Corporate governance: Islamic financial institutions and conventional banking

Corporate governance refers to the method by which a corporation is directed and administered. MOINUDDIN MALIM provides a comprehensive analysis of corporate governance under Islamic laws and conventional finance.

While the world's financial systems and economies are being haunted by the wrongdoings of their past - the exorbitant risk-taking to make a quick buck; the blind race to meet and beat the revenue targets; the lack of oversight by regulators determined to keep the big investment banks alive - the one key aspect that distinguishes one entity from another is good corporate governance.

It can be argued that corporate governance failed when the financial crises of 2009-2010 emerged, whether this failure was in the form of the bailing out of sovereign nations or large financial institutions. It has also been suggested that regulators not only turned a blind eye to the excessive risk-taking by big banks without actually sharing any of such risk themselves but, even post discovery of such violations, did not even attempt to prosecute them as they were considered 'too big to fail'.

While corporate governance in banking has been analyzed almost exclusively in the context of conventional banking, with Islamic banking and finance fortunately playing little part in this global downturn, they too have their share of challenges.

Corporate governance refers to the method by which a corporation is directed, administered or controlled. It covers the laws and customs affecting that direction, as well as the goals by which it is governed. The mechanisms and controls under corporate governance are designed to reduce the inefficiencies that arise from the selection of morally hazardous strategies and directions. Corporate governance should be viewed as a process of monitoring performance by applying appropriate counter-measures and dealing with concepts such as transparency, integrity and accountability.

Hence, corporate governance requires corporations to exercise immense accountability to shareholders and the public, and also to monitor the management of organizations in running their businesses.

One of the key debates that has ensued post the recent financial crises is the role of corporate governance in making institutions behave in a manner that at best describes how they should fulfill the "market discipline". While one may find that different entities have created their own distinct cultural, value and ethical paradigms, which define their corporate governance, there is no standard document which can be applied uniformly across institutions. Corporate governance takes different forms based on the business activities of the entity.

Everyone is expected to adhere to the corporate governance rules and every newcomer has to sign an agreement stating that they have read and understood the corporate governance of the firm and will uphold it.

Corporate governance is normally divided into two categories: self and statutory. Self-regulation involves aspects of corporate governance that are difficult to legislate and involve the human element, such as the independence of the board of directors, the relationship with the management and appraisal of the directors' performance. Statutory regulation, on the other hand, is the framework of corporate governance that can be explained in legal terms.

At the financial institution level, in a broad perspective, corporate governance means abiding primarily by the regulatory guidelines issued by the central governing and regulating body. It also provides for such functionalities as customer due diligence, knowing your customer, compliance, anti-money laundering, accounting and auditing standards, determination of risk, legal parameters for protection and remedy, operational guidelines, procedures, policies, and so on. In the conventional banking and finance framework, there are best practices which one can adapt or simply buy off-the-shelf.

Islamic banking and corporate governance

On the other hand, little has been written on governance structures for Islamic financial institutions (IFIs). One of the reasons may be that IFIs are still insignificant when it comes to global reach or perspective. There are well over 200 IFIs worldwide and they operate in 45 countries encompassing most of the Muslim world, along with Europe, North America and various offshore locations. While Islamic finance represents a radical departure from conventional banking and from the viewpoint of corporate governance, it embodies the core value of risk participation which is governed by and embodied in the principle of Shariah. However size does matter.

Firstly, IFIs up till now have been too small to create any of issues of such magnitude. The largest Islamic bank in the world, Al Rajhi Bank, a Saudi-domiciled bank with an asset base of over US$50 billion, is not even among the top three banks in Saudi Arabia and is only the ninth among the top 10 banks in the GCC countries. Secondly, Islamic finance still lacks an IFI with a real global presence, let alone a presence in all major Muslim countries, which limits any ripple effect from its business activities. Contrary to a conventional bank which is basically a borrower and lender of funds, an IFI is essentially a partner with its customer, on one side; and also a partner with entrepreneurs, on the other side, when employing customer/depositors' funds in productive direct investment. The financial arrangements between an IFI and its customer imply a very different relationship to that of conventional finance. The additional layer of governance for IFIs in the form of a Shariah advisor and Shariah board gives the customers comfort that their investment and financing is in strict conformity with Islamic law.

Shariah governance

The role of an IFI with its customers are encapsulated in the concepts of

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shirkah (partnership), Mudarabah (profit-sharing), wakalah (agency) and qard hasan (extending funding with gains). An IFI is conceived as a financial intermediary mobilizing savings from the public on various Shariah compliance manners and advancing capital to individuals, entrepreneurs and businesses. An IFI thus becomes an aggregator of funds where it has the right to apply the funds in a restricted or unrestricted manner to provide financing. In the purist form of Shariah interpretation, the profit is determined based on a formula which is linked to the underlying Islamic structure.

However, when one peels through these structures, one can find that profit and risk participation are not what we truly believe it should have been. The principle reason for this variation is often blamed on regulators, who tend to drive IFIs to follow similar regulations to conventional financial institutions, which they have adapted over number of years. However, it is vital that IFIs and their shareholders begin to take this responsibility for themselves.

The central theme for all corporate governance for an IFI is its basic framework, which nests around the Shariah supervisory board (SSB) and the internal controls which support it. The SSB is vital for three reasons. First, the SSB approves all products and issues fatwas. Second, those who deal with an IFI require assurance that it is transacting with Islamic laws. Third, the SSB reports demonstrate that the management of the bank is in compliance with its fatwas and statutes. Good corporate governance is an integral part of Shariah compliant banking and finance, as it promotes morality, honesty, integrity, trust, openness, performance orientation, responsibility and accountability, as well as mutual respect and a firm commitment to the organization from everyone who works there.

Governance structures

The pronouncements of the AAOIFI and the Islamic Financial Service Board (IFSB) are the basic guidelines under which IFIs must adapt their practice. All IFIs have to take account of risks and this is where it is essential to have good corporate governance and risk management. However, excepting a handful of jurisdictions, not many regulators have pushed the IFIs licensed in their jurisdiction to adapt AAOIFI or IFSB guidelines.

Whether it is AAOIFI or IFSB, the same Shariah scholars who have been guiding the IFIs have also played a critical role in the formulation of the guidelines and development of these two entities. A Shariah blueprint for an IFI to operate in accordance with policy guidelines may not contradict the laws outlined by the regulator but unless and until the regulators strictly adopt these guidelines, IFIs will continue to mimic the conventional finance sector, as if they are offering the same products in a Shariah compliant manner, to deliver the same financial and economic outcome. Perhaps for now, customers may find this an acceptable alternative rather than accepting conventional product and services.

However, as the level of awareness of customers increases, the obvious query will inevitably be raised: "Is my IFI providing pure Islamic products and services?" Hence, as part of corporate governance, IFIs need to also ensure that they continually push for research and development to evolve themselves into pure Islamic financial enterprises. The SSB at the IFI level, the regulator at the domestic level and various Shariah bodies on a global level will need to drive this change.

Financial governance

It is normal for a customer, whether retail or wholesale, to raise a simple query: "Why are IFIs charging similar or higher profit rates as compared to conventional products?" Like conventional banks, an IFI is a financial intermediary and trustee of people's money, with the difference that it should be based on 'true' risk and reward participation. What that means is that businesses should act as 'responsible' trustees to shareholders and customers. 'Responsible' means managing the business according to the principles of Shariah under the concept of amanah (trust). An IFI should manage its business responsibly, acting as a trustee for all of its stakeholders. Under the doctrine of amanah, financial governance has to be assured and unethical behavior must not be allowed to influence the IFI at any level.

The perception that IFIs operate on the concept of interest-free banking becomes very weak and at times difficult to defend when they cannot differentiate themselves from conventional finance. The key differentiating factors should be risk and reward sharing and structuring.

The IFI acts as a partner and is entitled to monitor, supervise and access books and records. As a consequence, the management of IFIs can find themselves confronted with an ethical dilemma when faced with a conflict of interest between shareholders and Mudarabah partners. Even though the management of IFIs have the authority to conduct the company's affairs, how many times do they really disclose the Mudarabah balance sheet to inform the customers where the funds were deployed and how much income was actually generated? True financial governance would mean a radical departure from current practice, with both risk and rewards shared equitably. Can anyone report when and where they have seen an IFI passing on the actual losses to its customers?

Conclusion

The examination of corporate governance under the scope of Islamic finance yields an interesting and intermittent role between the two. Shariah compliant banking and finance has corporate governance as its cornerstone. It is the Shariah jurisprudence which shapes how an IFI should be prudent, ethical, morally responsible, able to resist adverse strategies, self-governed, transparent, accountable and with strong integrity. There are elements which have curtailed the development of IFIs in their true form; however, ultimately the customers of IFIs will require better Shariah and corporate governance.

The regulators too will need to seriously revisit how they have been regulating IFIs up till now. Shariah jurisprudence provides the framework of how an IFI should be managed, operated and regulated. Deep-rooted issues such as IFIs copying the conventional industry for short-term gains may have won the game so far, but how long can this continue?

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