamic law and have financial expertise. The responses also reveal that SSB members are not entitled to be members of the board of directors, and do not currently own any shares of the banks, in compliance with the Accounting and Auditing Organization for Islamic Financial Institutions standards and the regulatory standards. They are however, allowed to be members of other banks’ SSBs.

The SSBs of all the surveyed Islamic banks meet on a quarterly basis and decisions are approved by the majority of the SSB members. The SSBs of 73 per cent of the banks report to both the board of directors and the shareholders, while the SSBs of 28 per cent of banks report only to the board of directors. Eighty-five per cent of the surveyed banks consider SSB decisions to be both mandatory and binding.

In conclusion, the observed characteristics of the SSBs among the majority of the surveyed banks suggest that they are well established and well equipped – in terms of composition, independence, background and enforcement of decisions – to avoid conflicts of interest and agency problems by providing constructive and independent guidance in relation to Sharia-compliant products.

Investment Account Holders. The agency problems that IAHs face are the primary issues that need to be resolved within the governance framework of Islamic financial institutions. The responses reveal that all of the surveyed banks prioritize the rights of shareholders and customers before those of other stakeholders. This suggests that Islamic financial institutions are aware of the importance of validating the rights of customers (including IAHs); however, this awareness of IAH rights is not put into practice. For example, the surveyed banks do not allow IAHs to be members of the board or to participate in managerial decisions. Thus, IAHs are unable to monitor their investments, communicate their needs, or express their concerns (Grais and Pellegrini, 2006b; 2006c). They are exposed to serious agency problems because managers – whose actions are not subject to strict monitoring and oversight – have the freedom to manage their funds and take excessive risks with them (Ahmad, 2000; Dar and Presley, 2000).

While under the principles of Sharia IAHs enjoy cash flow rights that depend on the performance of the banks in managing and investing their funds, they are neither granted control nor monitoring rights. In a survey of the preferences of consumers of Islamic banks, Chapra and Ahmed (2002) report an interest by account holders to be involved in the strategic management of the bank, which suggests that a practice of representing IAHs on the board might spread.
confidences among IAHs and attract them to invest their funds. However, as much as the practice of involving IAHs in the monitoring mechanism might sound beneficial, it might cause conflicts of the interests between IAHs and shareholders, with each group pushing for the achievement of its own interests (Chapra and Ahmed, 2002). For instance, conflicting interests might arise in relation to the risk appetite of each or the use of the profit equalization reserve (Abdel Karim and Archer, 2006). This might constitute one reason holding back Islamic financial institutions from allowing representation of IAHs on the board. These observations translate into the following theoretical proposition:

**Proposition 3:** Islamic financial institutions face a trade-off between bridging the gap of IAHs’ cash flow and control rights and the mitigation of conflicts between these investors and shareholders.

**Audit and Control.** The purpose of the questions under this section is to examine the implications of Islamic banks governance practices on the mitigation of agency issues, conflicts of interest, and risks. The responses demonstrate that all of the surveyed banks have internal control departments that report on a quarterly basis to the board of directors. This reflects a means for control over material risks and for tight oversight by the board of directors. In addition, members of the internal control department are not allowed to be on the SSB, enabling the banks to avoid conflicts of interest and leading to better SSB monitoring of the internal control functions in relation to Sharia-compliant behavior. Also, the responses show that 75 per cent of the surveyed banks believe that internal control functions are intended to ensure compliance with rules and regulations, including Sharia law. This practice accords with the recommendations of the Accounting and Auditing Organization for Islamic Financial Institutions (1996; 1997). Fifteen per cent of the banks consider the responsibility of the department to be mitigation of conflicts of interest. The majority of the surveyed banks (73 per cent) do not encounter difficulties in gathering accurate information about the quality of projects they invest in, and therefore, these banks should be able to control credit risks (Islamic Financial Services Board, 2005a). This is of particular importance as Islamic banks’ operations expose them to a unique set of risks whereby, acting as investors, they would be the ones exposed to credit risk, but they hold no collateral. Under these contracts, the clients would be the managers of the funds (Sundararajan and Errico, 2002).

As efficient as these practices may sound in terms of establishing clear channels for risk control and compliance, the governance issues relating to accurate and reliable financial reporting are nonetheless not appropriately addressed by the surveyed banks in general. While 83 per cent of the surveyed banks combine the internal control and internal auditing functions, only 10 per cent agree that the internal control department should be responsible for ensuring that the financial information is accurate. This suggests that the surveyed banks do not appropriately audit the financial reporting process. During our interview with Mr. Mohamad Tawfic Al-Tahawy, an assistant managing director at the Securities House in Kuwait (and a board member of Gateway Bank in London, UK), he highlighted this issue and added that

[the Islamic financial institutions do not give due consideration to the establishment of audit committees. They are not required but only encouraged to incorporate governance, compensation, and audit committees; thus the accuracy of the financial information could not be verified, leading to agency problems between the banks, its shareholders, and the depositors who share in profits. This appears to be an even more serious issue in light of the fact that 68 per cent of the surveyed Islamic institutions follow the International Accounting Standards, while only 8 per cent adopt those set by the Accounting and Auditing Organization for Islamic Financial Institutions and 25 per cent adopt both standards. This suggests that a certain level of inconsistency, even if quite small, may exist for the treatment of some transactions that are closely related to specific Islamic operations not covered by the International Accounting Standards (Abdel Karim, 2001) and possibly driving some Islamic banks to adopt both the International Accounting Standards and the Accounting and Auditing Organization for Islamic Financial Institutions standards. The lack of consistent accounting standards, coupled with the absence of audit committee and auditing processes, decreases the reliability of financial reports and prevents investors from accurately comparing bank performance. It also opens the door to additional agency problems that could arise when managers are given discretion in the accounting of unrestricted investment accounts and when control mechanisms, such as those suggested by researchers such as Abdel Karim and Archer (2002), are not in place to monitor the financial reporting process.

The external auditors of 78 per cent of the surveyed Islamic banks report to shareholders. This practice could alleviate agency problems that arise between banks and their shareholders because of poor internal monitoring of financial reporting. However, this practice may not address the conflicts that could arise between depositors and IAHs. For instance, Archer *et al.* (1998) suggest that the scope of an external audit be extended to cover all Mudaraba (trustee finance contract) funds and that Islamic banks incorporate a proper accounting system that includes the auditing of profit-and-loss-sharing ratios and cost allocations.

**Transparency and Disclosure.** The disclosure of information in an accurate and accessible manner is also a sound governance practice that allows stakeholders to better assess the performance of Islamic banks and make educated investment decisions (Islamic Financial Services Board, 2005b). Eighty-three per cent of the surveyed banks disclose information about themselves through the internet, including data on management and financial performance. Ten per cent disclose this information in their annual report, while three per cent disclose it only upon request. Other information disclosed includes the basis on which profits are distributed among various parties, the policies of risk management, the organizational chart, and party-related transac-
tions. None of the surveyed banks follows the Accounting and Auditing Organization for Islamic Financial Institutions’ (Abdel Karim and Archer, 2002) requirement of disclosing the return on investment account funds, the respective percentages of the profit that should be allocated to account holders, and the bank’s principles of corporate governance.

Mr. Abdul Latif Al Rajhi, regional director and board member, Rajhi Bank, Saudi Arabia, has referred to this insufficiency of disclosure as a critical issue facing investors at Islamic banks. He states

Islamic banks retain information that relates to the returns of IAH’s investments, and it is relevant and material for IAH to assess the performance of their investments and oversee the management’s activities.

According to Mr. Al Rajhi,

Managers would have more discretion in reporting the profits on the investments of IAH and would be tempted to take actions jeopardizing the interests of account holders when the profits on investments and profit allocations are not disclosed.

The results suggest that while Islamic financial institutions are committed to the disclosure of some information to the public, transparency in other areas – investment accounts and corporate governance in particular – needs to be improved in order to ensure the protection of investors’ rights and to reduce the opportunities for managerial misconduct.

The Implications of Governance on the Performance of Islamic Financial Institutions

Table 5 displays the results of the relation between the corporate governance index and performance for the set of Islamic financial institutions under study. The results are consistent with the previous findings linking corporate governance to performance in a conventional company context (Brown and Caylor, 2004).

Despite our finding that Islamic financial institutions in the best governance group are smaller than their counterparts in terms of the number of employees and total assets, they seem to operate more efficiently and to achieve superior returns. Better-governed Islamic financial institutions have superior operating (e.g., higher profits and higher sales growth) and stock performance and enjoy higher valuations in the market. They have larger market capitalizations ($4.64 billion versus $3.29 billion). Their profits exceed those of poorly governed banks by $.66 billion (significant at 1 per cent) and they record significantly higher yearly growth in revenues (by 21.87 per cent) and net profit (by 16.54 per cent).

In terms of index-adjusted stock performance, Islamic financial institutions with low governance index values have

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**TABLE 5**

<table>
<thead>
<tr>
<th></th>
<th>High</th>
<th>Low</th>
<th>Difference in Means</th>
</tr>
</thead>
<tbody>
<tr>
<td># of employees</td>
<td>911.50</td>
<td>931.88</td>
<td>-20.38*</td>
</tr>
<tr>
<td>TA ($ mil)</td>
<td>4534.60</td>
<td>6419.94</td>
<td>-1885.34*</td>
</tr>
<tr>
<td>Mkt Cap ($ mil)</td>
<td>4637.00</td>
<td>3287.65</td>
<td>1349.35*</td>
</tr>
<tr>
<td>TR ($ mil)</td>
<td>433.00</td>
<td>497.35</td>
<td>-64.35*</td>
</tr>
<tr>
<td>R Gr</td>
<td>.62</td>
<td>.40</td>
<td>.22*</td>
</tr>
<tr>
<td>Net Profits ($ mil)</td>
<td>258.40</td>
<td>192.35</td>
<td>66.05*</td>
</tr>
<tr>
<td>Net profits Gr</td>
<td>.57</td>
<td>.40</td>
<td>.17*</td>
</tr>
<tr>
<td>12 M Return</td>
<td>.35</td>
<td>-.20</td>
<td>.55*</td>
</tr>
<tr>
<td>6 M Return</td>
<td>.02</td>
<td>-.15</td>
<td>.18*</td>
</tr>
<tr>
<td>P/E</td>
<td>24.91</td>
<td>14.68</td>
<td>10.23*</td>
</tr>
<tr>
<td>P/BV</td>
<td>3.40</td>
<td>2.67</td>
<td>.73*</td>
</tr>
</tbody>
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underperformed the market as reflected by the 12-month (−20.13 per cent) and 6-month (−15.20 per cent) stock returns. They have also underperformed their well-governed counterparts by 55.24 per cent and 17.61 per cent, respectively (significant at 1 per cent).

Furthermore, the investors in the market appear to attribute higher values for the better-governed Islamic financial institutions. These have Price to Earnings and Price to Book ratios of 24.91 and 3.40, respectively, as compared with 14.68 and 2.67 for the worst governed banks. All differences in means of the two extreme terciles are statistically significant at 1 per cent.

An examination of these results in light of the two models of regulatory frameworks unveiled earlier in the paper offers some interesting insights which call into question the preferences of IAH when put in a trade-off between a securing of the return on their funds and a Sharia-compliant investment coupled with sound governance practices. Chapra and Ahmed (2002) observe that the ability of Islamic banks to attract investors might be affected by a lack of abidance by Sharia, as evidenced by that almost 86 per cent of depositors in Bahraini Islamic banks are prepared to withdraw their funds if those banks failed to operate in accordance to Sharia. Taken at the broad level, the descriptive statistics previously discussed in Table 3 show the highest cluster of Islamic banks in Bahrain (23 per cent), Kuwait (30 per cent), and the United Arab Emirates (15 per cent). This suggests that the more developed regulatory framework balancing between some idiosyncratic mechanisms of governance and compliance with Sharia are more effective in fueling the development of the Islamic finance industry as compared with the ones that institute agency mitigating mechanisms but jeopardize the compliance with Sharia. Together with the evidence for a positive link between performance and an index of conventional and idiosyncratic governance indicators, these observations lead to the following theoretical proposition:

Proposition 4: Islamic financial institutions would operate more successfully under idiosyncratic governance models that balance between the protection of IAHs and compliance with Sharia rather than under governance models that exclusively focus on maximizing financial returns.

CONCLUDING REMARKS

According to Grais and Pellegrini (2006a), the need to give special attention to corporate governance issues in Islamic banks is due to the importance of corporate governance for economic development, the growth of Islamic finance, the critical role of governance in financial institutions, and the unique agency issues faced by these institutions. This paper focuses on Islamic financial institutions that operate in the GCC. It sheds light on the uniqueness of the agency problems in this industry stemming from the managers’ duty to abide by Sharia and the separation of cash flow and control rights for IAHs. It then explores the impact of the governance practices by these institutions on the mitigation of agency issues and on operations and performance. The results suggest that most of the surveyed Islamic banks recognize the importance of, and the rationale for, incorporating governance mechanisms. Some governance instruments, including the board of directors, SSBs, and internal control departments, appear to have the qualifications and composition that would equip them to mitigate agency issues; however, deficiencies in the actual practices of governance are still observed, leaving agency issues unresolved. The establishment of a governance committee or an audit committee is not common among the banks surveyed, and clear internal audit functions are not properly established. Therefore, the financial reporting process does not appear to be tightly monitored, and this could potentially result in agency problems. Most importantly, IAHs and other investors still lack access to relevant information, and they continue to lack influence on management decisions, which expands the divergence between their cash flow and monitoring rights. These observations suggest that, while IAHs entrust managers with their money and exclusively bear the risk of the projects’ failure, they are not able to monitor the performance of their investments or to oversee the activities undertaken by the management, thus leaving some agency problems unresolved.

The results of the paper also reveal that the Islamic financial institutions that record higher value for the index of conventional and idiosyncratic governance mechanisms are more profitable and have superior stock performance and higher valuations than those with lower index values.

The paper has some limitations represented in the information used and that the responses were not verified through additional sources. Also, the investigation of the link between corporate governance and performance is based on a small sample of Islamic financial institutions and is limited to a single year of performance metrics. This might question the validity and reliability of the results.

By focusing on the GCC Islamic banking industry, the paper explores the variations in the regulatory frameworks and practices in a region that has witnessed tremendous growth rates. However, Islamic banking varies widely among countries and jurisdictions for factors not limited to different interpretation of Islamic law by Sharia scholars, levels of industry development, or regulatory frameworks (Ainley, Mashayekhi, Hicks, Rahman and Ravalia, 2007). This limits the implications of the paper to the GCC. It is hoped, however, that the paper motivates future research to extend the insights presented to other parts of the world. Islamic banks in Indonesia, for instance, dominate the industry in Southeast Asia (Movassaghi and Zaman, 2001). Malaysia is believed to have the most developed Islamic finance industry in the world, despite the fact that the operations of Islamic banks in the country more closely resemble those of conventional banks (Chong and Liu, 2009). In Turkey, customers are found to deal with Islamic banks driven by their religious beliefs (Okumus, 2005), yet the returns received by depositors in Islamic banks are not significantly different from those received by depositors of conventional banks (Kuran, 1995). The research could also be potentially extended to Islamic financial institutions operating in western economies, such as the United Kingdom, where secular models of regulations and governance are prevalent.
(Ainley et al., 2007). Such future research could bring interesting insights into the dynamics of the challenges to the agency theory in varying regulatory and religious environments of the Islamic finance industry.

Thus, despite these limitations, the paper’s contributions remain significant as it takes a preliminary move into a relatively unexplored area of research. The paper brings novel theoretical propositions that present insights for future research and it offers theoretical and practical implications.

From a theoretical perspective, the paper adds to both the literature relating to agency theory, as well as Islamic banking. Its contribution resides in its ability to explore the dynamics of agency theory in a special context, that of Islamic financial institutions, and shed light on the challenges to agency theory. For instance, the paper highlights conflicts between some agency mitigating mechanisms and Sharia law. It suggests that some regulations such as securing returns on investments accounts, while in principle seek to secure the investments of account holders against agency problems might cause a divergence from the banks’ purpose of operating in compliance with Sharia. An alternative model of governance practices that address the conventional and unique agency issues appears to substitute for the need to secure the returns on investments and to achieve the dual purpose of safeguarding the interests of IAHs and preserving the principles of Sharia.

However, due care shall be taken when assessing the implications of each governance mechanism separately. For instance, the insights of this paper imply that the representation of IAHs on the board, a mechanism that is intended to tighten the gap between their cash flow and control rights, might give rise to potential conflicts between the interests of the two categories of capital providers. This particular angle opens doors for wider avenues of research. For instance, a thorough investigation of the trade-off between costs and benefits of such a practice might lead future research to propose practices that resolve for these challenges and contribute to optimal balances. Challenging the agency theory from the perspective of agents working for the best interests of IAHs could also constitute a potential area of particular interest to both scholars and practitioners in the field.

Looking at the issue from another angle, future research could dig beyond the control aspect of governance to look into the compensations of managers. Previous research of corporate governance at conventional corporations suggests certain compensation schemes linking managers’ compensations to performance to align their interests with those of shareholders (Core, Guay and Larcker, 2003). Thus, an area for future research would be the exploration of the compensation structures that would entice the management of Islamic financial institutions to work in the best interests of both IAHs and shareholders.

Equally important is an issue that is unveiled in this paper and that is open for further investigation. It relates to the preferences of IAHs when they have the choice between Islamic financial institutions that secure the returns on their investments and consequently resemble more to conventional banks and those that treat them as investors as prescribed by the Islamic contracts.

From a practical angle, the paper has contributed in presenting both Islamic financial institutions and regulators with insights on the challenges of managing the industry in both a Sharia-compliant and investor-protective way and highlighting the conflicts that could arise by the adoption of seemingly agency mitigating practices. The implications reveal that a model of conventional and idiosyncratic governance practices that preserves both the foundations of Islamic finance and the rights of all investors, including IAHs is much needed to be developed by regulators and adopted by Islamic banks given the implications on performance and the development of the industry. Most importantly, while Islamic financial institutions are encouraged to follow practices that protect the rights of investors, the paper implies that due care shall be taken as to the adoption of mechanisms that do not give rise to potential conflicts.

ACKNOWLEDGEMENTS

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NOTE

1. Interested readers may contact the author, if they would like to receive a copy of the questionnaire.

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