Corporate Governance in Islam: What Can We Learn?

by

Abdelhafid Benamraoui
Principal Lecturer in Finance, Course Leader BSc Finance with Management,
Westminster Business School, C376,
35 Marylebone Road, London, NW1 5LS, United Kingdom
Tel: +44 (0)20 7911 5000 ext 66697, Fax: +44 (0) 20 7911 5939,
E-mail: a.benamraoui@westminster.ac.uk, a.benamraoui@westminster.ac.uk

IJMBE International Journal of Management, Business, and Economics

Corporate Governance in Islam: What Can We Learn?

by

Abdelhafid Benamraoui
Principal Lecturer in Finance, Course Leader BSc Finance with Management,
Westminster Business School, C376,
35 Marylebone Road, London, NW1 5LS, United Kingdom
Tel: +44 (0)20 7911 5000 ext 66697, Fax: +44 (0) 20 7911 5939,
E-mail: a.benamraoui@westminster.ac.uk, a.benamraoui@westminster.ac.uk

Abstract

The aim of the research paper is to examine the pillars of corporate governance in Islam and how they differ from those adopted in the Anglo-Saxon and other European countries. We focus primarily on the structure followed under conventional and Islamic models of corporate governance, the expected role of the managers and board of directors in a firm under each model, and implications on the shareholders and other stakeholders of a firm. The role of the sharia supervisory board, transparency and accountability are also examined as they are directly linked to the way corporate governance is implemented in a business entity adhering to Islamic precepts. Lessons are drawn from each of these areas and suggestions are made to improve the implementation of corporate governance as perceived in Islam.

Keywords: Corporate Governance, Islam, Anglo-Saxon

1. Introduction

The term corporate governance in its modern context was derived from an analogy between the governing of cities, nations, or states and the governance of corporations. The term has been first used by Eells (1960, p. 108), to refer to "the structure and functioning of the corporate polity" (Becht *et al*., 2002, p. 6). In recent years the concept of corporate governance has gained popularity following an increase in the need to protect the rights of all stakeholders of a company, including minority shareholders (See for instance Shleifer & Vishney, 1997). The foci of these studies have been both theoretical and empirical with special focus on: ii) hostile takeovers and proxy voting contests, iii) delegation and concentration of control in the board of directors, iv) alignment of managerial interests with investors through executive compensation contracts, and v) fiduciary duties for Chief Executive Officers (CEOs).

In practice, corporate governance provides the structure through which companies' objectives are set, determines the means used to attain corporate objectives, and mandates systems to monitor performance (Al Karasneh & Bolbol, 2006). One practical function of corporate governance is the provision of a system to protect outside investors from insiders, or those individuals and groups operating within the corporations, such as the managers and the controlling shareholders (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 2000).

Corporate governance can be seen as a set of organisational arrangements whereby the actions of the management of a corporation (or bank) are aligned, as far as possible, with the interest of its stakeholders. Such arrangements include mandating operational procedures (e.g., annual general meetings, external audits) and creating committees to manage the organisation. Stakeholders are individuals who have specific rights with respect to the corporation. Common stakeholder rights include property rights such as control rights and/or cash flow rights, and rights to information about the corporation. These rights are often granted to stakeholders by law, but may also arise from legal articles within the corporation or from external sources such as stock exchange regulations or codes of corporate governance (Alchaar *et al*., 2010).

During the last two decades, a number of surveys and reviews on corporate governance have been published (e.g., Becht *et al*., 2002). The focus of these reports have been both theoretical and empirical looking into the main mechanisms of corporate control including for example: i) concentration of ownership and control, ii) hostile takeovers and proxy voting contests, iii) delegation and concentration of control in the board of directors, iv) alignment of managerial interests with investors through executive compensation contracts, and v) fiduciary duties for Chief Executive Officers.

Originally, research examining corporate governance focused on Anglo-Saxon stock markets (Hasan, 2009). However, after the publication of the code of best practice in corporate governance in the United Kingdom (Cadbury Report, 1992) and the separation of ownership and management, other countries around the globe started to see the need for and to develop codes of governance practice suitable for their countries. Consequently, research of corporate governance in the countries and systems that do not fit the Anglo-Saxon market-based model has increased. Most countries in the world have legal systems different from those in the Anglo-Saxon system and are not consistent with the Anglo-Saxon model because the firms were originally owned and controlled by the founding families, the state, banks, or other companies (Brennan & Solomon, 2008). A handful of research has investigated the factors that determined the choice of different model of corporate governance in different countries (La Porta *et al.*, 1997, 1998, 1999).

Models of Corporate Governance

Research examining corporate governance identifies three main approaches to this theme: (1) the Anglo-Saxon model; (2) the European model; and (3) the Islamic model (Hasan, 2009). Each model has its own distinct features and outcomes.

The Anglo-Saxon Model

The Anglo-Saxon model of corporate governance (also known as the Neo-Liberal model, a market-based system, a shareholder-value system, or a principle-agent model) is characterised by arm's length relationships between corporations and investors who are said to be primarily concerned with short-term returns or wealth generated by the firm (Frank & Mayer, 2004). The main concern of the model is protecting the interests and rights of the shareholders, but there is no or limited specific focus on corporate social responsibility. The Anglo-Saxon model is also based on the corporate concept of a fiduciary relationship between the shareholders and the managers, with the relationship motivated by profit-oriented goals.

One of the most distinctive features of the Anglo-Saxon system is the structure of corporate ownership in which share ownership is widely distributed leading to weak influence by shareholders on how the firm is managed. Hence, in the Anglo-Saxon system the corporation needs strong legal safeguards to protect the shareholders (Hasan, 2009). With respect to accountability and information disclosure, the Anglo-Saxon model takes the view that managers hold inside information and are accountable to outside stakeholders of the firm. The board of director is unitary, composed of representatives of major shareholders plus (in some cases) members of the firm senior management board (Alchaar *et al*., 2010).

The Anglo-Saxon model has been developed in countries where capital is mainly raised through stock markets rather than banks. Therefore, the model relies extensively on the strength of these markets. This model is adopted by firms operating in the United States and the United Kingdom and is also practiced by many corporations in other countries, such as Australia, New Zealand, Canada, South Africa, and the majority of countries in South East Asia (Hasan, 2009).

The European Model

The European model, which is also called the Stakeholders model or Societal model, has evolved in countries where banks have close and long-term relationships with their corporate customers and play a large role in capital allocation. The model uses a two-tier board of directors, executive board and supervisory board. The European model of corporate governance is practiced by majority of the European countries (including Germany, France, the Netherlands, Scandinavia, and Greece) where many large firms are part of the social and economic structure. Under this model the term "stakeholders" refers to groups of constituents who have a legitimate claim on the corporation or to people who contributes directly or indirectly to the firm (Freeman, 1984, p. 46).

The set of stakeholders in the European model is broader and includes employees and other groups affected by the firm's activities. Such groups are entitled to representation on the firm's board of governance, namely on its supervisory board. There is also a specific focus on corporate social responsibility and the public interest may be represented by the supervisory board members to governmental affiliations.

Unlike the Anglo-Saxon model, the European model adopts the "insider" approach of governance in which stakeholder groups (including but not confined to shareholders) are represented on a supervisory board, the upper tier of a two-tier board structure (where the CEO is also the chairman of the board). In addition, employees have a direct say in the corporate governance by being having a representation on the board or through other tools (Alchaar *et al*., 2010).

The two-tier system is a special attribute of the European model of corporate governance. In Germany or France the supervisory board may be composed of outside directors and a separate management board of executive directors, and the two boards meet independently (Pesqueux & Salma, 2005). The legal system may not play much of a role in corporate governance. The supervisory boards also do not have much decision-making responsibility and codetermination undermines its monitoring effectiveness. A majority or 10% vote at a general meeting would be required to file a court petition so that shareholders could sue management in case of negligence or a wrongful act that does not involve a breach of contract and for which a civil suit can brought (Scott, 2003). The board of directors and the managers hold duties not only to the company itself but to employees, the trade union, the works council, and to the public at large (Snyder, 2007).

The History of Islamic Finance

Before discussing corporate governance in Islamic context we would like first to present a short history of Islamic finance and its underpinning pillars. Islamic finance has a long-standing history, dating back to the seventh century CE (600-699) and the beginning of Islam. The prophet Muhammad (SAW) approved the use of one of the main contracts of Islamic finance, the

Mudarabah. By the 11th century, practices that were originally used by Islamic merchants had been adopted for use in the Middle East, Asia, and Southern Europe. The Islamic merchants' methods of recording financial transactions also spread throughout the region, supporting the growth of trade and banking in the Middle East and across Europe (Alchaar *et al*., 2010).

However, it was not until 1963, approximately 50 years ago, that the first two Islamic banks (so named for their observance of and compliance to Islamic laws) were created. These original banks were developed to operate in ways that were consistent with ethics of Islam and to benefit and support Muslims. One of these banks, Mit Ghamr Saving Project, was created in Egypt and was based on profit and loss sharing and the concepts of the mutual credit union. The bank was created specifically to serve the local community of Mit Ghamr and their agricultural and land development projects. The other of these two banks was the Muslim Pilgrims' Saving Corporation in Malaysia; this bank was created to support Muslims so they could perform Pilgrimage (Alchaar *et al.*, 2010).

Islamic finance and banking continues to be practiced today. An expanding Muslim population has paved the way for a growing financial system that conforms to the Islamic financial theology (Stanley, 2008). Understanding the operations of this growing Islamic financial system is relevant to the recent increase of attention to financial management and practice because Islamic corporates are strictly governed by *Shari'a* law and also required by law to comply with general corporate governance principles (such as business law), thus having two layers of corporate governance. As such, Islamic corporates present a different case of the way they are governed.

The Islamic Corporate Governance Model

The most important objectives of a corporation following *sharia* principles are to maximise shareholders wealth and enhance social values and prosperity. A study by Liew (2007, p. 737) concluded that a different management system and corporate culture should be adopted by Islamic based corporations to attain these two objectives. Other studies have indicated that Islamic Financial Institutions (IFIs) in particular would best function under an alternative model of corporate governance (Hasan, 2009, p. 282).

The Islamic Financial Service Board (IFSB) defines corporate governance as "a set of relationships between a company's management, board of directors, shareholders and other stakeholders which provides the structure through which: (i) the objectives of the company are set; and (ii) the means of attaining those objectives and monitoring performance are determined" (IFSB, 2006, p. 27). The board further states that institutions offering financial products need to align the interest of its managers with those of other stakeholders, to ensure effective use of firm resources, and to have full compliance with the principles of sharia.

Corporate governance in an Islamic context emphasise greatly on honesty, transparency, documentation, accountability, and ethics (Stanley, 2008). S*hari'a* laws, which govern Islamic corporates, include a set of rules and laws as a basic framework for financial operations. Business activities must be *Shari'a*-approved, and only corporates that abide by the rules of *Shari'a* qualify to engage in economic activities. Another central tenet of the system is *Riba,* which literally means "an excess" and is interpreted as "any unjustifiable increase of capital whether in loans or sales". Iqbal (1997) noted that "any positive, fixed, predetermined rate tied to the maturity and the amount of principal is considered *Riba* and is prohibited. The general consensus among Islamic scholars is that *Riba* covers not only usury but also the charging of 'interest' as widely practiced" (p. 43). Therefore, Islamic corporates are prohibited from receiving or paying interest and this lies within the responsibilities of their directors.

In addition to the charging of interest, speculative behaviour is prohibited under *Shari'a* precepts. Other tenets of this framework indicate that hoarding, gambling, and transactions characterized by extreme uncertainty are prohibited. Protecting stakeholders' interests, the sanctity of contracts must be respected, and the open disclosure of information is considered a sacred duty that must be met by corporate directors. Finally, the Islamic corporates are expected to play positive social role besides of their economic role, which directly influence the responsibilities of corporate managers who have to adhere to these principles.

The *Shari'a* Supervisory Board

The responsibility of ensuring that an Islamic corporate is operating in compliance with *Shari'a* falls belongs to the firm's board of directors. A few different systems exist for determining how a corporate should operate in order to be in compliance with *Shari'a* and in order to monitor compliance on and on-going basis. For example, in some countries, every Islamic financial institution has its own *Shari'a* Supervisory Board (SSB). The SSBs are organs of governance that issue *fatawa* (rulings) specifying how the institution must operate in order to be in compliance with *Shari'a* law. The SSBs should also monitor the institutions' compliance.

In other countries, such as Sudan and Malaysia, a single, central body serves as the *Shari'a* authority for the country and performs the ex-ante compliance function for all Islamic financial institutions in the country. In these countries, SSB's role would be limited to monitoring compliance with the rules that are set out by the central body. That is, the SSB for each individual institution would not determine how the institution should comply with *Shari'a,* but rather whether the institution was complying with the rules determined by the central *Shari'a* authority.

However, there are numerous potential problems with the functioning of SSBs. For example, members of SSBs may not have the necessary auditing skills to monitor *Shari'a* compliance, or may not have adequate time to fully monitor compliance. If the SSB is unable to adequately monitor the institution, then another organ or group (e.g., internal auditors, external auditors, or a combination) must do so to ensure compliance. It needs to be recognised that failure to comply with the *Shari'a* may expose an Islamic corporate to being found guilty of misconduct and negligence.

Transparency and Disclosure (The Case of Islamic Banks)

Transparency is defined as "public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk management practices" (Basel Committee on Banking Supervision , 1998, p. 4). Therefore, the published information must be timely, accurate, relevant, and based on sound measurement principles that are properly applied. The information disclosed should enable the investors to properly assess the institution's activities and risk profile. In addition, stakeholders will have a better control and be able to make better decisions if they are well-informed about how the bank is being managed and governed.

Few research investigations examined transparency and disclosure practices within an Islamic context. A study by Haniffa and Hudaib (2004) regarding the disclosure practices of Islamic financial institutions (Al-Baraka Bank, Abu Dhabi Islamic Bank, Al-Rajhi Bank, Bahrain Islamic Bank, and Kuwait Finance House) indicated there was a, "lack of disclosure, clarity and consistency" (p. 19). They concluded that the practice of transparency and disclosure in these financial institutions were not sufficient to fulfil the institutions' obligations to God, society, and the institution itself, or to demonstrate accountability.

Another study concerning the annual reports of seven Islamic banks (Al-Baraka Bank, Abu Dhabi Islamic Bank, Al-Rajhi Bank, Bahrain Islamic Bank, Dubai Islamic Bank, Kuwait Finance House, and Shamil Islamic Bank) showed large discrepancies between the information disclosed in annual reports and the values of Islamic business ethics (Haniffa & Hudaib, 2007). The discrepancies are attributed to four factors: (1) a commitment to the community; (2) the disclosure of company mission and vision; (3) contribution and management of *Zakat*, charity and benevolence; and (4) information about loan management.

Ariffin *et al.* (2009) surveyed 28 sharia compliant banks in 14 countries. They collected information from bank supervisors, rating agencies, external auditors, and representatives' from the International Financial Service Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) on their perception of Islamic banks handling of transparency and risk disclosure. The result of the survey indicated that Islamic banks are still lacking transparency and adequate risk disclosure, even though they are more transparent than conventional banks due to their profit sharing arrangements.

Accountability and Record Keeping in Islamic Context

In addition to providing the framework for general tenets of operations and governance, the *Quran* provides some detailed, step-by-step processes for financial transactions, particularly record-keeping and contracts. For example, a detailed explanation in verses 282-283 of *Surah al-Baqarah*, states:

> *"O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you… You should not become weary to write your contract down, whether large or small, for its fixed term, that is more just with Allah, more solid as evidence, and more convenient to prevent doubts among yourselves… Take witnesses whenever you enter into a commercial contract…And if you are travelling and cannot find a scribe, then let there be a mortgage taken… And do not conceal any evidence for he whoever hides it, surely his heart is sinful, and Allah is all Knower of what you do."*

The general message behind verse 283 is the need for transparency and disclosure in business dealings. These verses highlight the importance of proper record-keeping so no party involved suffers injustice, and this prescription for record-keeping is coupled with the tenet that contracts are considered sacred. Although these verses date back to the writing of the *Quran*, they are also two of the important underlying principles of contemporary corporate governance; their long-time practice in Islamic finance makes the subject area an example to observe and learn from to inform financial management in general.

The concept of accountability was also highlighted in the sayings (or *Hadith*) of the Prophet Mohammed (PBUH) over 1,420 years ago. The Prophet Mohammed addressed the issue of social responsibility and accountability, saying, "Each one of you is a guardian, and each guardian is accountable to everything under his care." If this tradition is translated into modern business dealings, all persons involved in business transactions are indeed accountable for all their actions and for the moneys and investors in their care.

References

Alchaar, M., Archer, S., Cox, S., Gassner, M., Abu Ghuddah, A., Karich, I., Sabbagh, A., Schoon, N., Shakil, M., Thomas, A., & Usmani, M., *Islamic Finance Qualification IFQ,* The Official Workbook, Edition 4, 2010, Chartered Institute for Securities & Investment CISI.

Al Karasneh, I. & Bolbol, A. (2006, December 19). *Corporate governance and concentration in the Arab banking sector and economic growth: The case of GCC countries.* Abu Dhabi, United Arab Emirates: Arab Monetary Fund.

Ariffin, N. M., S. Archer and R. A. A. Karim, (2009), "Issues of Transparency in Islamic Banks", *Review of Islamic Economics*, Vol. 13, No. 1, 2009, pp. 89–104.

Basle Committee on Banking Supervision BCBS), (1998) "Enhancing Bank Transparency: Public disclosure and supervisory information that promote safety and soundness in banking systems" Basle, September 1998.

Becht, M., Bolton, P. and Röell, A. (2002), "Corporate governance and control", National Bureau of Economic Research (NBER) working paper no. 9371, New York.

Brennan, Niamh M. and Jill Solomon (2008) "Corporate Governance, Accountability and Mechanisms of Accountability: An Overview", *Accounting, Auditing and Accountability Journal*, 21 (7): 885-906.

Cadbury Code, The (1992), *Report of the Committee on the Financial Aspects of Corporate Governance: The Code of Best Practice*, Gee Professional Publishing, London. December 1992.

Eells, Richard Sedric Fox, 1960. *The meaning of modern business: an introduction to the philosophy of large corporate enterprise* (Columbia University Press, New York).

Frank. J and Mayer. C. 2004, Corporate Ownership and Control in the UK, Germany and France, Joel M. Stern and Donals H. Chew, Jr. (Ed.s), The Revolution in Corporate Finance, 4th Ed. United Kingdom, Blackwell Publishing, pp. 535-551.

Freeman, E. 1984, Strategic Management: A Stakeholder Approach, Boston, Pitman Press.

Haniffa, R., & Hudaib, M., (2004). Disclosure Practise of Islamic Financial Institutions: An Exploratory Study. Working Paper No 04/32 at the Accounting, Commerce and Finance: *The Islamic Perspective International Conference* V. Brisbane, Australia. 15-17 June 2004.

Haniffa, R., & Hudaib, M., (2007). Exploring the Ethical Identity of Islamic Banks via Communication in Annual Reports. *Journal of Business Ethics, 76*, 97-116.

Hasan, Zulkifli (2009), "Corporate Governance: Western and Islamic Perspectives", *International Review of Business Research Papers Vol.5 No. 1 .Pp. 277-293.*

Iqbal, A., (1997). *Islamic Financial Systems*. Washington, D.C.: World Bank.

Islamic Financial Services Board 2006. Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds. IFSB: Kuala Lumpur.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R.W. (1997), "Legal determinants of external finance", *Journal of Finance,* Vol. 52 No. 3, pp. 1131–1150.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R.W. (1998), "Law and finance", *Journal of Political Economy*, Vol. 106, pp. 1113–1155.

La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. (1999), "Corporate ownership around the world", *Journal of Finance,* Vol. 54, pp. 471–518.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. (2000). Investor Protection and Corporate Governance. *Journal of Financial Economics,* vol. 58.

Liew, C. L. (2007). From concept to context: toward socio-cultural responsibility in the organization of knowledge. In D. J. Pauleen (Ed.), Cross-cultural perspectives on knowledge management (pp. 81 – 94). Westport, Connecticut: Libraries Unlimited.

Pesqueux, Y. & Salma, D. A. (2005). Stakeholder theory in Perspective. *Corporate Governance: International Journal of Business and Society*, *5*(2) 5-21.

Scott, K. 2003, The Role of Corporate Governance in South Korean Economic Reform, Joel M. Stern and Donals H. Chew, Jr. (2004) (Ed.s) The Revolution in Corporate Finance, 4 th Ed. United Kingdom, Blackwell Publishing, pp. 519-534.

Shleifer, A. and Vishny, R.W. (1997), "A survey of corporate governance", *Journal of Finance,* Vol. 52 No. 2, June, pp. 737–783.

Snyder, L. 2007, Filling A Position Of Corporate Governance In France: A Practical Introduction, Corporate Governance: International Journal of Business and Society, Vol. 7, no. 3, pp. 238 – 250.

Stanley, M. (2008, January 22). Implementing corporate governance for Islamic finance. Bahrain: Ernst & Young Middle East and Islamic Financial Services Group (IFSG), Ernst & Young. Retrieved from http://www.gtnews.com/article/7059.cfm.