Corporate Governance of Islamic Banks, 
Its Characteristics and Effects on Stakeholders 
and the Role of Islamic Banks Supervisors

by

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TEXT BOUND INTO THE SPINE
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Abstract

The background to this study is as follows. In June 2004, the Basel Committee on Banking Supervision (BCBS) issued its *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, commonly referred to as Basel II. This document placed emphasis on corporate governance as a key factor in a bank's soundness, to which a banking supervisor should pay attention in deciding the style of supervision that is appropriate for a given bank. Basel II also emphasised transparency and market discipline as factors which could reinforce the quality of corporate governance. In addition, the BCBS has issued guidelines addressing the need for minimum international standards of corporate governance for banks to help reduce systemic risk and enhance the integrity of financial markets.

The Islamic Financial Services Board has issued a number of documents concerning the application of the principles of Basel II to Islamic banks, that is to say, banks which raise and invest funds in accordance with the rules and principles of the *Shari'ah*. Among other things, Islamic banks neither charge nor pay interest, and deposits are placed with them by investment account holders (IAH) on a profit-sharing and loss-bearing basis. This latter feature has major corporate governance implications, as does the obligation of Islamic banks to operate in accordance with *Shari'ah* rules and principles.

Islamic finance has become a significant phenomenon on the world financial scene. The annual growth in assets of Islamic financial institutions (IFI) has been estimated as 10% in the Gulf Cooperation Council (GCC) countries and almost 15% worldwide over the past 10 years.

This study addresses some key issues in corporate governance in Islamic banks. It deals with the special features of Islamic banks particularly with regard to (i) the relationship between the IAH and the Islamic bank and how it affects the issue of corporate governance; (ii) the corporate governance implications of the obligation of an Islamic bank to operate in accordance with the rules and principles of the *Shari'ah*; and (iii) issues of transparency and market discipline in Islamic banking.
The research was conducted by using an embedded case study approach. The case studies were conducted on four Islamic banks operating in three countries, Bahrain, Qatar, and Kuwait which apply different regulatory approaches to Islamic banks. The four banks surveyed were seen to be applying different practices in areas that raise various key issues in corporate governance.

The conclusions of the study point to a number of significant corporate governance problems and shortcomings in Islamic banking, connected notably with the following: (i) Islamic banks mainly operate in emerging market environments where, among other things, the conditions for market discipline are not satisfied; and (ii) regulatory and supervisory regimes designed for conventional banking fail to address some key characteristics of Islamic banks. This is shown to have implications for the regulatory regime and the style of supervision required in order to address the corporate governance problems and shortcomings that were identified.
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Chapter 1
An Overview of the Research

1.1 Introduction

This thesis is concerned with issues of corporate governance in Islamic banks. In the literature on corporate governance, the case is made by authorities such as the OECD and the BCBS that banks are a special case, both because they have fiduciary responsibilities for handling funds deposited by members of the public, and also for a related reason, namely the systemic risk to the banking system as a whole if there is a 'run' on a bank. As this thesis will explain, Islamic banks are a special case within banks, for two main reasons: (a) their 'depositors' place funds in Profit Sharing Investment Accounts, that is, on a profit-sharing and loss-bearing basis, and thus do not have the protection accorded to creditors; and (b) Islamic banks receive funds on the strict understanding that these funds will be managed in a way that is compliant with the Shari'ah rules and principles of Islamic commercial jurisprudence. Protection of Investment Account Holders (IAH) and Shari'ah compliance are thus two major issues in the corporate governance of such institutions. One of the main characteristics of governance in an Islamic bank is the existence of Shari'ah Supervisory Boards (SSB). The role of the SSB is to issue authoritative opinions (fatwas) on matters of Shari'ah compliance, with regard to the products and services offered by the Islamic bank, and to issue an annual report attesting to such compliance.

The globalization of financial markets necessitates minimum international standards of corporate governance for banks that can be transmitted into financial systems in a way that will reduce systemic risk and hence the integrity of financial markets (Alexander, 2004 p.1017). Banks are often more opaque than non-financial entities, because of the complexities of the financial instruments with which they deal.

At the time that this research was being carried out, the Basel Committee for Banking Supervision (BCBS) issued its International Convergence of Capital Measurement
and Capital Standards: a Revised Framework (BCBS 2004), commonly referred to as Basel II. Basel II is significant for the subject-matter of this thesis because its approach to capital standards is based on three "pillars". Pillar 1 deals with capital measurement and capital adequacy, while Pillar 2 is concerned with the supervisory review process and Pillar 3 with disclosure and market discipline. Pillars 2 and 3, in particular, are intended for application in well-developed financial systems and market environments. The intent is to facilitate a "hands-off" approach to banking supervision in which the supervisor evaluates the supervisee banks' internal systems, including notable corporate governance, in order to determine how "hands-off" the supervision may be, and relies as far as possible on market discipline, aided by transparency, to keep supervisee banks in order. An important set of issues which this research addresses concerns the extent to which the quality of corporate governance of Islamic banks, and the state of market discipline and the information environment in the markets where most Islamic banks operate, are such that the "hands-off" approach favoured in Basel II would be applicable.

Broadly speaking, corporate governance is a set of structures and procedures to assist the stakeholders of an enterprise in assessing the performance of the management and make sure that management behaviour is consistent with the interests of the stakeholders. This raises the key questions: who are the stakeholders, and what are their rights? The answers to these questions differ according to the model of corporate governance being applied.

There are two main models of corporate governance: the USA/UK or "shareholder" model, and the continental European or "stakeholder" model. As its name implies, the shareholder model focuses on shareholders as the key stakeholders, whereas in the stakeholder model other stakeholders are considered important. The UK/USA model is related in a more straightforward way to one of the economic theories most often evoked to analyse corporate governance issues, namely Agency Theory. This may be attributed to historical reasons: Agency Theory was originally developed to analyse issues of governance that arise when there is separation of ownership and control in
industrial corporations. In this theory, shareholders are considered as "owners" and management is considered as having control.

It is to be noted that the topic of corporate governance (CG) in Islamic banks is relatively new and therefore the literature in this area is sparse and there is a lack of well-developed theories. Nevertheless, this research will make use as far as possible of existing theories in order to identify research issues and questions.

One of issues this research aims to address is the importance of transparency in the development of the Islamic banking sector. In this regard, the roles played by the IFSB (in issuing regulatory standards) and AAOIFI (in issuing accounting, governance and auditing standards) are crucial in developing transparency and market discipline.

The following section provides the foundation for the thesis. It discusses the problem to be investigated and the historical background, research objective, the significance of the study, and the research plan.

1.2 Research Problem and Historical Background

IAH represent the main source of funding for a majority of the Islamic banks. The relationship between the Islamic bank and IAH involves a number of governance issues.

The status of IAH in Islamic banks creates a governance problem that can be characterised as an "agency problem" (see chapter 2) since IAH are not in a position to influence the decisions of management, for example, they have no right to appoint members of the Board of Directors or external auditors. IAH are therefore mainly dependent on the shareholders to monitor performance of the management of banks, so that their decisions should benefit the interests of both IAH and shareholders.
Archer & Karim (1997) suggest that there may be 'vicarious monitoring' that works in the interests of IAH, but this depends on there not being any significant conflicts of interest between shareholders and IAH. This situation is compounded where there are weak or inadequate governance structures (Archer and Karim, 2006 p.135).

Such a situation affects the interests of the IAH negatively, as demonstrated by an example where the dividend yield rate of the shareholders is much higher than the rate of return paid to IAH. This may seem anomalous insofar as the IAH are supposed to share profits with the shareholders. The influential factor in such a difference is the profit allocation formula used to allocate profits between shareholders and IAH, including the share of the IAH profit allocated to the bank as a fee for managing the funds of the IAH, combined with the leveraging effect resulting from the high ratio of IAH funds to shareholders' funds.

In Islamic banks, the SSB’s role is to ensure that the banks operate in accordance with Shari’ah. In reality, the SSB’s function is limited to reviewing the bank’s contracts before their implementation (ex ante); however, they do not verify the implementation of the contracts (ex post) since they rely on a type of internal audit function known as the Internal Shari’ah Review (ISR) to do this on their behalf.

The unique feature of governance in Islamic banks is the existence of the SSB. The role and duties of the SSB differ from one bank to another. Because the SSB members are part-time they normally appoint an ISR to help the SSB in their duties carrying out the ex post review of the bank’s compliance with Shari’ah.

The SSB’s reports differ from one bank to another. To improve this situation, the AAOIFI issued Shari’ah governance standards to guide the SSB and ISR in conducting their duties.

The majority of Islamic banks operate in what may be characterised as a weak information environment, including a lack of adequate information intermediaries (such as financial analysts and rating agencies producing reports on financial institutions).
Furthermore, in such markets the IAH are passive investors unlike investors in developed financial markets many of whom react to the information they receive. This puts additional challenges on the banking supervisors or regulators to protect the interests of the IAH.

Information intermediaries need an adequate level of transparency in order to do their work. Transparency and market discipline are crucial in developing Islamic banking, but one of the challenges facing the development of Islamic banks is the passive attitude of the IAH.

1.3 Research Objectives

The primary objective of the study is to examine corporate governance practices in Islamic banks. The following are the other objectives of the study:

a) To study the impact of the degree of shareholder concentration for protecting the interests of the IAH.

b) To assess the role of SSB in providing assurance via the report they produce as to the bank’s compliance with Shari’ah.

c) Given the lack of adequate implementation of applicable financial reporting standards (specifically, AAOIFI Financial Accounting Standards), to study the impact of this on the ability of IAH to assess the performance of Islamic banks.

d) To assess the role of the banking supervisors in enhancing transparency in Islamic banking, thereby protecting, among others, IAH interests.
1.4 Significance of the Study

The rationale for undertaking this study is the fact that there has been very little extensive and in-depth research in the area of Islamic banking despite its importance and rapid growth as mentioned earlier. The reasons for considering corporate governance are (a) the unique status of IAH in Islamic banks and (b) the issue of Shari'ah compliance.

The IAH have some characteristics of both conventional bank depositors and investors in a mutual fund. Such an equivocal status requires a good governance framework to protect the interest of the IAH as they neither benefit from the protection accorded to creditors nor enjoy the governance rights normally given to equity investors.

And without good governance and adequate disclosures, financial intermediaries will rate Islamic banks lower than conventional banks which will increase the cost of capital for Islamic banks.

An important factor which makes this study important, is the fact that banking supervisors or regulators apply different supervisory frameworks to Islamic banks. For example, in Bahrain the supervisor has developed specific regulations for Islamic banks, while some other national supervisors subject Islamic banks to the same principles as those applied for regulating conventional banks.

Here, the roles of the IFSB (in issuing regulatory standards) and AAOIFI (in issuing accounting, governance and auditing standards) are very critical in standardizing the regulatory and accounting practices among Islamic banks.

It may be worth mentioning that the researcher is a professional central banker with a number of years experience of the supervision of Islamic banks. This experience naturally colours the perspective adopted in this research.
1.5 Research Plan

Given the relative novelty of the research topic and the state of relevant theory, as well as data availability, it was decided to adopt a case study approach to this research. Case studies were carried out on four Islamic banks, using an "embedded" case study design in which the four banks were the main units of analysis, while a number of sub-units were identified in each bank to permit cross-sectional comparisons.

Figure 1.1 shows the research plan of this study. It starts with an introductory chapter, followed by three chapters relating to the literature review and Islamic banking practices (ch. 2 to ch. 4). Chapter 5 sets out the development of the research issues, and chapter 6 the research design and methods. Chapters 7 to 10 cover the four case studies. Chapter 11 covers analysis and comparison. The last chapter covers the researcher’s conclusions and final remarks.
Figure 1.1

The Research Plan

Wish to do Research?

Research Topic
Formulation and Clarification

Chapter 1

Chapter 2 to 3

Chapter 4

Chapters 5 to 6

Chapter 7 to 10

Chapter 11

Chapter 12

Writing the Project Report

Submitting Project Report
Chapter 2
Review of Literature on Corporate Governance

This chapter will review the literature on Corporate Governance. This chapter is important in widening the knowledge of the researcher on corporate governance and in helping to develop the research questions.

2.1 Corporate Governance in General

2.1.1 General Introduction on Corporate Governance

The intellectual debate in corporate governance first arose from considering the implications of the separation between ownership and control in industrial corporations that had occurred with the emergence of large firms with widely dispersed shareholdings in certain countries (notably the USA and the UK) in the early decades of the 20th century (see particularly Berle and Means, 1932). It was noted that the owners were not really able to control the management, which implied that ownership and control were separated. A major reason for this is asymmetry of information, since the management is much better informed about the firm's condition and prospects than the owners. Still earlier (Smith, A 1776 p.700) had stated the problem as follows: "the directors of joint stock companies are managers of other people's money, hence, it can not be expected that their actions will be taken with same vigilance as if they are the owners of the company. Therefore, negligence and profusion will always exist in the management of the company". Similar views were expressed by Alfred Marshall (1920).

These considerations led to the development of Agency Theory, which considers the owners (or shareholders) as "principals" and the management as "agents" who have an obligation to act in the interests of the principals but are able to put their own interests first. Agency Theory further considers mechanisms that may be employed to align the interests of the agent with those of the principals, namely "bonding" and "monitoring". Bonding consists of incentives for the agent to undertake actions that
in the interests of the principal and to avoid actions that are contrary to those interests. Monitoring is the use by the principal of information provided in order to observe the actions of the agent, and requires mitigation of the problem of asymmetry of information.

Following Berle and Means, Coase (1937) and Fama and Jensen (1983 b) also took the view that the essence of the agency problem is the separation of ownership and control.

The classic formulation of Agency Theory thus considers the principals to be the shareholders who are considered to be the "owners" of the corporation. This has given rise to an approach to corporate governance that is known as the Shareholder Theory. There is, however, an alternative approach, known as the Stakeholder Theory, in which stakeholders (i.e. principals) other than shareholders are considered.

In this chapter, we first consider the Shareholder Theory as it is based on the classic formulation of Agency Theory. Then, the Stakeholder Theory is considered, bearing in mind certain limitations of the Shareholder Theory when applied to financial institutions such as banks, and in particular to Islamic banks whose profit-sharing investment account holders constitute a class of principal distinct from shareholders. For example, according to the Basel Committee on Banking Supervision (1999) "Corporate governance is a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently". In addition, Edwards and Nibler (2000) defined corporate governance as a system of mechanisms that reduces information asymmetries and eases monitoring of the suppliers of external debt to firms.
2.1.2 Agency Theory and the Shareholder and Stakeholder Theories of Corporate Governance

Jensen and Meckling (1976) characterized the contract between the owner-manager and shareholders as an agency relationship. They claimed that an agency relationship is a contract involving one or more principals who engage another person (the agent) to perform certain duties on their behalf by delegating some of their decisions (Jensen and Meckling, 1976 p.308). This development of Agency Theory led to what is known as the Shareholder Theory of Corporate Governance.

The Anglo-American model of corporate governance which exists in the United Kingdom and United States reflects the Shareholder Theory, being aimed at maximising shareholder value, along with typical capital market and ownership features. This is contrasted with the German and Japanese conceptions of the company as a social institution, leading to the Stakeholder Theory of corporate governance which gives consideration to a number of classes of stakeholder including shareholders, creditors and employees.

2.1.3 Definitions of Corporate Governance

It follows from the above that definitions of corporate governance differ according to whether a Shareholder Theory or a Stakeholder Theory approach is adopted. As noted above, the classic problem of corporate governance as indicated by Berle and Means (1932) is due to the separation between the owners and managers. Zingales (1997), however, argued that corporate governance is a system by which directors and managers (or insiders) act in the best interest of outside investors (creditors and shareholders).

Mayer (2000) argued that "a basic question that corporate governance raises, if one thinks of it as really being concerned with performance accountability, its whether or not it leads to efficiency in terms of the management of corporations, whether or not incentive arrangements, such as shareholding arrangements, are giving rise to
adequate managerial efficiency". In contrast, John Wolfensohn, World Bank previous president, emphasised the need to mitigate the asymmetry of information and indicated that the purpose behind corporate governance should be "fairness, transparency, and accountability".

In dealing with problems that result from the separation of ownership and managers, corporate governance focuses on the internal rules of the board of directors and the creation of independent audit rules for disclosure of information to shareholders and creditors (Sullivan, 2000).

Tricker (1984) defined corporate governance as the "processes by which companies are run". Others believe corporate governance is implemented in corporations to restore investor confidence in markets that experienced financial crisis—as in the case of Malaysia, Japan, and Russia.

Academics and practitioners are of the view that good corporate governance creates competitive advantage and realises value (Corporate Governance, 2001).

Others like Shleifer and Vishny (1997 p. 737) have argued that corporate governance is a means of satisfying providers of finance to corporations such that they get returns on their investment. Other authors, like Kaplan and Norton (2000), claim that corporate governance is intended to establish a connection between directors, managers, employees, shareholders, customers, creditors, and suppliers to the corporation.

2.2 The Shareholder Theory of Corporate Governance

2.2.1 Agency Theory and the Classic Formulation of the Problem of Corporate Governance

In addition to what has been stated above, the Agency Theory is part of a broad research programme addressing information asymmetry. The theory deals with the
incentives given by the principal to motivate the agent to work for the advantage of the agent (Macdonald, 1984 p.415).

For the agent to work to the benefit of the principal may involve certain costs. Such costs are associated with the cost of monitoring by giving adequate incentives for the agent to limit the aberrant activities of the agent (the agent means the management and the board of directors) and also to ensure that there is no asymmetry of information. Jensen and Meckling (1976 p.81) argued that it is impossible for the agent to work for the benefit of the principal without any cost. This is called agency cost.

Agency costs arise from the following:

1. The monitoring expenditure by the principal to regulate the agents’ conduct.

2. Bonding expenditure by the agent to help assure the principal that the agent will not take actions which would damage the interests of the principal and will indemnify him if such actions are undertaken.

3. Residual loss, which covers the loss to the principal if the agent’s decisions deviate from the decision which would have been made by the principal if he had the same information and talent as the agent.

According to Fama and Jensen (1983a p.327):

"An agency problem exists because contracts are not costlessly written and enforced. Agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests, plus residual loss incurred because the cost of enforcement of contracts exceeds the benefits".
To enhance the level of monitoring by the principal on the agent and to monitor any self-interested action by managers at the expense of owners (Jensen and Meckling, 1976) argued for a representation of non-executive board members with greater responsibilities to act as watchdog on the board of directors.

In addition, Finkelstein & D’Aveni (1994) argued for the separation of the chairmanship from the position of chief executive officer since non-separation would restrict the monitoring of the board over the management. Rechner and Dalton (1991) advocated such views by indicating that companies "where a separation exists between chairmanship and CEO" out-perform the unitary structures of management on three different profitability measures. Also Donaldson & Davis (1991) claimed where a separation exist between the chairmanship and CEO, companies have achieved higher return on equity.

However, other writers like Donaldson & Barney (1990) have expressed a different view, by claiming that firms where the chairman is also the CEO will perform better since any ambiguity regarding responsibility for firms’ processes and outcome will be avoided.

2.2.2 Separation of Ownership and Control

As indicated by Hermalin and Weisbach (2003 p.10) the canonical agency problem exists between the owners (shareholders) and the management. One solution they suggest is to provide strong management incentives contractually.

However, in most large corporations, shareholders are too diffuse and uninformed to set incentives for management. Therefore, they will have no power to monitor effectively the behaviour of management (Hermalin and Weisbach, 2003 p.10).

Levine (2003 p.4) argued that in principle diffuse shareholders can exert corporate governance by directly voting on crucial issues, such as mergers, liquidation, and fundamental changes in business strategy and indirectly by election the board of
directors. However, a variety of factors, however, keep diffuse shareholders from effectively exerting corporate control. There are informational asymmetries between managers and small shareholders and managers have enormous discretion over the flow of information. Small shareholders frequently lack the expertise to monitor managers and cannot bear the cost of monitoring. This situation has led to little monitoring by the shareholders of the management (Levine, 2003 p.4).

To ensure that management behaviour is properly monitored for the benefits of all shareholders, some authors like Shleifer and Vishny (1997 p.26), argued that concentrated (majority) shareholders would have the incentive to collect information and monitor the management, thereby mitigating the problem of small shareholders lacking the expertise and resources to perform monitoring. The latter would in effect be "free riders" on the monitoring efforts of the major shareholders. Vishny (2003 p.5) likewise argued that majority shareholders\(^{(1)}\) or large blocks of shareholders (concentrated shareholders) could elect their representatives to the board of directors and exercise managerial control more effectively than an ownership structure dominated by small, comparatively uninformed shareholders.

These considerations have given rise to a proposition that effective corporate governance relies on "responsible shareholders" who perform monitoring not just for their own narrow interests but on behalf of the wider community.

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\(^{(1)}\) No definition is provided for majority-owned/controlling shareholdings, but the assumption is any shareholding (one family, one block of shareholders where their interest is the same) above 50% is logically deemed to represent majority ownership (concentrated shareholders or dominate shareholders) and hold half seat or above in the board of directors.
This proposition and the "concentrated shareholders hypothesis" have been criticized by a number of authors on the grounds that concentrated ownership implies wealthy investors who work for their own interests at the possible expense of minority shareholders, debt holders, and other stakeholders. Caprio and Levine (2002, p.6), for example, argued that large investors may pay themselves special dividends, exploit business relationships with other firms they own. These latter views are supported by DeAngelo and DeAngelo (1985); Zingales (1994).

The latter argument is applicable in Germany, where large commercial banks, through proxy voting arrangements, often control over a quarter of the votes in major companies (Franks and Mayer, 1994).

Furthermore, large shareholders may seek to shift the assets of the firm to higher-risk activities since shareholders benefit on the upside, while debt holders share the costs of failure (Jensen and Meckling, 1976).

Thus, Fama and Jensen, (1983a p.5) argued that to mitigate the agency problem there is a need to develop a controlling process to ensure that the decisions are taken for the benefits of the investors.

Berle and Means (1932 p.71) originally pointed out that, although the legal theory operates on the premise that the shareholders are the owners of the business and hence can exercise their rights, in economic reality the shareholders did not control the company.

This argument is supported by empirical research, which reveals that actual voting at 222 annual general meetings was as follows:

"In simple terms, a total of 45.46% of the share capital was voted, 41.61% of which was voted by corporate bodies. However, having taken the divergence of the economic interests of the agent (manager) from those of the principal (shareholders in the firm) led to the emergence of what is called the "internal agency problem". 
A sample analysis of the split of the total shareholdings between corporate and private shows that 47% of the total shares held by private holders were voted (Baird, 1999 p.71).

The Board of Directors is an economic institution, which in theory helps to mitigate the agency problem by providing a means for stakeholders to control the management (Hermalin and Weisbach, 2003 p.7). They also argued (2003 p.8) that, despite the absence of formal theory on the matter a major conflict exists within the boardroom between the CEO and the independent directors. The CEO wishes to maintain his position and increase his/her benefits while the independent directors have the incentive to maintain board independence in order to monitor the CEO and replace him/her in case his/her performance is poor. However, this view assumes that the independent directors are truly independent, which is highly questionable insofar as the CEO may influence their appointment.

As Archer and Karim (1997) point out, the divergence of the economic interests of the agent (manager) from those of the principal (shareholders in the firm) leads to the so-called "internal agency problem", as distinct from the "external agency problem" that arises between existing and prospective capital providers when a firm seeks to raise new capital.

Jensen (1989) argued that the classical method to control agency problem is a system of incentives, which makes the interests of the management align with the interests of the shareholders. However, other authors like Canyon and Leach (1994); and Ogden and Watson (1996) have claimed that empirical evidence suggest that the system of incentives does not effectively reduce the agency problem. However, Bushman and Smith (2003 p.68) argued that pure market forces motivate managers to work for the benefit of firms’ owners including market competition, the market for corporate control and labour market pressure (Fama, 1980).

Given the widespread separation of control of firms between owners and management, research on corporate governance has typically focused on mitigating
agency problems. The Shareholder Theory, as we have seen, has both its advocates and its critics. Some of the latter tend to look to the Stakeholder Theory.

2.3 The Stakeholder Theory

2.3.1 Introduction to Stakeholder Theory

Stakeholder Theory takes a somewhat different view of principal-agent relationships in the firm. The basic element is that firms are managed for the optimal satisfaction of stakeholders, which is different from Shareholder Theory. "Stakeholders" are defined as those parties that are affected by, or could affect, the company (Cook and Deakin, 1999 p.1), and stakeholders are considered as principals.

Donaldson and Preston (1995) argue for the recognition of stakeholder claims from property rights based on pluralistic notions of distributive justice. Based on this right, legitimate stakeholders are those who have a 'moral interest' or 'stake' in the existence of the company.

Blair (1995) defined stakeholders as those who have economic interests related to the long-term economic success of the company. Slinger and Deakin (1999) defined stakeholders as those whose relationship with the enterprise cannot be completely contracted for, but upon whom the enterprise will depend for its success and prosperity.

Mitchell et al (1997) identify urgency, legitimacy, and power as the three elements related to stakeholders, stating that these three are indicators of the amount of attention the management needs to consider in their relations with stakeholders.

Frooman (1999 p.193) identifies Stakeholder Theory as a theory of managing potential conflicts of interest between stakeholders (i.e. principal-principal problems) stemming from divergent interests.
The critics of the Stakeholder Theory, such as Sternberg (1997 p.5), point out that this theory explicitly denies that corporations should be accountable just to their "owners": instead the management should be accountable to all their stakeholders. But such critics do not believe that such a requirement for accountability is realistic, as it is not clear how it can be enforced (except perhaps by cumbersome regulations).

2.3.2 The Impact of Stakeholder Theory on Corporate Governance

Kay and Silberston (1995 p.88) highlight a different perspective by arguing that:

"If a company is not "owned" by its current shareholders, and the shareholders are simply one of number of stakeholders groups, each of whom enjoys claims against it, and then there is no reason to think that the interest of shareholders does or should enjoy priority over the interests of these other stakeholders".

In countries like Germany and Japan it is believed that to achieve prosperity of the economy, they implemented what is called social peace inside the corporation. For example, in Germany, after the Second War World full-parity codetermination by labour and shareholders was introduced in the coal and steel industry. In 1976, the government in Germany decided that half of the membership of the supervisory board (the board which lays down the polices and strategy of the corporation) of larger firms would represent stakeholders other than shareholders; however, the chairman of the supervisory board is a shareholder representative. This step is seen as a step to strengthen the role of other stakeholders particularly the trade unions.

The Stakeholder Theory is applied in various countries in continental Europe, e.g. Germany, Austria and Sweden. A similar system exists in Japan, where the employees are typically given job security for life to establish social peace within the organization and they have a strong say in running the company.
This suggests that the Stakeholders Theory is applied in countries such as Germany to enhance the position of other stakeholders such as employees and creditors to be of the same importance as the shareholders. This means that management of the enterprise should work for the benefits of all stakeholders with no priority given to one over the other.

2.4 The Political Influence on Corporate Governance

2.4.1 The Impact of the Neo-Liberal System on the Agency Theory

The political system of a country has an influence on the model used in corporate governance simply because the issue of corporate governance has an impact on the country's welfare, at the corporate and individual levels.

In this respect, policy-makers will have reasons to influence the structure of large corporations. Roe (2003 p.6&7) stated that for example, there is a strong political will in the USA to separate ownership from control in large listed corporations. This policy has led to the emergence on the one hand of large shareholders who influence the strategy of the corporation and on the other hand of dispersed shareholders who hold no influence on the enterprise.

In countries like USA and UK, the relevant political philosophy is Neo-Liberal. This ideology requires less intervention by the government in the capital market and allows the market to regulate itself and gives more priority to the shareholders over other interested parties of corporation. In most of these countries the common law system is in force and it gives more protection to shareholders over other parties (Cook and Deakin, 1999 p.5).

Adams (2002) argued that in a neo-liberal or Pluralist state, the government leaves much of the economic planning to the vagaries of the market. This suggests that the role of the state may merely be to act as a "referee" in the struggle among societal and interest groups.
In UK the neo-liberal philosophy has been predominant since 1979. In that year when the Conservative party came to power, it decided to make the country a more enterprising and market-based society similar to the USA system.

Warren (2000 p.58) argued that due to the above change, the legitimacy of UK companies as a creator and distributor of wealth becomes questionable. The employee's security and welfare become less important.

The advocates of stakeholder' theory criticize the Anglo-American system (Cook and Deakin, 1999 p.23) by arguing that during the hostile takeover of corporations, the main say is in the hand of shareholders and other important interests tend to be neglected.

2.4.2 The Impact of Neo-Corporatism on the Stakeholder Theory

The Stakeholder Theory is related to a political philosophy called neo-corporatism, which is based on combination of a society's culture and history as well as of cultural and social changes that occur with modernisation, economic development and industrialisation. Neo-corporatism typically stresses the roles of employers' organisations, labour unions and the government within a tri-partite structure of economic management.

It is important to mention that in countries applying the neo-liberal approach the stock market plays a more vital role since the shareholder base of listed companies is widely diversified. By contrast, in the countries adopting the neo-corporatist approach, the shares of companies are not diversified and are mainly held by large institutions such as banks or family holding companies which hold them as long term investments.

Furthermore, unlike neo-liberalism and pluralism, under the neo-corporatism the government plays a central role in regulating and organizing the social and economic interests of society.
The Stakeholder Theory has been characterized as an "insider" approach to corporate governance, since governance is performed by a supervisory board which has access to inside information about the firm. In contrast, the shareholder theory has been characterized as an "outsider" approach to corporate governance, as it places much reliance on the role of public disclosure and "market discipline" to monitor management.

Magone (2002) claimed the new globalisation thrust has put pressure on neo-corporatism, which emphasises stakeholder rights within a national community, to give way to a view that explicitly acknowledges the need to compete in world-wide markets.

2.5 Concluding Remarks

Agency Theory was established to address the agency problem between the principals (owners) and the agent (management). It was indicated in this chapter that agency problems exist where the owners are not the managers of the enterprise. Agency Theory pointed out that agency problem exist because the actions that the managers that may take may not to the best interest of the shareholders. In addition, agency problems are aggravated to the extent that information asymmetry exists between the owners and the managers.

Furthermore, agency problems exist particularly in large corporations where shareholders are too diffuse and unable to monitor the actions of the management.

To address such agency problem, some authors like Vishny (2003 p.50) argued that large shareholders may elect their representative in the board of directors because they are able to monitor the actions of the agent (managers) more effectively.

This is called the "concentrated shareholders hypothesis", and some authors like Shleifer and Vishny (1997 p.26) argue that these concentrated shareholders would
manage the agent more effectively on behalf of all shareholders (the other shareholders being effective free-riders).

The latter theory has been criticized on the ground that the concentrated shareholders will work for their own benefit rather for the benefit of small shareholders.

Some authors believe that the Agency Theory works mainly to address the agency problem between the shareholders and the managers and ignores the interest of other stakeholders.

It is important to mention that Agency Theory in its classical form is more relevant to countries applying the neo-liberal political system. In such countries like the USA and UK the stock market is more efficient since the shareholder base of listed companies is widely diversified.

The Stakeholder Theory has emerged to address the agency problem between the agent and a wider set of stakeholders including shareholders, employees, depositors in case of bank, etc. While the neo-corporatist background of Stakeholder Theory may be problematic in a world of globalised markets, the literature on the corporate governance of banks in general, and Islamic banks in particular, suggests that the exclusive focus on shareholders in the Shareholder Theory is a significant shortcoming in the context of this thesis.
Chapter 3

The Main Models of Corporate Governance

3.1 Introduction

There appears to be a great difference of corporate governance mechanisms. This chapter will discuss the UK and the USA models with special emphasis on corporate governance of banks.

The UK and USA model are characterized as a system with a large shareholder base (dispersed shareholders), accountability by the management is primarily to shareholders. The UK and USA model of corporate governance are both more relevant to the Agency Theory where shareholders are given more powers over other stakeholders.

Franks and Mayer (1994) argued that the differences in corporate governance models between counties are not due to the way in which financial systems are used to fund the companies, but rather because of the way in which ownership and control are organized. The Anglo-American model is known as the shareholder model.

The UK system is different from the USA model with regards to the subsidiary role of the government in establishing the model of corporate governance, where the private sector seems to have played the primary role in shaping the corporate governance in the eighties and later years.

On the other hand, the USA model of corporate governance is a system which is legally binding. The USA, unlike the UK allows the chairman of the enterprise to be the chief executive.
3.2 The Evolution of the UK Model of Corporate Governance

3.2.1 The Development of the UK Models

The system of corporate governance in the UK, as in the USA, appears to give the shareholders more control compared with other interested bodies of the enterprise.

Cook and Deakin (1999 p.3) argued that shareholders are treated as the [sole] owners of the enterprise and as having the residual rights and control. However, Deakin and Slinger (1997) indicated that it is difficult to obtain support within the practitioners and specialist that the shareholders "own" the enterprise.

The companies' acts in 1948 allowed the establishment of the exempt private company which did not require private companies to make its balance sheet and profit and loss account available to the public. This was for the revision benefit of "family" private company. In 1962, the Jenkins Report was issued as a result of an enquiry into the state of Britain's company laws.

In 1967 a new act was issued, the new act abolished the status of the exempt company and new requirements for the reporting of company accounts were introduced. Warren (2000 p.9) claimed that these changes were aimed to keep the shareholders informed of the company's activities. Despite these changes, the 1967 act adopted some of the recommendations that came up in the 1962 Jenkins Report.

Starting from the mid 1970s there was debate on whether the notion of shareholder value ignored the claims of other stakeholders to be represented in the company. This debate led to the endorsement in 1973 of the stakeholder's concept which was drawn from the best practice within the UK, USA, Japan and Germany by the Watkinson Report on the responsibilities of the British Public company (Gamble and Kelly, 2001 p.113).
Based on this report, in 1975 a corporate report was issued, but was not implemented due to the changes in government in 1979 when the Conservative party came to power. It is important to mention that the stakeholders approach is based on the neo-corporatism concept (this concept was discussed in chapter 2), which now exists in continental Europe like Germany and Austria.

The advocates of stakeholder's concepts were mainly from the Confederation of British Industry and the Trades Union Congress. The stakeholder's concept is based on the Stakeholder's Theory.

The issue of corporate governance became a heated issue in the eighties of the last century in the UK due to a series of corporate governance failures including major firms (Polly Pecks, Maxwells; Coloroll) and where the weaknesses of corporate governance were clearly a contributory factor (Charkham, 1994).

Demirag et al (2000) argued that these financial scandals in the 1980s triggered the debate on making managers more accountable to shareholders. Furthermore, there were also some sudden failures of a number of large companies in the early nineties without warning from the auditors. This has raised a serious concern on the quality and reliability of audited information (Cadbury, 1992 Humphrey et al, 1993).

In response to these concerns and for the managers to be more accountable, a committee was established in 1991 named "Cadbury Committee". The following gives more explanation on the responsibilities of this committee and other committees established to address the issue of corporate governance.

3.2.1.1 The Cadbury Committee

The Cadbury Committee was established in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession, under the chairmanship of Sir Adrian Cadbury. The terms of reference of the committee were
to address the following issues that relate to financial reporting and accountability and to make recommendations to be considered as good practice by the industry.

It is important to mention that the Cadbury code was mainly concerned with the discipline of the management of banks and the board of directors because the shareholders are widely dispersed and hence no shareholders group or majority of shareholders has the power to dismiss the management.

The Committee's approach was to provide a framework for establishing good corporate governance and accountability. The Cadbury code is used as a benchmark against which companies could be assessed. Although, the implementation of the code was recommended, the Committee's opinion was that it was voluntary to establish best practice in order to allow flexibility in implementing the code and to encourage companies to comply with the spirit of the recommendations, rather than straitjacket rules and regulations (Davies et al, 1999).

The Cadbury Committee issued the code of Best Practice, which recommends that boards of publicly-traded UK corporations include at least three outside directors and that the positions of the chairman of the board and chief executive officer not be held by a single individual. Banks were encouraged to apply the Cadbury Committee and if the banks failed to adopt it, they had to state in the annual report the reasons for not adopting, i.e. what is known as "comply or explain".

The code explicitly mentioned that legislation will be taken as a guide if companies failed to comply with the guidelines of the code. McConnell and Travlos (2000) argued that the report was given further boost in June 1993 by the LSE (London Stock Exchange), which now requires every listed company to prepare a statement that spells out whether the firm is in compliance with the code and, if not, requires an explanation as to why the company is not in compliance.
The Cadbury Committee emphasised the setting of measures to enhance financial accountability by the board and the chief executive to the shareholders through improving information transparency, and a more independent board by the separation of CEO and the chairman of the board. Also the report emphasised on having non-executive board members. The Cadbury Report identifies corporate governance as the relationship of three dimensions:

"The shareholders role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate structure is in place".

The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The financial aspects of corporate governance are the ways in which boards set financial policies and oversee its implementation, including the use of financial controls, and the process whereby they report on the activities and progress of the company to the shareholders.

The role of the auditors is to provide the shareholders with an external and objective check on the directors’ financial statements, which forms the basis of that reporting system (Cadbury, 1992 paras. 2.5 - 2.7).

The Cadbury report was aimed to improve the level of information to the shareholders and invites non-executive members to the company to bring more confidence to the financial market particularly to the investors (Demirag et al, 2000 p.344).

It is important to note that the excessive powers and responsibilities given to the board may lead to misuse of these powers resulting in 'creative accounting' practices in many companies with the manipulation of company earnings (Demirag, 1998). Therefore, the objectives of the Cadbury report are for banks and other institutions to establish an effective risk management and control systems (Conyon, 1997).
However, the critics of the Cadbury codes of practice such as (Dewing and Russell, 2000 p.355) argued that the government of the UK has failed to provide the legislative framework and hence, it provides the accountancy profession the opportunity to fill the legal vacuum. This is because the Financial Reporting Council (FRC) and the accounting profession were two of the three co-sponsors of the Cadbury Committee, the third being the London Stock Exchange (LSE) (Freedman, 1993).

The Cadbury Report established a debate between those who felt that the code went too far and those who believed that the code did not do enough by leaving it voluntary for the companies to implement it. According to Green (1994):

"There is a danger in an over emphasis on monitoring; on non-executive directors independence from the business of the corporation; on control of decision making activities of companies. When coupled with the clearly reduced status of executives on the governing boards, such requirements must blunt the competitive edge and deflect the entrepreneurial drive which characterises participants, let alone success in a free market".

To counter the claims that the code did go far, it was agreed:

"The committees' recommendations are steps in the right direction. But, if the government is to address the problems, which led to the Maxwell, Polly Peck, BCCI and other recent scandals, then new rules in a legal framework are required. Shareholders, investors and creditors will be disappointed that just when the corporate failures of recent years cried out for bold and imaginative legal return, the body from which so much had been expected came up with a little tinkering and a voluntary code". The Cadbury Committee Draft Orders Mixed News for Shareholders (Financial Times, June 2, 1992).
Chapter 3 The Main Models of Corporate Governance

It can be argued that since the code was not explicitly stated in the legislation, two issues were not complied with by the companies such as the director's report on the effectiveness of internal control and that the business was a going concern.

The Committee recommended that guidelines need to be established for the above two issues by the accountancy profession together with representatives of preparers of accounts. Two working parties were set up under the auspices of the Hundred Group of Finance Directors, the ICAEW and the ICAS: the Going Concern Working Group, under the chairmanship of Mr. Rodney Baker-Bates and the internal Control Working Group (Davies et al, 2000).

Although the original terms of reference were to apply the code on the list companies, now other companies including unlisted private companies, subsidiaries of domestic or foreign companies, public sector bodies, charities and educational institutions have applied the code with greater or lesser effect (Davison, 2001).

3.2.1.2 The Greenbury Committee

The main shortcoming of the Cadbury recommendations was on the directors' remunerations. The market was concerned on the unjustifiable remunerations paid to companies' directors, including the share options offered to them. For this purpose, a committee was established known as Greenbury Committee. The Committee was under the chairmanship of Sir Richard Greenbury, chairman of Marks and Spencer. The Committee was established in January 1995 at the initiative of CBI to identify the good practice in determining directors' remuneration and preparing a code of such practice for use in the UK, PLCs.

The Greenbury Committee issued its report in July 1995, which contains code of Best Practice. In October 1995 and June 1996, the London Stock Exchange gave effect to certain of these recommendations by amending its Listing Rules (Davies, et al, 2000).
The main recommendations of the Code of Best Practice were as follows Short (1998 p.61):

1. Remuneration’s committees should consist only of non-executive directors with no personal financial interest other than as shareholders in the issues to be discussed. No potential conflicts of interest arising from cross-directorship and no role in the running affairs of the business.

2. Remuneration committee should report directly to shareholders in the annual meeting.

3. Remuneration committee’s report should include the company’s policy regarding the setting and awarding of executive remuneration.

4. Shareholders’ approval is required for the adoption of long-term incentive plans.

Share options should never be issued at discount, should be phased rather than issued in one large block and should not be exercisable in less than three years (Short, 1998 p.61).

The Greenbury Report received criticism from the accounting profession such as Ernst and Young which suggested that average disclosures take up six to seven pages in the annual report. There were accusations that the volume of information has become a barrier to effective communication and has supported claims that the Cadbury and Greenbury codes have led to increase in bureaucracy and burdens on companies without achieving real benefits to shareholders.
3.2.1.3 Combined Code Guidance

The Combined code includes both codes of Cadbury and Greenbury. During the last two decades audit committees (ACs) have become a common mechanism of corporate governance in several countries. Bank regulators and governmental bodies in many countries, including the UK and USA voiced concerns about the effectiveness of ACs (Turley and Zaman, 2003 p.3).


Turley and Zaman (2003 p.5) argued that AC is expected to have an impact on the appointment, removal and remuneration of auditors, the content and extent of audit work and auditor independence.

COSO (1994) also claimed that AC can strengthen the internal audit function and that internal audit can in turn be an important resource to the AC in fulfilling its responsibilities.

To streamline the role of the audit committees for banks and the listed companies, the Financial Reporting Council (FRC) formed a group headed by Sir. Robert Smith to prepare a report on audit committees, which should be used by UK listed companies. The Financial Services Authority (FSA), the body responsible for regulating banks, requested banks operating in UK to adopt the FRC Combined Code.

This guidance applies in respect of accounting periods starting on or after 1st, July 2003. This guidance was designed to assist company boards in making suitable arrangements for audit committees, and to assist directors serving on audit committees in carrying out their role (Combined code guidance, 2002).
3.2.1.4 The Hampel Report

The Hampel Committee on corporate governance was established in November 1995 based on the initiative of the Chairman of the Financial Reporting Council, Sir Sydney Lipworth. The establishment of this committee was the adoption of the recommendation of the Cadbury and Greenbury Committees that a committee should be established to review the implementation of the findings of the two committees. Banks in the UK are required to adopt the combined code.

3.3 Market Reaction to the UK Model of Corporate Governance

3.3.1 The Advocates of the UK System of Corporate Governance

The approach of self-regulation adopted in the UK allowed for the greater speed of response and flexibility in the face of a changing environment, and the ability to draw on practitioner expertise which is made available at a reduced cost (Cheffins, 1997 p.p. 378-397). This has worked for the benefit of the Cadbury Committee since it allows practitioners to be represented in the Committee.

Others like Baggott, (1989 p.438) argued the codes of corporate governance in the UK have evolved in consistency with British beliefs of self-regulation. Also the political environment during the eighties and nineties which had encouraged less government interference and supported the trend for market self-regulation has effected the approached used by the Cadbury Committee.

Because the UK system is based on large base of shareholders, it seems to have made the capital market more efficient compared with the German capital market. Also, since the main decisions are in the hand of the shareholders only, this appears to have made the decisions process on strategic issues became faster than the German model.
In addition, managers are always under pressure to satisfy their shareholders because once the shareholders are not happy with their performance they can be removed.

### 3.3.2 Critics of the UK Model of Corporate Governance

The corporate governance codes that have been issued such as the Cadbury, Greebury and Hampel reports are not explicitly stated in the legislation, which makes them weaker than other models like in the USA.

As indicated by Dewing and Russell (2000, p.356), the process of setting and amending the codes of UK corporate governance has been to a large extent at an ad hoc basis and the mechanism for monitoring and enforcing compliance with the codes are weak and some times does non exist.

The UK government says it prefers an approach based on best practice, rather than legislation (PriceWaterhouseCoopers, 2002). Because of this policy, two issues were not complied with by the companies, for example the director's report on the effectiveness of internal control and that the business was a going concern.

Young (2002), who is a businessman and cabinet minister in former UK Prime Minister Margaret Thatcher's government, argued that a part-time board of directors to police boardrooms was naive and government attempts to regulate non-executives were "dangerous nonsense". He added "non-executives directors actually become a shield behind which the executive's shelter and investors should hold shareholders directly accountable to them".

The Department of Trade and Industry appointed Derek Higgs, an investment banker, to review whether non-executive have "cosy" relationships with executives because they sit on each others' boards (Roberts, 2002).
Young (2002) claimed that "the idea has come about that in some manner non-executive can second guess the executives. If management is not too forthcoming, they can never even know, until it is far too late". It can be argued that because the executive board of directors appoints the non-executives, the non-executives may not be able to do their job in a professional manner.

In contrast, Peter Montagnon, London-based head of investment at the Association of British Insurers (ABI) claimed, shareholders are not expecting non-executives directors to second-guess the executives or know as much about business as the management. They are not there to do that. But they have to know enough to judge the validity of management decisions at least in terms of strategy, ask challenging questions and ensure robust board debate.

Furthermore, self-regulation within the context of the UK resulted in a lack of coherence and co-ordination in the development of corporate governance policy and practice in the UK and can be noted in the ad hoc establishment of corporate governance committees as a direct response to particular public concern (Cheffins 1997 p.p.379 – 418).

Lastly, as stated earlier, the UK model is more relevant to the Agency Theory, which gives priority to the shareholders over other stakeholders. It can be argued that such treatment allows the management to make decisions for the interest of shareholders, which at the same time may be against the interest of other stakeholders.

To draw a similar conclusion on the case of Islamic banks. Any Islamic bank may take a decision such as increasing the rate of Mudarib, which works for the interest of the shareholders, but at the same time would not be the interest of the investment account-holders because this would reduce their share of profit.
3.4 The System of Corporate Governance in USA

3.4.1 Development of the USA model of Corporate Governance

Traditionally, in America, shareholders have a comparatively big say in the running of the enterprise they own, workers have much less influence. In contrast, in continental Europe workers have a bigger say in the running of the enterprise over the shareholders.

The structure of the Anglo-American system (e.g. UK, USA and Australia) is based on appointing the board of directors "by the shareholders" to act for their interest and be accountable to them, electing non-executive directors to monitor the decisions taken by the executive board and appointing independent auditors to ensure that the financial results are reliable.

It has been argued that, by committing the future managers to particular monitoring and accountability, the original owner-manager will be able to increase the future profitability of the firms and maximize the sale of equity issue (Jensen and Meckling, 1976).

The Stock market crash in 1929 in the USA and the exploitation of residual claimants by opportunistic decision agents is reflected in the argument for the establishment of the Securities and Exchange Commission (SEC) in 1932, particularly with respect to common stock of publicly listed corporations which allows more efficient sharing of risk than proprietors and partnership companies and where the decision-makers are in the hand of the residual claimants (shareholders) (Fama and Jensen, 1983a p.4).

The USA system of corporate governance went through a reform in the 1970s: It posed a challenge to self-interested directors who regularly hold insignificant stake and whose interest contradicts of those of shareholders (Mertzanis, 2001 p.89, and Jensen and Chew, 1995).
The unique feature of the USA federal system is that the law of each state regulates companies to operate in its jurisdiction which might be different from another law of another state. As a result, competition arises between different states to attract companies to have a presence in its jurisdiction.

As a consequence, the role of the Securities and Exchange Commission (SEC) with regard to Corporate Governance is shared with the respected States (Charkham, 1994).

For instance, rules on the disclosure of executive remuneration exist in the SEC disclosure requirements and do not exist in the States disclosure requirements. This suggests that such issues are not approved by the shareholders since it's not stipulated in the States law.

A significant development took place in December, 1999, when the SEC started to require all large USA companies listed in The New York Stock-Exchange or in NASDAQ to appoint at least three outside directors, all of whom have no relationship to the company that may interfere with the exercise of their independence from management and the company (Klein, 2002 p.435). However, some (e.g. Daily & Dalton, 1992, and Rechner & Dalton, 1989) argue that the composition of the board has no impact on the firm performance.

Berle and Means (1932) claim that corporate governance intends to allow disperse shareholders to exert corporate governance by directly voting on crucial issues, such as mergers, liquidation, and fundamental changes in business strategy and electing board's members.

Furthermore, banks whose shares are listed, are required to adopt the rules of the SEC. It is worth mentioning that the UK and the USA models are similar because both systems are giving the interest of the shareholders preference over the interest of other parties of the enterprise.
3.4.2 The Advocates of the USA Model of Corporate Governance

In the USA, the ownership structure of corporations is widely dispersed, hence the authorities decided to re-address the issue of principal-agent problem. As a result, the USA authorities have strengthened the role of the shareholders "including the right to remove the management" and disclosure laws (Beim and Calomiris, 2001 p.p.198 - 199).

On the other hand, the Anglo-American model can be applied virtually by every country because the right of shareholders is, the same between one country and another. In this respect the approach taken by the International Accounting Standards Board is based on the Anglo-American approach of corporate governance which primarily addressed the needs of the shareholders, hence, this model lends itself as an international model.

Following the failures of large corporations such as Enron and WorldCom in 2001 and 2002, the issue of the independence of the audit committee was largely debated in the USA. In order to restore the confidence on the role of the audit committee, the Sarbanes-Oxlay Act, which came into effect on 30th, July, 2002, required all members of audit committee to be external directors.

Furthermore, the new act required every audit committee to appoint a financial expert within its members and if the company decides not to appoint, it should disclose the reason for not appointing such an expert. The Sarbanes-Oxlay Act states that audit committee is the sole body within the company responsible for appointing, compensating, and overseeing the company's external auditors (Bies, 2003).

3.4.3 The Criticism of the USA Model of Corporate Governance

It has been argued that one of the limitations of the Anglo-American model is that the voice of the individual shareholder is limited. The ability to sell share in the stock
market gives the shareholder a low-cost opportunity exit (Jensen and Meckling, 1976).

One of the characteristics of the USA financial system is that the shares of American large corporations are diffusely owned and they dominate the USA business. Manager's agenda differs from shareholders; hence, the authorities in the States are trying to tide the interest of the shareholders with those of the managers (Row, 2003).

As the USA economy grows, business units are becoming larger, and the right of the shareholder is diminishing. This is because ownership became more dispersed and few shareholders have the power to influence the choice of directors or chief executive officers (Row, 2003).

Row (2003) claimed that the Chief executives in the USA system play the key role in managing the business units not the board to the extent that the appointed board members are within the "slate" proposed by the CEO.

The audit committee of each listed public company (including banks with listed shares) on a securities market or NASDAQ would be responsible for the appointment, compensation, and oversight of the work of a registered public accounting firm related to issuing audit reports.

Each member of such an audit committee must be a member of the board of directors and shall otherwise be independent. In addition, the audit committee member cannot accept any consulting, advisory, or compensatory fee for the public company, other than fees for serving as a board of committee member. The audit committee must establish procedures for processing complaints. All of the processing should be confidential, anonymous submissions by employees regarding accounting, internal control, and auditing matters.

Another corporate governance weakness existing in the USA system as indicated by Row (2003) is the pressure on the CEOs from the investment community to meet
short term expectations, which encouraged companies to practice accounting treatments to obscure potential adverse results. External auditors on several cases have sanctioned such practices in order not to lose their clients, for example the Enron and WorldCom scandals.

In the USA, boards especially dominated by outside directors, sometimes remove top managers after poor performance, Weisbach (1988) Mace (1971) and Jensen (1993) argue, as a general rule, corporate boards in the United States are captured by the management. There is limited empirical support that the preponderance of out-side directors is positively associated with profitability (Ezzaamel & Watson, 1993) or return on equity (Baysinger & Butler, 1985).

Jensen (1989, 1993) argued that the USA corporate governance system is deeply flawed and that a major move from the current corporate form to much more highly leveraged organizations, similar to LBOs, is in order.

As mentioned before, in the USA many large corporations allow the same person to be the chairman and the CEO of the company. Under such system, the chairman will have greater responsibilities and influence compared to other systems (where a separation exist between the chairman and the CEO), for example the UK’s combined code of June, 1998 which states that a clear division of responsibilities at the head of the company will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. In the USA, the independent directors will be appointed by the chairman.

Concentrated Shareholders Structure:

One the main differences between the European models (e.g. Germany, Belgium, and France) and the Anglo-American model is that the European block holdings are much higher than the Anglo-American model. Hence, the relationship between large controlling shareholders and weak minority shareholders is as important to analyze as between the dispersed shareholders and the managers, (Oogh,U, and De
Lange, 2002 p.439). Due to the limited information disclosure, the ownership structure in Continental European countries is not as transparent as in Anglo-American countries. Regulations such as anti-trust laws and the "arm's length rules" between parent and daughter companies have limited the complexity of the ownership structure in Anglo-American countries (Van Hulle, 1997).

Pyramidal structures (control firms through a chain of companies) and mutual shareholders are more common in countries with poor shareholder protection (Oogh,U, and De Lange, 2002 p.439). Families have control over firms in excess of their cash flows rights, particularly through pyramids, and typically manage the firms they control. Pyramidal ownership appears to be an important mechanism used by controlling shareholders to separate their cash flow ownership from their control rights.

Through pyramids, controlling rights acquire power disproportionate to their cash flow rights (Wolfenzon, 1998; LaPorta et al, 1998). In countries with good legal protection of the minority shareholders, widely held companies are more common (La porta et al, 1998, Becht et al, 2000).

3.5 The Importance of Corporate Governance for Banks

Corporate governance for banks is to make them operate for the interest of their shareholders, depositors and for the financial sector at large and it is also one of the measures to help regulators in supervising banks (Ciancanelli and Gonzalez, 2000 p.3).

Corporate governance for banks involves the manner in which the individual banks are governed by their board of directors and senior management (Basel, 1999). Effective corporate governance is an essential element in the safe and sound functioning of a bank.
Also the European Commission revealed the existence of some forty different corporate governance codes across the EU for banks (Davies, 2002).

It is important to mention that moral hazard in banks is more severe due to the existence of deposit insurance schemes to protect the interest of small depositors (Caprio and Levine, 2002 p.24). Dionne et al (2003 p.4) claimed that the structure of a bank's balance sheets, with their high leverage and their variations in liquidity for assets and liabilities, seems to support the argument that bank directors should assume fiduciary obligations to fixed claimants as well as to equity claimants.

Due to such risk, Dionne et al (2003 p.4) also argued that the bank's creditors should be able to sue directors for violations of their fiduciary responsibility for prudence and loyalty.

The regulation of banks is vital for the safety of the financial sector. A failure of a bank might have contagious effect on other banks and on the financial sector at large. Bank's reputation and confidence is critically more important than non-financial institutions. Any rumors on a bank might affect the financial sector as a whole.

Market discipline\(^{(2)}\) and good corporate governance play an important role in protecting the individual banks and the financial sector in general. As put in a recent IMF Study: "An open and competitive banking market exerts its own form of discipline against weak banks while encouraging well-managed banks", (Lindgren, et al, 1996).

\(^{(2)}\)Market discipline: refers to the environmental features which, in response to the disclosure of material information, elicit prompt adjustments in either prices or quantities of financial positions of Islamic banks, and thereby provide incentives for Islamic banks to limit excessive risk-taking and pursue good governance. Market discipline, in this sense, requires a set of mechanisms through which markets can penalise excessive risk-taking or inadequate transparency (IFSB, 2006c).
Llewellyn (1999 p.9) argued that the weak banks in terms of disclosure and transparency and poor accountancy data may face risk charged on their inter-bank borrowings. In addition, weak internal control in banks; weak surveillance by (mainly non-executive) directors, and ineffective internal audit is an indication that the bank has unsound corporate governance (Llewellyn, 1999 p.9).

The structure of banks and lines of responsibilities among various posts is a determining factor whether the bank has sound corporate governance or not, particularly if the bank is part of larger group. In the absence of good governance connected lending and weak risk analysis of borrowers may be noted.

In well developed financial regimes, the discipline imposed by the market forces makes it difficult for banks not to establish good corporate governance, including frequent and adequate disclosures to the market.

Caprio and Levine (2002 p.10) argued that because banks are more less transparent than non financial entities, this intensifies the agency problem. This is due to greater information asymmetries between insiders and outside investors; it is more difficult for equity and debt holders to monitor managers and incentive contracts; easier for managers and large investors to exploit the benefits of control for their private benefit.

There are other authors who advocated such views, e.g. Furfine (2001), who argued, that information asymmetries exists in all sectors and is worse in banks.

The existence of information asymmetries lead to Agency problems because the shareholders will have little information to assess the performance of the management. The result of information asymmetries will establish unsound corporate governance since the shareholders will have little information to monitor the actions of the management.

Caprio and Levine (2002 p.2) state that under information asymmetries, it makes it very difficult for outsiders to monitor and evaluate managers. It also makes it
difficult for diffuse equity and debt holders to write and enforce effective incentive contracts, to use their voting rights as a vehicle for influencing firm decisions, or to constrain managerial discretion through debt covenants.

In countries where the domination of large sectors of the banks is by few families, this makes insider abuses more likely most often at the expense of outside equity investors, depositors, and ultimately taxpayers (Levine, 2003 p.8).

Levine (2003 p.5) also claimed there are particularly large information asymmetries in banks between managers and small shareholders, because managers are controlling the level of information to be published and small shareholders relied on others (free-rider) to monitor the behavior of the managers.

On the other hand, Levine (2003 p.7) indicated that greater information asymmetries between insiders and outsiders in banking make it very difficult for diffuse equity and debt holders to monitor bank managers.

Furthermore, the intervention by the IMF, Bank for International Settlement (BIS) and World Bank to ask countries to strengthen their supervision over banks, has put pressure on all countries to implement the best regulatory standards. One of the important issues that these international organisations are emphasizing on is the issue of corporate governance.

3.6 Concluding Remarks

The UK model of corporate governance is characterized as a system that gives priority to shareholders over other stakeholders through making the management accountable to the shareholders.

This model has been criticized by researchers, businessmen and other interested parties. It has been argued that since the government did not enacted the FRC Combined Code into law it has lacked the power to enforce compliance with the
Code. (This was in fact a deliberate choice of the UK government, which preferred to rely on a voluntary code with self-enforcement on a "comply or explain" basis).

The appointment of non-executive directors to ensure that the board works for the interest of the shareholders can be questioned since the non-executive director will be appointed by the executive board which may create some conflict of interest.

On the other hand, some researchers and practitioners supported the UK model of corporate governance as a model of dispersed shareholders which has impacted positively on the capital market and made one of the most efficient capital markets along with USA.

To restore the market confidence which had been negatively affected by the failures of large corporations and banks, there was a strong debate among professionals and academics to establish effective corporate governance. In 1991, The Cadbury Committee issued the code of Best Practice. The Cadbury Committee focused on enhancing financial reporting and making the management more accountable to the shareholders.

The Financial Services Authority (FSA), the body responsible for regulating banks and other financial institutions requested banks operating in UK to adopt the FRC Combined Code (see page 32).

All these codes intend to strengthen the role of the board by enabling them to monitor the management more effectively, enhancing transparency, and strengthening the internal control and risk management through the establishment of an audit committee and a remuneration committee.

The USA model of corporate governance went through two main changes, one in 1932 when the SEC was established which was intended to restore confidence in the capital market after the 1929 stock market crash. The second major reform was in
2002 when the Sarbanes-Oxlay act came into effect which was a result of failures of large corporations like Enron and WorldCom in 2001.

The Sarbanes-Oxlay act required every audit committee to appoint a financial expert within its members. The new act also stated that the audit committee is the sole body within the company which is responsible for appointing, compensating and overseeing the external company's external auditors.

The USA federal states sometimes create contradictions between the responsibility of the State and the duties of the SEC. This has resulted in reducing the role of the SEC in enforcing its laws, including those requirements relating to corporate governance.

One of the main drawbacks in the USA system is the diversity of the shareholders base which had resulted in little control on the management by the shareholders. Banks are more opaque than non financial entities. This tends to intensify the agency problem and thus requires an effective corporate governance. This is due to greater information asymmetries between insiders and outside investors.
Chapter 4

Islamic Banking Practices

Islamic banks mobilize a large proportion of their funds in the form, not of interest bearing deposits, but of profit-sharing and loss-bearing investment accounts held by Investment Account Holders (IAH). These accounts, from the point of view of Shari'ah jurisprudence, have equity-like rather than liability-like characteristics.

IAH funds represent the main source of funding for a majority of the Islamic banks. Investment accounts, which are in most cases based on a version of the profit-sharing and loss-bearing Mudaraba contract under which the funds are managed on behalf of their holders.

Due to contractual relationship between the Islamic bank and the IAH, the Islamic banks as manager (Mudarib) are entitled to a percentage of the IAH profits. Usually Islamic banks stipulate in their contracts with IAH the maximum Mudarib rate.

While an Islamic bank is entitled to receive its Mudarib share of profits only when the IAH funds generate profits, in contrast, fund managers receive typically their management fee based on the net assets value (NAV) and regardless of whether the funds generate profits or not.

IAH funds share several features of subordinated debt, including, most importantly, the subordination of their claims to those of creditors. Also, unlike conventional depositors, neither holders of subordinated debt nor IAH are in a position to initiate a bank run, and stand to lose part or all of their capital if their investments yield negative returns (Archer and Karim, 2006).
Chapter 4 Islamic Banking Practices

Types of IAH:

i) **Unrestricted IAH (Mudaraba Contract):** Unrestricted IAH refers to funds received by the *Mudarib* (the bank) from the *Rab al Maal* (investor) on the basis that the *Mudarib* will have the right to use and invest those funds without restrictions.

This includes the *Mudarib*’s right to commingle those invested funds with its own investment for proportionate participation in profits and losses after the *Mudarib* receives its share of profit as *Mudarib* (*Mudaraba* Standard, AAOIFI, 1996).

It is worth noting that IAH represent 60 per cent or more of the funding side of the bank’s balance sheet, which is the case with many Islamic banks (Archer and Karim, 2006 p.140).

The nature of Unrestricted Investment Accounts (UIA) permits the bank to commingle its own funds with the bank’s assets, unlike conventional banks where a separation exists between the bank’s assets (Chinese Wall) from those funds managed under fiduciary basis; such separation includes appointing dedicated staff responsible for fiduciary accounts to avoid any conflict of interest.

Al-Baluchi (2006 p.4) claimed that fiduciary risk is related to the nature of the *Mudaraba* contract, which places liability for losses on the *Mudarib* in case of wrong-doing, negligence or breach of contract on the part of the management of the *Mudaraba*.

Due to the nature of unrestricted investment accounts which allows the bank to commingle its own funds with IAH funds, adequate transparency is absolutely essential to enable the IAH to assess the performance of the management. This will be discussed in more detail later in this chapter.
Standard & Poor's in their latest commentary paper in 2006 on the rating of Islamic banks pointed out that for unrestricted investment accounts, neither the returns nor the principal is guaranteed.

Even if an Islamic bank makes a loss that impairs the principal value of the unrestricted investment accounts, S&P (Standard & Poors) would not recognise a "soft default", because no contractual obligation would be breached. Only in the case of management misconduct or negligence would the bank be liable to IAH for all losses incurred (S&P, Oct. 2006).

As claimed by S&P, holders of unrestricted Profit Sharing Investment Account (PSIA) should refer to the ratings of the Islamic bank offering the PSIA as the best indicator of the PSIA’s overall creditworthiness as measured by a given probability of default. Such comments by S&P have made new interesting and relevant interpretation of the assessment of Islamic banks which will help in providing the market with a fair assessment of Islamic banks.

Other credit rating agencies are so far silent on this issue which may be interpreted as treating a loss than impairs the equity of IAH as default. This runs contrary to the treatment of IAH in the IFSB Capital Adequacy Standard which calls for the deduction of the total risk weighed assets financed by IAH from the denominator to the capital adequacy ratio, which is in line with the S&P rating methodology.

ii)  **Restricted IAH (Mudaraba Contract):** Restricted IAH refers to funds received by the Mudarib (the bank) from the Rab al Maal (account holders) on the basis that the Mudarib should follow the Rab al Maal’s instructions on matters such as the type of investment, the level of risk and the commingling of its own investment with the Mudarib funds (Mudaraba Standard, AAOIFI, 1996).

Archer and Karim (2006 p.134) argues that the status of IAH raises lack of clarity regarding the status of these investment accounts in practice.
Unlike conventional banks where dedicated staff is appointed for managing fiduciary accounts, Islamic banks have no dedicated staff responsible for managing the restricted investment accounts from those responsible for managing the bank’s assets.

This creates conflict of interest and hence the risk that the interest of restricted IAH may not be adequately protected.

4.1 Current Accounts

Current accounts in Islamic banks are demand deposits, that is, debt claims on the bank which can be withdrawn at any time, and are not entitled to any remuneration; they are "capital certain" since repayment is a contractual right protected by the bank having adequate equity capital. The bank commingles the funds of current accounts with its own funds.

4.2 Fiduciary Risk

A fiduciary relationship exists when the shareholders (principal) appoints someone (agent/manager) to manage their enterprise on their behalf. A disciplined corporate governance mechanism ensures that the manager works for the interests of the shareholders (owners) by making management accountable to the shareholders.

Establishing an effective system of accountability requires, among other matters, an effective risk management system, appointment of audit committees, and transparency in order to enable shareholders to monitor the managers effectively.

(3) Fiduciary Risk: This is related to the nature of the Mudaraba contract, which places liability for losses on the Mudarib (manager) in case of malfeasance, negligence or breach of contract on the part of the management of the Mudaraba.
Archer and Karim (2006) argued that to fulfill its fiduciary duty the bank as (Mudarib) is expected to maximize profit for and act in the best interests of IAH. This will be examined in more details in chapters 7, 8, 9, and 10.

The management of the Islamic bank owes a fiduciary duty to two categories of equity holders, shareholders and IAH, whose interests may not necessarily be congruent (Archer and Karim, 2006 p. 136).

IAH expects the management as part of its fiduciary duties to manage their funds prudently and pay them an attractive rate of return while compensating the management with an acceptable Mudarib rate for their services. However, the shareholders expect the management to pay them an attractive dividend yield and a good value for their share.

4.3 Transparency and Market Discipline

A bank’s failure may lead to detrimental impact on the financial sector as whole (Caprio et al, 2003). This makes transparency all the more important in banks as it enables the shareholders to monitor management more effectively and accordingly prevent systemic risk.

In Islamic banks, prior to the establishment of AAOIFI, the lack of adequate disclosure by Islamic banks was very apparent.

Transparency of an IIFS refers to an environment where material and reliable information about the IIFS is made available in a timely and accessible manner to the market at large and to all stakeholders. Such transparency can reduce asymmetric information and uncertainty in financial markets, refers to the environmental features, which, in response to the disclosure of material information, elicit prompt adjustments in either prices or quantities of financial positions in the IIFS, and thereby provide incentives for IIFS to limit excessive risk-taking and pursue good governance. Market discipline, in this sense, requires a set of mechanisms through which markets can penalise excessive risk-taking or inadequate transparency (IFSB, 2006c).
This may have been due to a lack of appreciation of the financial reporting requirements which Islamic banks should comply in order to provide adequate disclosure to IAH in their capacity as equity investors, not depositors. Prior to implementation of AAOIFI’s Standards Islamic banks were hardly required to disclose any information relating to the investments of IAH’s funds.

Also Islamic banks were also divided as regards the accounting treatment of IAH on their balance sheet. Some banks reported IAH funds on the balance sheet under liabilities, while other treated them as part of equity. Yet a third group of banks treated all IAH funds as off-balance sheet items. Karim (2001) argues that these differences were due to the approaches adopted by various countries to regulate Islamic banking.

As the issue of transparency is very critical, AAOIFI was established in 1991 to improve the transparency of Islamic financial institutions by setting accounting standards that would allow shareholders and IAH to have access to information that helps them in their decision-making. For example, Accounting Standard No. 5 provides the basis on which profits are distributed between the Shareholders and IAH (AAOIFI, 2002 p.224).

Enhancing transparency in Islamic banks should improve market discipline. The Basle Committee for Banking Supervision (BCBS’s) Revised Capital Adequacy Framework (BCBS 2005, commonly known as Basel II) has taken the view that market discipline is increasingly important in a world where banking activities are becoming more and more complex.

This is reflected in Pillar 3 of Basel II, which encourages greater bank disclosure to strengthen market discipline and accordingly establish good governance.

As IAH have no direct monitoring role over the management of an Islamic bank, adequate transparency may be the only mechanism that can be used to enable them to assess the performance of the management. Therefore, should the IAH receive a
lower than expected IAH return, IAH can sanction management by withdrawing their funds.

Furthermore, IAH requires more information than depositors of conventional banks since, like the shareholders, IAH bear the risk of loss of their investments.

In spite of the AAOIFI efforts in developing transparency and disclosure, there is demand for developing new standards or for updating the existing standards. For example, AAOIFI Standards do not require the disclosure of the actual Mudarib percentage rate charged to the IAH provided the rate does not exceed the maximum rate stated in the Mudaraba contract.

Furthermore, the existing AAOIFI Accounting Standards do not require disclosure of the actual returns generated on IAH funds. This means IAH will not be able to assess the performance of the management with regard to the management of their funds.

4.4 Corporate Governance in Islamic Banks

The debate in the corporate governance literature has mainly concentrated on whether corporate governance should focus exclusively on protecting the interests of shareholders, or whether such a focus should be broadened to protect the interest of other stakeholders (Many and O'Hara, 2003).

The essence of the agency problem is the separation of ownership (shareholders) and control (management) (Fama and Jensen, 1983b). To address such problem good governance is a mechanism to encourage management to work for the interest of the shareholders.

Such mechanism of corporate governance is to make the manager accountable to the shareholders. Establishing effective corporate governance includes establishing an effective risk management system, an effective audit committee, visionary board of
directors "representing the interest of shareholders and IAH", adequacy of information "to shareholders and IAH", among other matters.

Greuning and Iqbal (2007 p. 29) stated that IAH are like quasi-equity holders but without participation in the governance of the Islamic bank. As a result, IAH do not have any direct recourse to the bank to protect their rights.

In spite of the potential risk of the IAH losing their funds, IAHs have no governance rights.

Therefore, they rely on the board of directors/shareholders to represent their interest, but actual practice reflects otherwise. For example, there are a number of Islamic banks, which have attempted to pay shareholders a constant high rate of dividends for a long period, while IAH in those banks were receiving minimum returns. This is due to PDF high Mutarib rate and Islamic financial leverage effect(5). This will be discussed in more details in chapter 11.

This apparently was due to certain expenses were charged to IAH. Such practices tend to please the shareholders. This will be discussed in more details when we analyze the case studies in chapter 11.

However, in order to protect the interests of the Unrestricted IAH (the funds of Unrestricted investment accounts are commingled with the shareholders funds), some

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(5) Islamic financial leverage: Extent to which an Islamic bank uses investment accounts financing to fund a portfolio of assets in order to benefit from the Mutarib share of profit. This enables the Islamic bank to increase its shareholders' return on equity for no additional financial risk. This is subject to the possibility of DCR (Archer and Karim 2006). DCR arises when the Islamic bank is under pressure to give up part or all of its Mutarib share of profits in order to enhance the returns to the IAH. This pressure may come from the market or from the supervisor.
countries (e.g. Qatar and Malaysia) the banking supervisor takes the view that Islamic banks should not allow unrestricted IAH to suffer a loss of their capital or a major fall in their returns.

Such decision by the bank supervisors is a signal to the management of the Islamic banks to take equally, the interests, of the Unrestricted IAH and shareholders.

This decision would also give investors the confidence to place their funds with the Islamic banks.

Archer and Karim (2006 p.140) argued that in order to mitigate the effects of this practice, which could not be sustained in the longer term if the shareholders had consistently to forgo the bank’s Mudarib share, that the management of many Islamic banks introduced the PER\(^{(6)}\) (Profit Equalization Reserve).

Similar considerations apply to the IRR\(^{(7)}\) (Investment Risk Reserve); the IRR may give rise to moral hazard problems similar to those arising from deposit insurance schemes, since the existence of IRR in Islamic banks is likely to encourage management to engage in excessive risk-taking.

\(^{(6)}\) PER is an amount set aside from the income of both IAH and shareholders before the allocation of the Bank’ share as Mudarib to smooth the profit of IAH to match the returns of instruments in the market, thereby encouraging IAH to retain the funds with the Bank to mange them on their behalf. The PER may also be used to increase owners’ equity; AAOIFI, Financial Accounting Standard No. 11, Provisions and Reserves Manama, Bahrain, 1999). The PER serves to mitigate DCR.

\(^{(7)}\) IRR is an amount set aside from the income of IAH, but not the shareholders, after the allocation of the Bank’s share as a Mudarib to absorb losses attributed to investments financed by IAH before the losses affect the equity of IAH. Shareholders cannot contribute to this reserve because this is considered as indirectly compensating IAH for losses, which is prohibited by the Mudaraba contract.
While the declared objective of the PER was to reduce volatility of IAH returns, it provided management with a mechanism to tap this pool of funds to relieve shareholders of the burden of smoothing the returns of IAH or to mitigate problems of asset-liability management.

Since the relationship between the IAH and the Islamic bank is based on Mudaraba, the bank as manager (Mudarib) is not permitted by Shari'ah to fix in advance the amount of the return to be paid to IAH. The amount of the return will be based on the results of the investment, which are shared between the IAH and the bank as Mudarib, with the bank's percentage share being stated in the Mudaraba contract (in practice, this percentage is normally a maximum).

This allows the Islamic banks to change the IAH return from year to another. However, in order for the Islamic bank to be competitive in the market, sometime the shareholder will give up part of their Mudarib (commission) share of profits to beef up the IAH return.

This is because losses can be covered, at least in part, by this reserve, which is financed only from the funds of IAH and not those of shareholders, and this is likely to increase the management's risk appetite to a higher level than that of the IAH, especially as the IRR is appropriated from profits after the calculation of the Mudarib share which is unaffected, while in the case of a loss, Mudarib share is zero irrespective of the size of the loss.

Even if a loss arose due to misconduct and negligence it could wrongly be absorbed by the IRR, although, according to the Mudaraba contract it should be borne by the shareholders. It would indeed be difficult for IAH to be aware of such occurrences because of the absence of either adequate disclosure or adequate governance structures to prevent such practices.
4.5 Appointment, Duties and Responsibilities of the \textit{Shari'ah Supervisory Board (SSB)}

The main purpose for establishing Islamic banks is to allow Muslims to conduct their financial transactions in accordance with \textit{Shari'ah} precepts. In order to give credibility and to satisfy the ethical expectations of their customers, the majority of Islamic banks have developed a control process in the form of in-house religious advisers, commonly called the \textit{Shari'ah} Supervisory Board (SSB). The membership of the SSB is drawn exclusively from very knowledgeable \textit{Shari'ah} Scholars (Gambling et al, 1993).

The SSB is a part time board. At the end of financial year, they submit a report to the shareholders’ annual assembly on the bank’s compliance with \textit{Shari'ah}. This matter will be discussed in more details in chapter 7, 8, 9, and 10.

The members of the SSB are appointed by the bank’s shareholders or in some cases by the board of directors. They have the right to attend the annual general meeting of the bank, and perform all or some of the following duties (Karim, 1990):

1. Design and approve the bank’s contracts for its basic activities and issue religious rulings in response to requests by the staff.

2. Advise the external auditors and the management of the bank on the accounting treatments, which require departure from generally accepted accounting principles in order to comply with \textit{Shari'ah} precepts.

3. Ensure that the bank’s practices conform to the spirit as well as the letter of Islamic teaching.

4. Prepare a religious [compliance] report as part of the annual report, in which it attests whether the bank’s operations are in conformity with the \textit{Shari'ah}. 

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The functions of a SSB, which are usually spelt out in the articles of association of the bank, lie in two main areas. These are *ex ante* compliance (e.g., the checking of contracts in advance of their use), and *ex post* compliance. The *ex ante* is usually conducted by an Internal *Shari'ah* Review (ISR) comprising of *Shari'ah* staff which are appointed by the management or in some cases by the SSB.

Usually members of the SSB are not employees of the bank. While, the ISR is a full time staff of the bank. However, the SSB has a right of access to any source of information and, at the end of the financial year; it issues a special report that is published with the external auditor's report.

Karim (1990b) claims that in some banks, the SSB's role is mandatory and in other banks, the SSB's role is advisory in nature.

The transparency created by the central *Shari'ah* board' rulings can at times impact on governance related matters. These rulings create benchmark of acceptable practices, which can reduce differences between a bank's management and its SSB and encourage meaningful dialogue about the acceptability of new products and services (McKinsey, 2007 p.111).

In the absence of a single authority on how to interpret and apply Islamic law, individual banks appoint recognized Islamic scholars as members of the SBB, to rule on whether new products or services are compliant, as well as to audit a bank's day-to-day operations.

The existence of a religious authority within banks also creates clear governance challenges, particularly when the opinions of its management and board, with their focus on financial results, diverge from those of the SSB.

However, in certain countries (such as the United Arab Emirates and Malaysia) it is a legal requirement for Islamic banks to establish an SSB. The Malaysian Islamic Banking Act (1983) states that "the Central Bank shall not recommend the grant of a
license, and the Minister shall not grant a license, unless the Central Bank or the Minister, as the case may be, is satisfied that there is, in the articles of association of the bank concerned, provision for the establishment of a Shari'ah Supervisory Board to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam".

In Bahrain, the Central Bank of Bahrain (CBB) appoints an internal part-time Shari'ah Supervisory Board and its role is to give advice to the CBB on matters relating to banking or other business issues.

The fiduciary responsibility of Islamic banks towards their customers includes a primary undertaking by the Islamic banks to comply with Islamic Shari'ah rules and principles at all times (IFSB, 2006b).

The appointment of SSB and ISR is aimed at acting as a watchdog on the bank's management to ensure that the bank operates in accordance with Shari'ah.

The IFSB Corporate Standard (2006b) recommends that Islamic banks form a three-member Governance Committee, which shall include an independent non-executive director to chair the Governance Committee. A Shari'ah scholar who is an SSB member for the purpose of leading the Governance Committee on Shari'ah related governance issues and also to coordinate and link the complementary roles and functions of the Governance Committee and the SSB.

One of the objectives of the IFSB Corporate Governance Standard is to address the fiduciary responsibility to make sure that the Islamic bank adheres to Islamic rules and principles laid down by the SSB.

AAOIFI Governance Standards complement the role played by the IFSB to ensure that the Islamic banks perform its fiduciary responsibly towards its stakeholders on the bank's compliance with Shari'ah.
4.6 Concluding Remarks

Corporate governance is a mechanism to ensure that management work for the interests of the shareholders (owners) by making them accountable to the shareholders. It encourages transparency and accountability to enable IAIs and other stakeholders to assess the performance of the management and to enable them make more informed investment decisions.

In an Islamic bank, the IAIs expect more information than depositors of conventional banks because, unlike a deposit holder, the IAIs are exposed to the risk of losing their investments. Further, the IAIs share a similar characteristic with small and dispersed shareholders as both these groups have limited influence on management.

As an IA has no direct monitoring role over the management of an Islamic bank, adequate transparency may be the only mechanism that can be used to enable them to assess the performance of the management. Therefore, should the IA receive a lower than expected IAH return, IAH can sanction management by withdrawing their funds.

The nature of Unrestricted Investment Accounts (UIA) permits the bank to commingle its own funds with the bank’s assets. Unlike conventional banks where a separation exists between the bank’s assets (Chinese Wall) from those funds managed under fiduciary basis, such separation includes appointing dedicated staff responsible for fiduciary accounts to avoid any conflict of interest.

In spite of the potential risk of the IAH losing their funds, IAHs have no governance rights.

Therefore, they rely on the board of directors/shareholders to represent their interest, but the true reflects otherwise. For example, there are few Islamic banks, which have attempted to pay shareholders a constant high rate of dividends for a long period, while IAHs in those banks were receiving minimum returns.
However, in order to protect the interest of the Unrestricted IAH (the funds of Unrestricted investment accounts are commingled with the shareholders funds), in some countries (e.g. Qatar and Malaysia) the banking supervisor takes the view that Islamic banks should not allow unrestricted IAH to suffer a loss of their capital or a major fall in their returns.

The IFSB Corporate Governance Standard is to address the fiduciary responsibility is to ensure that Islamic banks adhere to Islamic rules and principles laid down by the SSB.

AAOIFI Governance Standards complement those issued by the IFSB. While the IFSB addresses the Shari'ah governance by recommending the establishment of an effective governance system within the bank, the AAOIFI Governance Standards tackle the Shari'ah governance by promoting transparency and accountability of management.

The functions of a SSB, which are usually spelt out in the articles of association of the bank, lie in two main areas. These are \textit{ex ante} compliance (e.g., the checking of contracts in advance of their use), and \textit{ex post} compliance. The \textit{ex ante} is usually conducted by an Internal Shari'ah Review (ISR) comprising of Shari'ah staff which are appointed by the management or in some cases by the SSB.

The transparency created by the central Shari'ah board rulings can at times impact on governance related matters. These rulings create benchmark of acceptable practices, which can reduce differences between a bank’s management and its SSB and encourage meaningful dialogue about the acceptability of new products and services.
Chapter 5

Research Issues

5.1 Introduction

Based on a view of pertinent literature and the prevalent industry practice, it can be inferred that the existence of profit-sharing and loss-bearing investment accounts in Islamic banking and the lack of clarity regarding the status of these accounts, raise important questions of corporate governance, transparency, market discipline and the role of the regulators.

The following sections set out the theoretical basis development of this thesis, i.e. the issues concerning corporate governance in Islamic banks particularly from a banking supervisor’s point of view.

5.2 The Accountability of the Board of Directors and Management

As discussed in chapter 2 above, Agency Theory is concerned with the relationships between various stakeholders in the corporation. In the first instance, it is concerned with the principal-agent relationship (that arises owing to the separation of ownership and control) between the shareholders as principals and the management as agent. But it also considers principal-principal relationships between two sets of principals where there may be conflicts of interests. For example, creditors such as bondholders constitute a class of principal different from shareholders. With particular reference to Islamic banks, while there are obviously no bondholders, there is not merely a potential principal-agent problem with regard to the relationship between the IAH as principals and the management as agents, but also a potential principal-principal problem with regard to the relationship between the IAH and the shareholders as two sets of principals whose interests may not coincide. However, the Agency Theory literature does not consider principals such as IAH who are a form of stakeholder specific to Islamic banks.
Managements of banks in the USA and UK, and indeed elsewhere, typically adopt the view that maximisation of shareholders’ wealth is the main duty of management. Such a view ignores, however, the Islamic bank's duty as Mudarib to pay equal attention to the interests of its IAH.

Agency Theory considers certain mechanisms that serve to mitigate the principal-agent problem. As mentioned in chapter 2, these include bonding and monitoring. Bonding consists of binding undertakings by the management to avoid certain types of action that may be contrary to the interests of principals. One common form of bonding which is used to protect the rights of bondholders consists of debt covenants that restrict the right to pay dividends to shareholders and to raise further borrowings unless the rights of the new lenders are subordinated to those of the bondholders. Monitoring involves providing principals with the means to exercise scrutiny of the actions of management, such as the provision of periodic financial statements, external audit and annual general meetings. Shareholders typically have the right to approve the appointment of members of the board of directors and to vote directors off the board. Moreover, if bondholders do not receive payments of interest and principal by the due dates, they can typically acquire governance rights such as the right to appoint an administrator to manage the corporation in their interests.

Islamic banks are built around the profit sharing concept which is different from the conventional banks. The IAH share the profits earned from the investment of their funds with the Islamic bank as fund manager (i.e. Mudarib) and are exposed to losses on such investments, unlike depositors in conventional banks whose funds are remunerated by means of a contractually agreed rate of interest with the principal amount being guaranteed. Hence IAHs are crucially affected by their bank’s investment performance. In spite of this, under the Mudaraba contract IAH have no right to intervene in the Islamic bank's investments and policies, which are the sole prerogative of the Mudarib. A clear separation must occur between IAH and their invested capital. However, unlike the situation with shareholders, this separation of capital ownership from management under Mudaraba as currently applied does not provide any rights of governance or oversight to IAH in exchange for their funds.
The lack of governance rights of IAH means that they cannot exercise monitoring over management; even if they have access to periodic financial reports, they have no say in the appointment or removal of members of the board of directors and their only recourse if they are dissatisfied is to withdraw their investment (perhaps at a loss).

In such a situation, it can be suggested that the IAHs may place reliance on the shareholders to monitor the management of the Islamic bank on their behalf "vicarious monitoring" by shareholders of behalf of IAH (see Archer and Karim 2006). The same authors (Archer and Karim, 2006) pointed out that the management of an Islamic bank has a fiduciary duty both to the shareholders and also to the IAH. Moreover, there is a similarity between IAH and dispersed shareholders as both have little influence on the management. Yet since the interests of shareholders and IAH do not necessarily coincide, there is a potential principal-principal problem that may undermine the "vicarious monitoring" as described above.

With regard to the principal-principal problem between shareholders and IAH, it is certainly in the shareholders' interest to attract and retain the funds of IAH, as the bank's Mudarib share of the profits earned from investing these funds is a major source of income for the shareholders (Al-Deehani et al, 1999). Thus, depriving IAH of attractive returns in order to offer significantly more attractive returns to shareholders might seem to be a poor policy for management to follow. In principle, therefore, the hypothesis that vicarious monitoring is effective has some plausibility.

As indicated in chapter 4, however, it was noted that some Islamic banks were paying consistently high returns to shareholders compared to very minimal returns to IAH. Such a difference in the payment of returns between the shareholders and IAH not merely implies that management gives preference to the interests of the shareholders over the IAH, but also casts great doubt on the "vicarious monitoring" hypothesis. In fact, there would seem to be a double agency problem affecting the interests of IAH: both a principal-agent problem as between the IAH and the management, and a principal-principal problem as between shareholders and IAH. Moreover, no bonding or monitoring mechanisms are available to the IAH to mitigate these agency
problems. They have the right to withdraw their funds if they are dissatisfied with the management of their funds, but do not have the right to receive the information on the basis of which they can make a well-founded decision on such a matter (an instance of the problem of asymmetric information).

This situation results a failure of the managements' fiduciary duty toward the IAII and constitutes weak governance which will be discussed further in this thesis.

5.3 Transparency and Disclosure

The benefits of adequate information are the reduction of information asymmetry between the management and stakeholders which facilitates monitoring of management by the stakeholders and, in principle, the promotion of effective market discipline.

This coincides with the Basel Committees' new strategy. Pillar 3 of Basel II encourages greater disclosure by banks to strengthen market discipline and accordingly to promote good governance. This part of the new policy of the Basel Committee aims to establish what is called a friendly approach of supervision through reliance on fuller disclosures, better market discipline and good governance.

The Basel Committee believes that fuller disclosures and good governance makes the board of directors and management more accountable towards their shareholders and other stakeholders.

In this new policy, financial intermediaries play a significant role in assessing the reports published by banks in terms of transparency with the aim that the market will have access to greater information which will be reflected in the bank's share price and its borrowing costs.

The question that arises in the context of this thesis is how effective market discipline is likely to be in the case of Islamic banks. With regard to financial reporting, Islamic banks are subject to various accounting standards. Some regulators require Islamic
banks under their supervision to adopt the International Financial Reporting Standards (IFRS), while others promote Accounting and Auditing Organization for Islamic Financial Institutions adopts (AAOIFI) Standards. Such differences make it difficult to compare information between Islamic banks applying different accounting standards.

Although AAOIFI-based disclosures provide greater information than IFRS-based disclosures, there is still a lack of adequate information published by Islamic banks. This is part of what is called a weak information environment. This suggests that without adequate disclosures, development of effective market discipline and good governance will be hampered, to the determent of shareholders. The existence of a weak information environment will contribute to weak governance and ineffective market discipline. This issue will be discussed in more detail later in this chapter.

In a weak information environment, the board of directors and management may decide on strategic issues that may affect the interests of other stakeholders without their knowledge (i.e. an inadequate provision of monitoring facilities). For example, Islamic banks in the Arabian Gulf pays very attractive salaries to their executives since neither the accounting standards nor the regulators require them to disclose such information. Currently there is a debate within the industry as to whether Islamic banks should be required to disclose certain information about the salaries of their executives. Islamic banks are expected to resist to such a move because it may put pressure on the board of directors to provide adequate explanations to the shareholders and IAHs of practices outside the norm of conventional banking.

While a weak information environment is detrimental to the interests of shareholders, it is equally detrimental to those of IAH. Among other things, IAH may be misinformed about the actual returns on their investments. This may result from the use of creative accounting techniques, such as profit equalisation reserves and investment risk reserves, which is standard practice in Islamic banks in most countries where they operate (see chapter 4).
However, for market discipline to be effective, market actors such as shareholders and IAH not only need to be adequately informed, but they also need to be sufficiently knowledgeable and active to make use of the information. In the case of shareholders, such action may take the form of selling their shares, but they may also remove members of the board of directors. By contrast, IAH may withdraw their funds but they have no say in the composition of the board of directors. Moreover, while sales of shares are visible as they take place in public stock markets, and this visibility contributes to market discipline, withdrawals of funds by IAH are not similarly visible.

5.4 The Role of SSB

All Islamic banks must appoint a SSB to monitor the performance of the management on Shari'ah matters and report to the shareholders on the bank's compliance with Shari'ah. However the length and contents of the Shari'ah reports differ from one bank to another. The lack of standardisation makes it difficult to make comparisons between reports and thus various banks' compliance. A negative or inadequate report on a bank's compliance with Shari'ah might, in principle, lead to a run on the bank as disappointed IAH and current account holders withdraw their funds. Without standardisation, it would be difficult to come to accurate conclusions when analysing an Islamic bank's compliance.

It is worth noting that the relationship between the SSB and the Islamic bank is similar to the relationship between the external auditors and the Islamic banks, as both are outside the bank's organisation and both acts as independent reporters on the operations of the bank.

The roles and responsibilities of SSB will vary across Islamic banks and jurisdictions. A clear understanding of the role and influence that SSB has on the business of Islamic banks is a matter for careful consideration by a regulator.

The AAOIFI has provided some guidance on the composition and role of the SSB of Islamic banks, which is a welcome move to bring consistency in this area, but in the absence of mandatory implementation of such standards across the industry the roles
and responsibilities of the SSB will continue to vary. Moreover, the SSB members are not professional bankers and therefore, rely on the explanations of transactions provided to them by the management in arriving at their Shari'ah opinions (fatwas). This may allow the management to influence the SSB's decisions so as to produce the Shari'ah opinions that they want.

Despite its importance, most of the supervisors of the Islamic banks do not interfere with the bank's compliance with Shari'ah because as supervisors they believe it is outside their remit.

Islamic banks typically appoint an ISR to help the SSB in their task; the role of the ISR is similar to the role played by the internal auditors.

Unless the bank's by-laws specify explicitly the role of the SSB, their role will depend upon what the board of directors decides regarding their responsibilities. Most of the supervisors think that their role should focus on protecting IAH funds. A failure of the role of the SSB is an example of weak governance. This is a corporate governance issue which is examined in a subsequent section.

5.5 The Role of the Supervisors of Islamic Banks

The supervisors of Islamic banks have different approaches to supervising Islamic banks. The majority of supervisors apply to Islamic banks the same regulations that were designed for conventional banks. Other countries such as the Kingdom of Bahrain have developed a specific set of regulations for Islamic banks; these regulations are based on AAOIFI Standards and Basel Committee Standards.

The researcher being a former supervisor of Islamic banks for over 10 years discovered that the majority of supervisors lack the understanding of the types of Shari'ah compliance risks associated with the Islamic banks and their relationship with fiduciary risk. Failure to comply with the Shari'ah is a breach of the Mudarib's fiduciary duties to the IAH. The fiduciary risk in Islamic banks should go hand in
hand with protecting the IAHs funds because any misconduct by the bank could damage its reputation dearly and result in the inability to mobilise further funds. More seriously, it could result in the transformation of the IAH funds into liabilities which might well make the bank insolvent.

As indicated previously, in spite of their importance as a major source of funding for Islamic banks, IAHs do not have the rights either of shareholders or of creditors, the latter having a variety of control rights including the right to appoint an administrator or receiver in case of default or violation of debt covenants.

This situation requires the supervisors to take into account the characteristics of the Islamic investment accounts and to come up with regulations that protect the interests of the IAH while at the same time safeguarding the interests of the shareholders.

It is worth noting here that any direct rights given to IAHs to monitor their funds may represent a violation to the concept of *Mudaraba* which is based on giving the rights of managing the IAH funds to the banks in their capacity as *Mudarib* (Manager).

It might be argued that supervisors would do better to focus on improving the Islamic banks’ financial reports so as to enable the IAH to assess the performance of their funds. IFSB and AAOIFI play a very instrumental role in issuing standards with the aim of improving the bank’s disclosures and allowing the market to react to such information. This will encourage information intermediaries to use the information provided by the Islamic banks which will help to establish market discipline. Where the information given by the Islamic banks is insufficient, this will lead to weak governance. Shareholders and IAHs will be unable to assess the Islamic bank’s performance. This will also impede information intermediaries in their role of using their expertise to assess the bank’s performance for the benefit of investors and other interested parties.

Following this line of thought, it may be suggested that the supervisors of Islamic banks could play a more important role in establishing good governance by adopting
and enforcing standards that enhance the bank's disclosures and establish good governance.

Based on the above, the following are the research questions on corporate governance in Islamic banks that this research will examine:

1. Does the existence of shareholder concentration in an Islamic bank affect the way in which attention is paid to the interests of IAH? In other words, does shareholder concentration affect the principal-principal relationship between the shareholders and the IAH, and the vicarious monitoring by shareholders on behalf of IAH that may be part of that relationship?

2. Does the *Shari'ah* Supervisory Board (SSB) provide stakeholders with adequate assurance that Islamic banks are in compliance with *Shari'ah* jurisprudence in their operations?

3. Is there are lack of adequate implementation of AAOIFI Accounting Standards that restricts the ability of IAH to assess the performance of Islamic banks?

4. How important is the role of banks supervisors in enhancing transparency, good governance and effective market discipline?

To address the above research questions, the following research propositions are established in order to test the findings of the research to the existing theory or in this study to examine if the theory which was developed for conventional banks can be applied in the case of Islamic banks. Therefore this research will focus on testing propositions that are implications of the existing theory of corporate governance, rather than developing a new one:
Chapter 5

Research Issues

1. The principal-principal relationship between shareholders and IAH and the possible effects of shareholder concentration

Unlike the shareholders in an Islamic bank, the IAH do not have the right to appoint and monitor the performance of the board of directors and executive management. They also do not have a say in the appointment of the SSB members or the external auditors. Archer & Karim (2006) suggest that there may be "vicarious monitoring" by shareholders in the interests of IAH, but its effectiveness is primarily dependent on there not being any significant conflicts of interest between the shareholders and the IAH. Such conflicts of interest are arguably more likely to occur where there is a concentration of shareholders. In such a situation, the shareholders may pursue their own interests (via their control of the board of directors) which may differ from those of the minority shareholders and the IAH.

Hence, we formulate Research Proposition No. 1 as follows: There is a correlation between the extent of shareholder concentration and the ratio of the shareholder return on equity to the IAH return on equity - the higher the concentration of shareholders, the higher the ratio of the shareholders return on equity to the IAH return on equity.

2. Compliance with Shari'ah Rules and Principles

The role of SSB has typically been defined in terms of ex ante compliance of contracts with Shari'ah, but not ex post compliance of transactions with the fatwas issued by the SSB (which requires an audit process to verify compliance). This highlights the need for internal Shari'ah review as proposed by the AAOIFI Governance Standard No. 2. However, AAOIFI Auditing Standard No. 2 requires the external auditors to report on Shari'ah compliance. One way of measuring the effectiveness of internal Shari'ah review is by the external auditors when they perform their audit to report on the bank's compliance with Shari'ah rules and principles. On the other hand, given that they do not perform their ex post audit, the SSBs will tend to depend on the findings of internal Shari'ah review to issue their report to the shareholders.
Hence, we formulate Research Proposition No. 2 as follows: The findings of the ISR will be reflected in the wording of the SSB’s report that is included in the Islamic bank’s annual report.

3. The Information Environment and the Role of Industry Supervisors

There is substantial empirical support for the proposition that small investors (of whom IAH are a category) do not pay much (if any) attention to financial reporting information of companies in which they invest. Rather, they rely on information intermediaries to study such information. Hence, in the absence of adequate information intermediaries (e.g. financial analysts publishing report, or rating agencies) covering Islamic banks, the issue arises of the role of banking industry supervisors in protecting the interests of investors, especially small investors.

4. The Role of the Bank Supervisors in Improving the Information in the Financial Reports

The weak information environment in which IIFS operate tends to have implications for this issue. Arguably, there is a ‘chicken and egg’ situation in which information intermediaries are rare because there has been a lack of good quality information, while AAOIFI Standards should have improved this situation (Al-Baluchi, 2006). Hence, there is a need for a ‘bootstrapping’ of the information environment by supervisory authorities, i.e. by enforcing AAOIFI and IFSB Standards that promote the provision of better financial reporting and governance. But to what extent do supervisors recognize this.

The banking industry supervisors and supervisors will play an important role in protecting minority shareholders as well as the IAH. Among other things, banking supervisors recognize the need to improve financial reporting of Islamic banks, even if there is currently only a very limited amount of information intermediation.
5.6 Concluding Remarks

In the corporate governance of Islamic banks, there are various issues concerning the existence or effectiveness of the mechanisms such as bonding and monitoring that serve to protect the interests of investors, with particular reference to the IAH. Three such issues have been identified above.

The next chapter will discuss the research methodology that will examine the above issues them. A further set of issues that arise concerns the implications of the answers to the above questions for the regulation and supervision of Islamic banks. These will be considered in the concluding chapter.
Chapter 6
Research Design and Methods

6.1 Introduction

In carrying out research, the researcher may first identify a theoretical issue which is expressed in terms of a set of research hypotheses and then design an empirical study to show whether the hypotheses are consistent with empirical evidence. In this way, the theory relating to the issue either receives empirical support or is shown to require modification.

Alternatively, the researcher may identify a problem or issue from practical point of view and then characterize the issue in theoretical terms using and possibly adapting existing theory prior to proceeding in a manner similar to that above, except that research hypotheses may be replaced by research propositions leading to questions to which answers are sought.

Finally, the researcher, having identified a problem or issue from a practical point of view, may, instead of characterizing it in theoretical terms, develop theoretical propositions inductively on the basis of the research findings, and then test whether these propositions are supported by further research – a process known as the Grounded Theory approach.

This study uses the second approach, by first examining the problems of corporate governance in Islamic banks and then looking to existing theory to try to get a theoretical understanding of the problem. However, the existing theory is not entirely applicable because it was developed for different types of institutions and different types of environment. Hence some adaptation of the existing theory was called for.
It is to be noted that CG in Islamic banks is a relatively new topic and therefore the theories in this area are relatively few and are not well developed. Accordingly, this research will attempt to test corporate governance theories developed for conventional banks on Islamic banks.

Such research has the characteristics of exploratory research, which is defined as research when there are very few or no earlier studies to which we can refer for information about the issue or problem. The aim of this type of study is to look for patterns, ideas or hypotheses, rather than testing or confirming a hypothesis (Hussey and Hussey, 1997 p.10).

It is worth noting that each research strategy has peculiar advantages and disadvantages, depending on three conditions which are characteristics of the chosen field of study and the research objectives: (a) the type of research questions; (b) the control an investigator has over actual behavioural events; and (c) the focus on contemporary as opposed to historical phenomena (Yin, 2004 p.1).

6.2 Research Objectives

Following the issues highlighted in the previous chapter, research objectives are developed which are as follows:

a) To study the impact of the degree of shareholder concentration for protecting the interests of the IAH.

b) To assess the role of SSB in providing assurance via the report they produce as to the bank’s compliance with Shari’ah.
c) Given the lack of adequate implementation of applicable financial reporting standards (specifically, AAOIFI Financial Accounting Standards), to study the impact of this on the ability of IAH to assess the performance of Islamic banks.

d) To assess the role of the banking supervisors in enhancing transparency in Islamic banking, thereby protecting, among others, IAH interests.

6.3 Research Questions

The development of research questions is probably the most important step in conducting research since it will have an impact on the research methodology that to be used. As mentioned in chapter 5, the following are the research questions:

1. Does the existence of shareholder concentration affect the way in which attention is paid to the interests of IAH?

This research question in the study will investigate the extent to which the research findings support the proposition drawn from conventional corporate governance theory (see chapter 2), (see chapter 2), that shareholder concentration works to the disadvantage of smaller investors, including the IAH. On the other hand, literature on corporate governance of Islamic banks (e.g. Archer and Karim, 2006 p.138) suggests that the shareholders of the Islamic banks have a vested interest in looking after the interests of IAH. This incentive is motivated by the operation of the Mudaraba contract which is used to mobilize the funds of IAH, whereby a major component of the shareholders’ earnings is their (typically very large) share in the profits generated by the bank for its IAH, whereas the latter

(1) The reader is referred to the percentage shares noted in the four case studies that appear in subsequent chapters.
bear all the risk of loss. The IAH may thus be compared to the proverbial "goose that lays the golden eggs" for the shareholders (See Al-Deehani et al, 1999).

If we categorize shareholders into concentrated and minority, it would be mainly the concentrated shareholders who would have the power, through their control of the board of directors, to look after the interests of IAH. The role of the IAH in the bank's capital structure differs from that of minority shareholders who do not play this role of the "goose that lays the golden eggs" via the operation of the Mudarib share.

Another difference between minority shareholders and IAH is that minority shareholders normally (i.e. in the absence of related party transactions for the benefit of dominant shareholders) have the same payoffs from the bank's operations as majority shareholders, while IAH are exposed to losses on investments of their funds to which the shareholders (via the bank as Mudarib) are not exposed. A further important difference is that, in principle, minority shareholders have governance rights, including property rights, rights to control (although they may have difficulty in exercising them) and rights to information while benefiting like the concentrated shareholders from sharing in the profits generated for IAH, however, the latter have no such governance rights, even in principle.

2. Does the Shari'ah Supervisory Board (SSB) provide stakeholders with adequate assurance that Islamic banks are in compliance with Shari'ah jurisprudence in their operations?

One of the unique features of Islamic banks is the role of the SSB to make sure that the bank's transactions are in compliance with Shari'ah. The role and authorities of the SSB differ from one bank to another. Also the mode of appointment of the SSB members differs from one bank to another. The existence
of an effective SSB is a governance tool to act as watchdog on the bank’s transactions from a Shari‘ah perspective. Thus, the existence of an ineffective SSB would be expected to reflect negatively on the bank’s reputation and to lead to withdrawals of IAH funds.

3. Is there a lack of adequate implementation of AAOIFI Accounting Standards that restricts the ability of IAH to assess the performance of Islamic banks?

To establish an effective governance regime, Islamic banks arguably need to provide investors including IAH with good quality information to enable them to make well-founded economic decisions about their investments in the banks. However, if the Islamic banks that are required to implement AAOIFI Accounting Standards fail to implement fully AAOIFI Standards in a satisfactory manner. What impact will this have on the effectiveness of corporate governance?

4. How important is the role of bank’s supervisors in enhancing transparency, good governance and effective market discipline?

The roles of supervisors in regulating Islamic banks differ from bank to another. For example, countries like Sudan and Malaysia promulgated Islamic Banking Acts as early as 1983 that includes specific regulations for Islamic banks. Bahrain has developed specific regulations for Islamic banks. Some countries like Bahrain, Qatar and Sudan have adopted AAOIFI Standards, other countries like Kuwait adopts IFRS Standards. Such differences make it difficult to compare Islamic banks operating in different jurisdictions. Developing effective market discipline requires an adequate level of disclosures to enable the financial intermediaries to assess the performance of Islamic banks.
6.4 Research Methodology

Research methodology is concerned with the reasoning behind the choice of research method and research design. This reasoning reflects the characteristics of the chosen field of study, and is informed by a literature search and review.

The degree to which a research study in social science requires theoretical motivation is a matter of debate. In the case of the Grounded Theory approach, the initial theoretical motivation is minimal, as theory is developed inductively during the research. However, the absence of a firm initial theoretical motivation makes it difficult to frame the research issues or questions. In any case, use of theoretical concepts remains one of the most important strategies for completing research successfully (Yin, 2004 xv).

The Steps used In Conducting Research Methodology:

1. The literature review focused on corporate governance generally as well as on Islamic banks in particular. A review of the literature on corporate governance was carried out with particular emphasis on variants of one of the two main models of corporate governance, namely the USA, and UK variants of the neo-liberal model. These models and their variants were explained in more detail in chapter 3.

2. Chapter 4 highlighted governance issues in Islamic banks with emphasis on fiduciary responsibility, market discipline and disclosure. In chapter 5 research issues, questions and propositions were then developed on the governance of Islamic banks. It needs to be emphasised that the literature review on corporate
governance focused predominantly on conventional corporations, i.e. non-Islamic banks and other non-Islamic entities. This raised the issue of the extent to which the research propositions and questions largely derived from this literature review would be applicable to Islamic banks.

3. To examine the applicability of the research propositions and questions, a pilot study was conducted to have a better insight of the governance issues in Islamic banks and refine the interview questions and the questionnaire used for the survey where appropriate. In this chapter, we analyze the findings of the pilot study.

4. Then a survey within a set of case studies was carried out to examine in depth some of the research questions. These were then analyzed to ascertain the extent to which they support propositions behind the research questions. The research attempted to highlight the implications of its findings on the corporate governance literature.

6.4.1 Research Methods

As indicated above, the research methodology leads to a choice of research methods. Yin (1994 p.3) states that there are several research methods/strategies for doing social science research, which include for example, surveys, case studies, experiments, cross sectional and longitudinal studies, histories and analysis or archival information. All these methods have positive and negative attributes.

To address the research propositions and questions in exploratory research, an appropriate method to use is based on the case study approach. This approach is supported by a number of authors including Hussey and Hussey (1997 p.p.66) who argue that case studies are often used in areas where there are few theories or a deficient body of knowledge or to gain insights and familiarity with the subject area for more rigorous investigation.
However, Yin (1994) emphasises the role of theory in case-based research, with particular reference to 'generalisation to theory'. Yin (2003 p.10) further states that case studies, like experiments, are generalisable to theoretical propositions and not to populations or universes. In this sense, the case study, like an experiment, does not represent a "sample" and in doing a case study, the goal will be to expand and generalize theories (analytic generalisation) rather than to enumerate frequencies (statistical generalisation).

In other words, since case studies do not employ statistical sampling, they cannot be used as a basis for empirical generalizations. However, they can be used to test theoretical propositions, if they are designed to produce empirical evidence for or against such propositions ("generalisation to theory"). In particular, a counterexample to a theoretical proposition indicates a likely need to modify the theory from which it is derived. In formal logic, a single counterexample to a proposition that states a generalisation is considered to refute the proposition; however, in empirical research the result is more likely to be a suggested modification of the theory from which the proposition is derived.

6.4.2 Research Design

Case study research may use either single or multiple cases, and in the latter each case may be treated separately as a single unit of analysis (unitary cases) or as a set of sub-units of analysis handled cross-sectionally within an "embedded" case design. The form of design that will be employed in this study is an embedded case design, using several case studies so as to reduce the limitations of case study research on single phenomena which provide little basis for scientific generalization (Yin, 1994 p.10). The use of an embedded case study design helps to understand the phenomena in more depth, to make comparisons, which may make it possible to generalize the findings to theory and to modify or extend the theory.
The use of several subunits of analysis allows the researcher to establish the differences and analyze them in more detail. This is important in order to highlight the different practices within Islamic banks that have impact on the issue of corporate governance in Islamic banks.

Although a case-based research approach is sometimes presented as an alternative to survey-based research, in fact surveys using interviews and/or questionnaires may be carried out as part of the data acquisition process in case-based research. Yin (1994 p.51) stated that to facilitate generalization to theoretical propositions, a survey could be used within a case study (structured questionnaire-based survey within case study). Such surveys do not use statistical sampling techniques or aim to be the basis for statistically-based empirical generalisations. Their function in an embedded case study design is to form part of the data collected for certain sub-units of analysis. Such an approach is taken in this study, for the sub-units of analysis constituted by the IAH. The survey will be carried out by using a questionnaire that was sent to 350 IAH (see Appendix 1.9).

This research will focus on testing propositions that are implications of the existing theory of corporate governance, rather than developing a new one. However, the existing theory which was intended for application to conventional institutions in a well-developed market setting may not fit the four Islamic banks in emerging markets which are the main units of analysis of this study.

So we may need to suggest modifications to the theory based on the findings of the research, for example as regards the effects of shareholder concentration.

One of the key aspects of the case study approach with which the researcher must be concerned is the reliability and validity of evidence. Ryan et al (1992 p.123) argued that the validity of each piece of evidence should be assessed by comparing it with other kinds of evidence on the same issue. Other subjects might be interviewed, records checked or observations made. The researcher has chosen to use the case study approach
because, as Yin (1994 p.13) pointed out, a case study is an empirical inquiry that investigates a contemporary matter within its real-life context. The researcher believes that because the case study is conducted mainly through face to face interviews, the case study approach is more appropriate for this research study given its exploratory aspect. There are different methods of collecting data in which selected participants are asked questions in order to find out what they do, think or feel. Interviews make it easy to compare answers (Hussey and Hussey, 1997 p.156), and are thus appropriate in an embedded case study design.

However, to achieve a greater degree of generalisability, a survey can be used within a case study, such as a structured questionnaire-base survey within a case study (Yin, 1994 p.51).

In brief, this research adopted the following research design. These steps were also stated by Yin (2003 p.45) for conducting a case study:

1. Articulate the objectives and questions of the study.

2. Link objectives and questions to the basis unit of the study (e.g. single case, multiple cases or survey).

3. Identify the critical evidence (e.g. interview) that will support the major propositions.

4. Stipulate the relevant techniques for analyzing the evidence.

Every type of empirical research has an implicit, if not explicit, research design. In the most elementary sense, the design is the logical sequence that connects the empirical data to the study’s initial research questions and, ultimately, to its conclusions (Yin, 2003 p.20).
6.5 Research Pilot-Study

As mentioned earlier, this research will examine the governance practices in Islamic banks and attempt to identify pertinent problems or issues rather than to develop a new theory. However, areas where the existing theory does not appear to fit, or to provide explanations of, the phenomena observed, will be noted.

Yin (2003 p.79) stated that a pilot case study will help the researcher to refine his/her data collection plans as to both the content of the data and the procedures to be followed. In this regard it is important to note that a pilot test is not pre-test.

The pilot case study can be so important that more resources may be devoted to this phase of the research than to the collection of data from any of the actual cases. For this reason, several subtopics are worth further discussion: the selection of pilot cases, the nature of the inquiry for the pilot cases, and the nature of the reports from the pilot cases (Yin, 2003 p.79).

6.5.1 The Following Steps were Adopted in Conducting the Pilot Study

The pilot study was conducted by using a mix of open-ended\(^{\text{(9)}}\) and close-ended\(^{\text{(10)}}\) questions through face-to-face interviews that were held with 18 persons, including CEOs of two Islamic banks in one of the GCC countries (see the sample of the questions used in the interviews with the management of Islamic banks Appendix 1.1).

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\(^{\text{(9)}}\) Open ended questions: where each respondent can give a personal response or opinion in his or her own words.

\(^{\text{(10)}}\) Close ended questions: where the respondent's answer is selected from a number of predetermined alternatives.
Out of the 18 persons interviewed including 3 shareholders of Islamic banks (see Appendix 1.2) one internal Shari'ah reviewer (see Appendix 1.3), three managers representing auditing firms (see Appendix 1.4), two senior Islamic banking supervisors from two different jurisdiction (see Appendix 1.5) and two SSB (Shari'ah Supervisory Board) members from two Islamic banks (see Appendix 1.6) and five IAH (see Appendix 1.7).

For one of these banks, its ownership structure shows that it is owned by Islamic financial institutions and small shareholders, while in the other bank the majority shares are held by one family and their relatives (concentrated shareholders), and the remaining shares are held by small shareholders.

6.5.2 The Findings of the Pilot Study

The findings of the pilot study indicated, among other things, that the questions used for the interviews with the IAH needed to be simplified so that they could be understood by the IAH. Accordingly an amended interview questions (see Appendix 1.8) was developed.

It was also observed from the pilot study that IAH have very little background on the Islamic bank’s characteristics, including the bank’s contractual arrangements with the IAH, and the potential risk of their investments.

However, the pilot study indicated that some of the bank’s management suggested that AAOIFI needs to improve their disclosure requirements especially on restricted investment accounts, for example with reference to the disclosure standards required for mutual funds (IFSB, 2006c).
Most of the IAH that were interviewed indicated that they placed their funds with Islamic banks primarily for religious reasons. Other reasons considered were the expected returns paid to IAH and the quality of service provided to them.

It was also noted that generally the IAH and shareholders do not read the SSB’s report on the bank’s compliance with *Shari'ah*.

The interviews held with two members of the SSB indicated some differences with regard to their responsibilities. One stated that the SSB’s role is purely to make sure that all the bank’s operations are line with *Shari'ah*. The other scholar indicated that the SSB has two main duties. One is to check on the bank’s compliance with *Shari'ah* and the other is to protect the interests of the IAH.

Also interviews were held with two external auditors from different auditing firms that audit Islamic banks, in order to understand their role with regard to the SSB report. It was noted from the interviews that each audit firm conducts its audit somewhat differently with regard to the bank’s compliance with *Shari'ah*. One auditor mentioned that they always review any *fatwas* issued by the bank before they start their normal audit to be able to check whether the bank implements them. The other auditor stated they do not simply review the *fatwas* but also sometimes they discuss them with the SSB. Also interviews held with two internal *Shari'ah* reviewers (ISR) of two banks indicated differences in the role of the ISR.

The pilot study gave the researcher a better understanding of the governance issues relating to Islamic banks and helped in amending the interview questions that would be used in conducting the case studies.
6.6 Research Case Study

To address the above research questions, the researched used a survey within case studies. For this reason, four banks located in three jurisdictions in the Arabian Gulf were selected for the case study. To preserve the confidentiality of the four banks, each bank is given a fictitious name.

The Reasons for choosing an Islamic Bank operating in Bahrain are as follows:

1. Bahrain hosts more than 27 full fledged Islamic banks.

2. It is the first jurisdiction that issued specific regulations for Islamic banks.

3. The Central Bank in Bahrain, as in the other four jurisdictions, requires Islamic banks to adopt the AAOIFI Accounting and Governance Standards, including those Standards that deal with the roles, duties, appointment, and removal of the SSB members.

4. Only Bahrain has adopted the AAOIFI capital adequacy framework.

The Reasons for choosing an Islamic Bank operating in Qatar are as follows:

Central Bank of Qatar has not developed special regulations for Islamic banks, apart from the following:

1. Islamic banks in Qatar are required by the Central Bank to implement the AAOIFI Accounting Standards.

2. The regulations indicated that IAH should bear no losses on investments made with their funds, except as decided by the regulators.
The Reasons for choosing an Islamic Bank operating in Kuwait are as follows:

1. Prior to 2003, Islamic banks in Kuwait were outside the direct supervision of the Central Bank.

2. In 2003, the Central Bank began to regulate Islamic banks.

3. Islamic banks are not required to adopt the AAOIFI Accounting Standards; instead, they are required to adopt International Financial Reporting Standards.

The features of each of the four banks selected for the case study can be summarised as follows:

a) Ahmed Bank (this bank is located in Kuwait):

1. The government owns 43% of the bank’s capital and the remainder is widely dispersed (no single party holds more than 5%).

2. It uses the partial commingling approaches such that some assets are jointly financed by shareholders and IAH.

3. The appointment of SSB members is the responsibility of the General Assembly whereas the chairman is appointed by the board of directors.

4. The bank applies IFRS Standards and not AAOIFI Standards.

5. The bank has paid a modest rate of return to its IAH (far below the dividend rate paid to shareholders but better than the interest rate on conventional deposits).
b) Mohammed Bank (this bank is located in Bahrain):

1. A single shareholder owns 40% and the remaining capital is distributed among small shareholders.

2. The bank has changed its profit allocation policy from commingling of assets to separating the assets that are financed by shareholders from those of the IAH.

3. The appointment of the SSB members is the responsibility of the general assembly based on the recommendation of the board of directors.

4. The bank applies AAOIFI Standards.

5. The bank has paid a very modest rate of return to its IAH (far below the dividend rate paid to shareholders and even below the interest rate on conventional deposits).

c) Khalifa Bank (this bank is located in Bahrain):

1. The bank is a subsidiary of a large financial group.

2. The appointment of the SSB members is the responsibility of the general assembly based on the recommendation of the board of directors.

3. The bank applies AAOIFI Standards.

4. The rates of return to the IAH during the period studied are almost equivalent to the dividend yield rates for the shareholders and higher than the prevailing interest rates.
d) Sara Bank (this bank is located in Qatar):

1. One family holds the majority of the shares of the bank.

2. The SSB members (including the chairman of the SHEC) are appointed by the general assembly of the bank and the SHEC (other than the chairman) members are appointed by the SSB.

3. The bank uses the commingling approach, i.e. IAH funds are commingled with shareholders' and current account holders' funds.

4. The bank applies AAOIFI Standards.

5. The bank paid a very high dividend yield rate, the highest among the four banks in the sample, and paid IAH rates of return that were more than the interest rates on conventional deposits but far below the dividend yield rate.

6.6.1 The Following Steps were Adopted in Conducting a Survey within the Embedded Case Study

The four research questions mentioned below are those set out in Section 6.3 above.

a) Interviews Held:

Research Question No. 1:

In order to understand the impact of the degree of shareholders concentration on the financial outcome for the IAH, with particular reference to the profit distribution formula between the shareholders and IAH, fact-to-face interviews were held with CEOs or their
deputies' in the four banks. Financial controllers and the internal auditors attended the meeting with the CEO or his deputy.

The interviews focused on the role of the management in protecting the interests of the IAH (see Appendix 1.1). It is worth noting that the same questions were used to interview the management in conducting the pilot study and case studies.

Preparing the questions in such a form is intended to enable the researcher to evaluate the responses more easily and at the same time to allow the interviewee to expand in his/her response. All interviews were recorded to enable the researcher to analyze the responses in more depth.

Also, a survey was conducted of the IAH (the survey questionnaire see Appendix 1.9). A total number of 350 IAH were selected from the four banks on a random sample basis and 164 responded, representing 47%. The survey was important in helping to understand the IAH level of satisfaction with regard to their financial returns. The survey was conducted by mail and used close-ended questions.

The researcher conducted interviews with a mix of open-ended and close-ended questions.

Research Question No. 2:

With regard to research question No. 2, the researcher conducted face-to-face interviews with Internal Shari‘ah Reviewers (ISR) (see Appendix 1.3), the SSB of the four banks (see Appendix 1.6), and with the external auditors (see Appendix 1.4). This was important in order to analyze the role of the SSB members and ISR with regard to Shari‘ah compliance. The meeting with the external auditors was in order to understand the role played by them in auditing the Shari‘ah compliance. It is worth noting that the
same questions were used to interview the ISR, SSB and external auditors in conducting the pilot study and case studies.

The researcher conducted interviews with a mix of open-ended and close-ended questions.

Research Question No. 3:

Face-to-face meetings were held with bank supervisors of the four banks in order to understand the role of the banks' supervisors (see Appendix 1.10) in enhancing transparency and encouraging the activity of information intermediaries. Also, interviews were held with rating agencies (see Appendix 1.11) that rated Islamic banks, to gain an understanding of the methodology they use in rating Islamic banks.

The researcher conducted interviews with a mix of open-ended and close-ended questions.

Research Question No. 4:

These research questions address the issue of transparency from the prospective of bank supervisors and rating agencies (see Appendix 1.10 and 1.11). For this reason, interviews were held with the supervisors of all the four banks in order to determine to what extent the supervisors understand the problem and how they would address it.

Furthermore, specific questions were sent to two rating agencies that rate Islamic banks. The questions relate to issue of Shari'ah, and the responsibility of the management and the board of directors towards the IAH.

The researcher conducted interviews with a mix of open-ended and close-ended questions.
b) Secondary data:

The research also involved analyzing the financial statements of the four banks for a four-year period (2002-2005), as well as reviewing the articles and memorandum of association (by-laws) of the four banks.

This was important in order to review the banks’ extent of disclosures and their policy in respect of profit distribution. The researcher also reviewed the SSB reports regarding the bank’s compliance with Shari'ah from 2002 - 2005.

As part of the research, a review was carried out of the banks by-laws, to determine the responsibility of the SSB members and whether their role is advisory or whether the management is obliged to comply with the SSB's opinions.

6.7 Concluding Remarks

In summary, with regard to research design and methods:

1. The case study method was used as an exploratory strategy in view of the underdeveloped state of relevant theory.

2. A pilot study was carried out in order to test and refine the research propositions and questions.

3. An embedded case study design was used in order to facilitate generalization to theory and theory development.

4. As the main units of analysis, 4 banks were selected in 3 different countries and with differing ownership structures.
5. A survey approach with questionnaire was used within the case study and secondary data such as annual reports were also used.

It was decided to use an embedded case study design with sub-units of analysis in order to make cross-sectional comparisons and to analyze the differences in more detail (please see Figure 6.1 below).
Figure 6.1 Embedded Case Study Design

Main units of analysis

Ahmed BK  Mohammed BK  Khalifa BK  Sara BK

Subunits of analysis (for each of main units)

Management  BOD  SSB  ISR

Other relevant parties consulted

Banking Supervisors  Rating Agencies  External Auditors  IAH
Chapter 7

The Case Study of Ahmed Bank

7.1 Introduction

Ahmed Bank (henceforth also referred to as the "Bank") is a public shareholding company incorporated in one of the GGC states established on 23 March, 19xx. Its core business activities include the providing banking services, the purchase and sale of property, leasing and other trading activities. All of the bank's activities are strictly in accordance with Islamic principles. The financial statements of the bank were prepared in accordance with the International Financial Reporting Standards (IFRS). The bank is not required to adopt AAOIFI accounting, Shari'ah and auditing standards.

The bank is run by a general manager who has a team of eight assistant general managers reporting to him. Prior to 2003, Islamic banks were outside the direct supervision of the central bank. In 2003, law No. 32 of 1968, (pertaining to currency, the central bank and the organization of the banking business), was amended by incorporating a new section which was to allow the central bank to regulate Islamic banks. The new section requires that the founder of an Islamic bank should hold, at all times, 51% of the capital, leaving the residual for public subscription. In case the founders are a non-bank entity, they shall hold, at all times, a minimum of 10%, and not exceed 20% of the bank’s capital.

Table 7.1: Snap-shot on the financial highlights in millions

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Equity</td>
<td>230</td>
<td>249</td>
<td>287</td>
<td>540</td>
</tr>
<tr>
<td>Total Investment A/c Holder</td>
<td>1977</td>
<td>2300</td>
<td>2563</td>
<td>3189</td>
</tr>
<tr>
<td>Current Accounts</td>
<td>13</td>
<td>64</td>
<td>122</td>
<td>71</td>
</tr>
<tr>
<td>Ratio of Total Share Capital to IAH</td>
<td>1:8.5</td>
<td>1:9.2</td>
<td>1:8.9</td>
<td>1:5.9</td>
</tr>
<tr>
<td>Ratio of Total Share Capital to Current Accounts</td>
<td>1:0.06</td>
<td>1:0.3</td>
<td>1:0.4</td>
<td>1:0.1</td>
</tr>
<tr>
<td>Net Income</td>
<td>56</td>
<td>60</td>
<td>77</td>
<td>129</td>
</tr>
<tr>
<td>Total Assets</td>
<td>2554</td>
<td>3000</td>
<td>3458</td>
<td>4681</td>
</tr>
<tr>
<td>Return on Average Equity %</td>
<td>24</td>
<td>24</td>
<td>27</td>
<td>24</td>
</tr>
<tr>
<td>Return on Average Assets %</td>
<td>2.1</td>
<td>2</td>
<td>2.2</td>
<td>2.8</td>
</tr>
</tbody>
</table>

Capital Intelligent (2005) commented that the bank has a good asset quality as 57% of the bank’s assets are invested in short-term commodities which are highly liquid and carry low risk. This explains why returns in assets are generally low. Also deposits with banks make up a further 17.1%. As indicated in table 1 above, the bank enjoys a strong return on equity. What is striking in this bank is that although there was a significant increase in IAH returns during the four years, the return on equity remained constant, except for 2005 when it went down.

This would lead to believe that this bank is adopting very conservative investment policies.

7.2 Ownership Structure

The government owns 43% of the bank’s capital and the remaining is widely dispersed (no single party held more than 5%). In 2003 the bank came under the supervision of the Central Bank. Prior to 2003 the Ministry of Commerce and Finance had been its formal regulatory authorities.

There are 9 board members in the bank, of which there are two representatives of the government. The bank’s by-laws limit the ownership of one individual/entity (other than the government) of not exceeding 10% to ensure that the bank’s shares are widely dispersed.
To avoid conflict of interest, the board members are restricted from serving as members of the board of directors of competitor banks. Moreover, they are restricted in engaging in business with competitors of the bank (Article 18, 1977).

7.3 Types of Investment Account-Holders

The bank’s accounts maintain different types of investment accounts holders as explained below:

- **Current Account**: These accounts bear no risk of loss and give no return as the bank guarantees to pay the outstanding balance on demand. These accounts are considered as Qard (free loan) to the bank.

- **Deposits for unlimited period and saving accounts**: As Ahmed Bank indicated in the audited accounts, unlimited accounts are initially for the duration of one year, and is automatically renewable thereafter, for the same period, unless notified to the contrary, in writing by the depositors (IAH). Investment saving is for an unlimited period.

In all cases the IAH share of profits are determined by the board of directors based on the results of the financial year. The bank, however, states in the contract only the maximum Mudarib rate.

The bank’s audited accounts state that 60% to 90% of the deposits are available for investment by the bank. The remaining is set-aside for liquidity and is guaranteed by the bank (e.g. the amounts set-aside for liquidity is funded by IAH). Any returns generated from the amounts set-aside for liquidity are for the shareholders. All investment deposits, except the current account, are based on Mudaraba contract.

As reported by the bank’s management, the bank is liable to pay back 100% of the saving accounts on demand by the account-holder. The bank’s contract does not make any reference to the type of contract it is, the liability of the bank or the profit sharing percentage of the Mudarib.
It is important to note that (article 96, 2004) of the Central Bank law requires that Islamic banks shall be under obligation to fully pay sight deposits i.e. current accounts to their depositors upon request, while such deposits shall not incur any losses.

The Level of dividends paid to Investment account-holders and Shareholders from 2002 to 2005:

Table 7.2: Snap-shot on the profit distributed to shareholders and Investment account-holders for 4 years

<table>
<thead>
<tr>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Percentage of returns distributed to Investment Account-holders for 4 years (bank's financial statements)</td>
<td>4.5</td>
<td>4.500</td>
<td>4.800</td>
</tr>
<tr>
<td>b) The annual interest rate for 4 years (Reuters)</td>
<td>2.84%</td>
<td>2.2%</td>
<td>2.38%</td>
</tr>
<tr>
<td>c) Dividends yield distributed to shareholders for 4 years (bank's financial statements)(12)</td>
<td>47%</td>
<td>50%</td>
<td>50%</td>
</tr>
</tbody>
</table>

The bank's audited accounts do not disclose the methods that the bank uses in order to determine the profits allocated to shareholders and the IAH. As mentioned in page 1 of the case study, the bank applies the IFRS standards, and these standards do not require the bank to disclose information relating to the methods used in allocating and distributing the profits between the shareholders and IAH.

The management justifies the higher dividend yield paid out to shareholders, as compensation for their exposure to fluctuations in the price of their shares. This is not the case with the IAH, as their deposits are not subject to such fluctuations.

(12) Bank's Financial Statements
The Formula of distributing profits between the shareholders and IAH:

The following are financed by both the shareholders and IAH:

Investment in International Commodities

Plus: Murabaha financing

Plus: Murabaha with banks

Plus: Consumer Finance

Total: Assets financed by Shareholders and IAH

Total: Income allocated to IAH proportionate to their investments in the above

Less: Provision for non performing Murabaha
Specific provisions

Less: Direct expenses relating to IAH investments e.g. feasibility study

Less: Mudarib Share (decided by the board of directors)

Total: Profits allocated to IAH

(Source: obtained from the bank’s records)

The bank’s methods of profit distribution between the shareholders and IAH is based on the sharing of profits generated from Murabaha transactions with other banks (inter-bank transactions), including investments in international commodities, consumer finance and Murabaha financing.

Murabaha Financing is defined by Fuqaha (Jurists) as the sale of goods at cost plus an agreed profit mark up.
All other assets are financed solely by the shareholders and profits are exclusively an entitlement of them including investments in real-estate, capital investment in other institutions, bank fees, and returns on current accounts.

The bank may, at its discretion, give additional profit to the IAH from its share as Mudarib, under the new method of profit distribution.

However, in the case of AAOIFI Standards, Islamic banks are required (under accounting standard No. 5 regarding the Disclosures of basis for profit allocation between owner’s equity and investment account-holders) to disclose in the notes on significant accounting policies, the basis that are applied by the Islamic bank for the allocation of profits between owners equity and unrestricted investment accounts(14).

7.4 The Role and Composition of the Shari'ah Supervisory Board (SSB)

The bank’s Shari'ah Supervisory Board (SSB) may consist of no less than 3 members and they shall be appointed by the general assembly, whereas the board of directors appoints the chairman of the SSB(15).

The SSB claimed that it is responsible for monitor the bank’s transactions and operations, to determine whether the bank’s has complied with Shari'ah. Based on the research conducted, the SSB conducts ex post monitoring and ISR conducts the ex ante Shari'ah audit which who then report to the SSB. The memorandum and articles of association permit the SSB to check all contracts, agreements, policies and transactions held between the bank and a third party(16). In practice the role of the SSB is limited in conducting ex post monitoring of Shari'ah compliance, while, the ex ante is carried out by the ISR which we are going to examine its role latter in this case.

(14) No profit equalization (PER) reserve is created.
In case there is a dispute among the members of the SSB regarding a particular opinion, the bank’s management can consult the Al-Fatwas Board in Awqaf and the Islamic Affairs Ministry, whose ruling is mandatory\(^{17}\).

According to Article 50 of the bank’s Articles of Association states the following:

"The SSB will be responsible for monitoring the conformity of the activities conducted by the management to ensure that they are in line with Islamic guidelines as approved by the Shari‘ah Supervisory Board".

The bank’s memorandum and articles of association state that the SSB can carry out the following activities\(^{(18)}\):

- Submitting annual report to the general assembly stating whether transactions were conducted in accordance with the Islamic law.

- Conducting Shari‘ah courses for the bank’s staff so that they can abide by the Islamic principles while performing their duties. Besides, the SSB shall have the right to suggest organizing seminars and conventions pertaining to the Islamic economy.

- Other duties as assigned to the SSB by the board of directors.

\(^{(17)}\) Article, 64. b, 1977.

\(^{(18)}\) Articles, 64. b, 1977 and amended in 2004.
Analysis of the SSB’s report:

As in the case of all Islamic banks, the SSBs report forms a part of the bank’s annual report. The report of Ahmed Bank states the following:

"By following up the performance of Ahmed Bank during the year ended 31st, December, 2005, we certify confidently that all activities were practiced in compliance with Islamic Shari'ah and no violations have occurred, to the best of our knowledge".

The report falls short of the AAOIFI Governance Standard No. 1 (AAOIFI, 1999), which requires the SSB to state the following opinion:

- The Islamic bank's contracts and related documentation are in compliance with the Islamic Shari'ah rules and principles.

- The contracts, transactions and dealings entered into by the Islamic bank during the year ended xxx that we have reviewed are in compliance with the Islamic Shari'ah rules principles.

- The allocation of profit and charging of losses relating to investment accounts conform to the basis that had been approved by the SSB in accordance with Islamic Shari'ah rules and principles.

Where appropriate, the opinion paragraph shall also include the following:

- All earnings that have been realized from sources or by means prohibited by Islamic Shari'ah rules and principles have been disposed of to charitable causes; and
The calculation of Zakat is in compliance with Islamic Shari'ah rules and principles.

The bank's report makes no reference to the methodology used in arriving upon such an opinion and to whom the report is addressed. Moreover, the report makes no reference to the Internal Shari'ah Reviewers (ISR). However, the bank indicated that the above opinion is in accordance with the central bank requirements that require all Islamic banks to adhere to the above opinion.

7.5 Report on the Interviews Conducted

7.5.1 Report on the Interview held with the Management of Ahmed Bank

The management indicated that the relationship between the shareholders and the IAH is a form of partnership where the IAH delegate to the bank (owned by the shareholders) the responsibility to invest IAH funds on the IAHs' behalf.

The bank's management also indicated that the bank's strategy is to work for the benefit of the shareholders and the IAH, regardless of the ownership structure.

The bank's policy is one that has a long-term view, based on providing the IAH with an exceptional service, and paying an attractive rate of returns to the shareholders and IAH. The management stated that it is accountable to the board of directors, as the latter acts as custodian for all stakeholders. Such views were shared by one rating agency who stated that the role of the board of directors of Islamic banks is to play a monitoring role in assessing the performance of the management on behalf of the IAH as well as the shareholders.

[Zakat means "blessing, purification, increase and cultivation of good deeds: In Shari'a, it is an obligation in respect of funds paid for a specified type of purpose and for specifies categories. It is an individual duty if the criteria for making it obligatory are satisfied. It is also one of the pillars of Islam.]
Another rating agency asserted that both the board of directors and rating agencies should play a role in assessing the management of the bank on behalf of the IAH as well the shareholders.

The supervisors of Ahmed Bank argued that protecting the interest of the IAH is a means of establishing sound corporate governance (issued in May 3, 2004) to make sure that Islamic banks apply a regulatory system that protects the interest of all stakeholders. The supervisors also indicated that their supervisory role is limited to the bank’s financial statutes and they have no supervisory role over the SSBs since this is difficult role to conduct.

The supervisors of Ahmed Bank believe that enhancing transparency and market discipline are of high importance in better assessing the bank’s performance, and will encourage rating agencies to play a significant role in protecting the interests of all stakeholders. In this respect the supervisors of Ahmed Bank supported the role of the IFSB and AAOIFI to enhance transparency and establish market discipline. As stated earlier, Islamic banks are required to adopt IFRS or other relevant and accepted accounting standards.

The management of the bank rejected the issue of allowing IAH to be represented in the bank’s organs of governance as an impractical and unrealistic solution. It is worth noting that in Ahmed Bank many IAH attend the annual (general meeting) of the bank and participate in the discussions therein. The supervisors also rejected the idea of allowing the IAH to be represented in the bank’s organs of governance since the boards of director’s responsibilities already include the protection the interest of all stakeholders.

7.5.2 Report on the Interview held with Shari'ah Supervisory Board Members (SSB)

The main duties of the SSB as reported to the researcher include the following:
- Answering to questions by the management, approving new products, approving new contracts and issuing *fatwas*. 

- Reviewing and auditing the bank's compliance with *Shari'ah* in all its activities.

The *Shari'ah* Board of Ahmed Bank is accountable to the board of directors, and their report is presented to the board of directors. The appointment of SSB members is the responsibility of the general assembly based on the recommendation of the board of directors. This is in line with AAOIFI Governance Standard No. 1 on *Shari'ah* Supervisory Board, (AAOIFI, 1999) Appointment, Composition and Report.

It is worth noting that AAOIFI Governance Standard No. 1 on *Shari'ah* Supervisory Board: Appointment, Composition and Report, states that the SSB’s report should be appropriately addressed as required by the circumstances of the engagement and local laws and regulations.

However, the remuneration of the SSB members is decided by the board of directors based on recommendation of the management.

The bank’s by-laws and procedural manuals allow the *Shari'ah* Supervisory Board to review and audit various operations of the bank from a *Shari'ah* perspective. And, as appropriate, financial auditing, and reviewing the annual financial statements.

[The SSB’s main responsibility in Ahmed Bank is to carry out *Shari'ah* reviews of bank's contracts to ensure compliance with *Shari'ah*]. As indicated earlier the SSB of Ahmed Bank also conducts an *ex ante* *Shari'ah* review and the *ex post* review is carried out by the ISR who report to the SSB.

The SSB claim that the reason for this review is to reach at a reasonable assurance that the activities of the bank are according to the expectation of shareholders and other stakeholders.
The relationship between SSB and the external auditors is limited to discussing the financial reports when the SSB asks for some clarifications on the financial statements. The external auditors conduct no testing on the ISR procedures to determine the effectiveness of the system.

It is worth noting that the auditors opinion in the bank's financial statements falls short of what is required in AAOIFI Auditing Standard No. 4, since it makes no reference in the opinion in the bank's compliance with SSB fatwas and rulings.

The SSB members meet once every week and with all the internal Shari'ah units present in the meeting. In this meeting they discuss any Shari'ah issues presented to them and give the relevant opinion.

7.5.3 Report on the Interviews held with the Internal Shari'ah Review (ISR)

The ISR is an integral part of the organs of governance of the bank and operates under the policies established by the bank. The staff salaries and other benefits is decided by the SSB.

The ISR is the 'right hand' of the Shari'ah Supervisory Board. Since the SSB members are not full-time employees, the SSB carries out its tasks in accordance with the information given by the ISR. The ISR looks into the day-to-day transactions of the bank and reverts to the SSB for major Shari'ah issues that need collective discussion.

The staff members of ISR are nominated by the management and approved by the SSB. However, there are no written policies and procedures for the ISR.

The SSB relies on various reports of the ISR since these reports play a vital role in assisting the SSB to accomplish its goals and objectives to come to a reasonable conclusion or a set of recommendations, with respect to the bank's compliance with Shari'ah principles.
A noteworthy feature of Ahmed Bank’s ISR is that it is a separate unit, headed by a senior Shari‘ah scholar and 5 Shari‘ah staff working under him. Its role is to carry out a regular audit on the bank’s and its related entities’ compliance with Shari‘ah and reports its findings to the SSB.

7.5.4 Report on the Rating Agency

One rating agency emphasized the importance of financial reports, as they play an important role in monitoring the performance of the management. They are also instrumental in ensuring that the management does not give preference to one party over the other. However, the same rating agency believed that AAOIFI and IFSB Standards needs the support of the supervisors to make them more effective.

One rating agency claim the board of directors of Islamic banks is to play a monitoring role in assessing the performance of the management on behalf of the IAH as well the shareholders.

Another rating agency argued that board of directors and rating agencies should play a role in assessing the management of the Islamic bank on behalf of the IAH.

7.6 Concluding Remarks

The government holds 43% of the bank’s capital of Ahmed Bank and remaining is widely dispersed. Ahmed Bank used to be outside the supervision of the central bank until 2003 when the law was amended to allow the central bank to regulate Islamic banks. The bank’s applies the IFRS on its financial reports.

As the case study indicates the rate of return paid to IAH are very low compared to the dividend yield distributed to shareholders. The management claim the high dividend yield distributed to shareholders is compensation for their risk of fluctuations in the price of their shares.
The management of Ahmed Bank rejected the idea of allowing IAH to be represented in the bank's organs of governance as an impractical and unrealistic.

The bank's applies the method of profit allocation between the shareholders and IAH which is based on following factors:

1. Profits generated from Murabaha with other banks, investments in international commodities, consumer finance and Murabaha financing are allocated between shareholders and IAH;

2. All profit generated from other assets including investments in other Islamic banks are solely paid to shareholders;

3. Mudarib commission and profits generated from funds of current accounts are paid to shareholders;

4. Returns generated from investing amounts set-aside (60% to 90% of the IAH funds) for liquidity are entitlement if shareholders.

The SSB of Ahmed Bank is accountable to the board of directors, and their report is presented to the board of directors. The SSB members are appointed by the general assembly of the bank, whereas the board of directors appoints the chairman of the SSB. The SSB carries out a review of any transaction after implementation, either through its members or through the ISR members. The supervisor of Ahmed Bank does not require Islamic banks to adopt AAOIFI Governance Standards.

The SSB does not rely on the work of external auditors on the bank's compliance with Shari'ah since all external auditors lack the expertise on Shari'ah matters.

The bank's by-laws allow the SSB to check all contracts, agreements between the bank and third party. However, the bank's Shari'ah report makes no reference to the role played by the ISR, this is because the central bank developed a specific opinion
wording and requires the Islamic bank to adhere to it. The SSB relies on the ISR report to assist it in forming an opinion on the bank’s compliance with Shari’ah.

The management of Ahmed Bank argued that it is accountable to the board of directors and not to the IAH.
Chapter 8

The Case Study of Mohammed Bank

8.1 Introduction

Mohammed Bank (the "Bank") was established in 19xx (audited accounts ending 31st December, 2005). With its core activities focusing on the provision of standard banking services, including the sale and purchase of properties and leasing finance. All projects are Shari'ah compliant, i.e. strictly in accordance with Islamic principles.

The bank is required by the Central Bank to implement accounting Shari'ah and auditing standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

The bank maintains a strong quality of investments and a low ratio of non-performing financing, with good overall coverage. This is largely attributed to the bank's conservative policy towards investing its funds. The bank's prudence is reflected by the fact that approximately 65% of its financing activities were in the form of low-risk Murabaha with other banks, in international commodities (Quasi Bank placements guaranteed by the counterparty banks)(20).

The following research studies the bank's performance, and benchmarks the same to other case studies, for the period 2002-2005, as illustrated in table 8.1. In the interest of discretion regarding the bank's identity, the table will not reveal the currency that denotes the figures used.

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(20) Capital Intelligent, 2005.
Table 8.1: Snap-shot of the financial highlights in millions (The bank’s financial statements, 2005)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Share Capital</td>
<td>38</td>
<td>40</td>
<td>53</td>
<td>72</td>
</tr>
<tr>
<td>Total Investment A/c Holders</td>
<td>147</td>
<td>160</td>
<td>168</td>
<td>198</td>
</tr>
<tr>
<td>Current Accounts</td>
<td>13</td>
<td>29</td>
<td>30</td>
<td>47</td>
</tr>
<tr>
<td>Ratio of Total Share Capital to IAH</td>
<td>1:3.8</td>
<td>1:4</td>
<td>1:3.16</td>
<td>1:2.75</td>
</tr>
<tr>
<td>Ratio of Total Equity to Current Accounts</td>
<td>1:0.3</td>
<td>1:0.7</td>
<td>1:0.6</td>
<td>1:0.7</td>
</tr>
<tr>
<td>Net Income</td>
<td>2.1</td>
<td>2.5</td>
<td>3.7</td>
<td>7.4</td>
</tr>
<tr>
<td>Total Assets</td>
<td>210</td>
<td>231</td>
<td>255</td>
<td>321</td>
</tr>
<tr>
<td>Return on Average Equity %</td>
<td>5.4</td>
<td>6.2</td>
<td>7.9</td>
<td>12</td>
</tr>
<tr>
<td>Return on Average Assets %</td>
<td>1.0</td>
<td>1.1</td>
<td>1.5</td>
<td>2.5</td>
</tr>
</tbody>
</table>

8.2 Ownership Structure

The bank’s ownership is spread among financial institutions and individual shareholders. Prior to 2003, no single shareholder held more than 5% of the capital. The management revealed that in 2003, a single institution bought around 40% of the bank’s capital\(^{(21)}\). (This information is not stated in the bank’s published statement of accounts).

Highlighted below are the bank’s strengths and weaknesses.

8.2.1 The bank’s strengths

- Strong capitalisation and liquidity
- Solid asset quality
- The Central Bank acts as a lender of last resort

8.2.2 The bank’s weaknesses

- Small franchise
- High concentration in low yielding commodity Murabaha impacts profitability
- Increasing competition in a small over-banked market.

\(^{(21)}\) Capital Intelligent, 2005.
The Capital Intelligent report highlights that the bank aims to increase the return to its shareholders by moving away from low yielding short-term investments, towards high yielding assets thereby the increasing leverage of its balance sheet. The above table 8.1, indicates that in 2005 ROA increased to 2.5% compared to 1.5% in 2004. This attributed to the increase in net income in 2005 compared to 2004 (see table 8.1). Prior to 2003 the bank was headed by a management team that followed a conservative investment policy. In 2003 however, a new management took over.

It is worth mentioning that the new management was appointed before the sale of the 40% of the capital to the new shareholder.

In the same year the new management changed the bank's profit allocation from 'commingling' of assets to separating those assets that are financed by shareholders from those of the IAH. As a result, long-term investments, such as investing in the share capital of other banks and real estate investments are financed by shareholders only and any return generated on these investments are paid entirely to the shareholders.

8.3 Types of Investment Account-Holders

The bank's accounts maintain different types of investment accounts holders as follows:

- Current Accounts: These accounts bear no risk of loss and give no return, as the bank guarantees to pay the outstanding balance on demand. These accounts are considered as Qard (free loan) to the bank. The financial statements disclose no information on the nature of these accounts. (This information is obtained from the CEO of the bank).
- Un-restricted Investment Accounts with limited period of one month, three months, and six months.
- Un-restricted Investment Certificate Accounts for the duration of three years.
- Un-restricted Private Investment Accounts.
The bank’s contracts with the IAH state clearly that the IAH authorises the bank to invest his/her funds on his/her behalf. The contracts clearly state that the bank is not responsible in case of any loss, other than that due to negligence or misconduct on part of the bank.

The bank’s contract states that as Mudarib, it would charge up to 65% of the profits attributable to the IAH. It can also set-aside up to 65% of the IAH funds for maintaining its liquidity. The irony is that the bank’s contract does not clearly reveal that it can invest the amounts set-aside for the purpose of maintaining liquidity and that shareholders are entitled for such returns. In addition, the bank’s contract makes no reference to the amount set-aside for liquidity which is established from deducting the IAH funds.

Presented below are financial statements of the bank, pertaining to the distribution of profits.

Table 8.2: Snap-shot on the profit distributed to shareholders and investment account holders for 4 years:

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Annual Returns distributed to Investment Account-Holders for 4 years</td>
<td>1.48%</td>
<td>1.02%</td>
<td>1.26%</td>
<td>2.76%</td>
</tr>
<tr>
<td>b) Annual Returns distributed by a competitor of Mohammed Bank</td>
<td>2.16%</td>
<td>1.31%</td>
<td>2.10%</td>
<td>4.0%</td>
</tr>
<tr>
<td>c) Annual interest levels for the period 2002-2005</td>
<td>2.206%</td>
<td>1.23%</td>
<td>2.00%</td>
<td>3.84%</td>
</tr>
<tr>
<td>d) Dividends Yield distributed to shareholders for 4 years</td>
<td>10%</td>
<td>10%</td>
<td>22%</td>
<td>27%</td>
</tr>
</tbody>
</table>

(23) The Information Obtained from the Bank.
(24) Reuters.
The bank's formula for the distribution of profits to the IAH (the 'commingling' approach between the shareholders and IAH is used):

Prior to 2003, the bank used to apply the commingling method; i.e. commingling shareholders funds with those of the IAH. At the end of financial year, the bank used to share the profits between the shareholders and IAH proportionate to their investments. The expenses will be deducted from total revenues. Presented below are both the old and new methods for calculating the distribution of the bank's profits.

### 8.3.1 The Old Method

- Net profit after deducting all expenses ............
- Deducting the shareholders share in the profit ............
- Gross Share of Holders of unrestricted investment accounts ............
- Deduct-Bank's *Mudarib* income ............
- Net Share of holders of unrestricted investment accounts in the profit ............

### 8.3.2 The New Method\(^{(26)}\)

- The average balance of IAH ..........................
- Deduct the cash reserve with the Central Bank ..........................
- The amount invested for the IAH ..........................
- Profits achieved for IAH ..........................
- Deduct profit equalisation reserve (IAH share) ..........................
- Distributable profits ..........................
- Deduct banks share as *Mudarib* (up to 65%) ..........................
- Deduct investment risk reserve ..........................
- Net profits entitle for distribution to IAH ..........................

\(^{(26)}\) As per the Bank's Records.
As stated above, in 2003 the bank has changed its method of distribution of profits between the shareholders and IAH by moving from the commingling approach to the separation approach. The new method is applied in 2004, this has resulted in a doubling of the dividends yield distributed to shareholders. The irony is that while the dividends yield for 2005 reached 27%, the IAH received only 2.76% in the same year for generally the same risk as both the shareholders and IAH are exposed to the same risk of losing their investments.

Taking into consideration the potential risk on IAH funds, we expect the IAH rate of return is higher than the annual interest rate, in fact the IAH of Mohammed Bank receives rate of return lower than the annual interest rate and much lower than the rate paid by the competitor bank.

In this respect, the bank has paid 1.63% as an average rate of return to IAH from 2002 till 2005 lower than the average rate of interest during the same period which was 2.282%. On the other hand, the bank paid an average dividend yield of 17.25% during the same period.

Under the new method of profit distribution, investments in real-estate, capital investment in other institutions, bank fees, and returns on current accounts will be the entitlement of the shareholders. This will be in addition to the profits generated from investing the amounts deducted from the IAH funds for liquidity purposes. The IAH will also be entitled to the returns generated from other forms of financing including Murabaha financing, leasing, Musharaka etc. The PER is allocated for the IAH only.

We can see from table 8.2 that prior to 2003 (the year when there was a change in management) the bank use to distribute a constant 10% dividend to shareholders. The bank did not indicate in its financial statements, as per AAOIFI requirements of accounting standards No. 5 on Provisions and Reserves, to disclose in the notes to the financial statements, the basis it has applied to determine the profit equalisation reserve and the investment risk reserve\(^{(27)}\).

\(^{(27)}\)Para 25, AAOIFI, 1999.
In addition, the bank did not make any reference to the note to the accounts as required in AAOIFI Standard No. 6 to the percentage of funds of unrestricted investment accounts holders which the bank had agreed with them to invest in order to produce returns on to them (para 15).

Furthermore, in spite of the requirements as stated in AAOIFI Standard on Disclosure of Bases for Profit Allocation between owners' and IAH, the bank failed to state in their accounting policies the bases applied by them in the allocation of profits between owners' equity and unrestricted investment accounts holders (para 2, Oct. 1996).

Furthermore, although this is required by AAOIFI Standard No. 1 on General Presentation and Disclosure in the Financial Statements of Islamic banks and Financial Institutions, Mohammed Bank did not make disclosures of the method used to allocate investment profits (losses) between unrestricted investment account holders or their equivalent and the bank as a Mudarib, or as an investment manager whether or not participating in the investments with its own funds (AAOIFI, 1993).

8.4 Report on the Interviews Conducted

Following are the findings of interviews conducted with the bank’s management, its regulators and rating agencies.

8.4.1 Report on the Interviews held with the Bank’s Management

The management of Mohammed Bank claimed that it is accountable to the board of directors. It also confirms its commitment to provide the shareholders and IAH with attractive returns of profits. As indicated in table 8.2, the average rate of returns paid to IAH from 2002 to 2005 was much lower than the dividend yield paid to shareholders. The management presented several justifications to explain the apparent discrepancy.
One reason was that shareholders are long-term investors, while, IAH in most cases, place their funds for a maximum of one year. As a result, the returns to shareholders will be higher than the returns paid to IAH.

The management reported that IAH are not subject to fluctuations in the market value of their deposits, unlike the shareholders, whose share price is subject to changes based on the movements of the shares in the stock market. This means that the IAH are not subject to the risk of price fluctuations as compared to the shareholders.

The management of Mohammed Bank claimed that since the bank's establishment, the bank maintains a policy of not giving (higher returns) to shareholders over IAH or visa versa. The researcher, however, believes this does not hold true if we take into consideration the level of returns paid to shareholders as compared with those of IAH.

The management of Mohammed Bank are in favour of some form of representation for the IAH in the bank's organs of governance. This is important to bring more discipline to the market.

The management believe that SSBs should be given greater role specifically to ensure that the IAH interest is adequately protected. Presently, the role of the SSB is fairly limited, for example, the SSB provide a fatwa only to those issues that are presented to them. The management can avoid presenting certain Shari'ah matters to SSB, in order to avoid the regulation thereon.

The bank indicated that there is no regulation by any authority, including the external auditors and regulators, to ensure the bank's compliance with the conditions stated in the agreement between the bank and IAH. For example, if the agreement states that the bank will invest 70 % of the IAH funds, this is not checked for compliance by anyone including the auditors, the regulators, and the ISR (ISR role will be discussed latter in this case study).
The management argued that in order to bring more discipline to this market, the SSBs should consist of *Shari’ah* scholars and professional auditors.

The management suggested that bank supervisors, rating agencies and other information intermediaries should take the issue of corporate governance more seriously, particularly with respect to the rights of IAH.

### 8.4.2 Report on the Interviews held with the Rating Agencies

These rating agencies shared the views of the bank’s management on the level of transparency. They further claim that the level of information disclosed in the Islamic bank’s financial statements is less than satisfactory.

One rating agency proposed that the board of directors are responsible for assessing the management on behalf of the IAH as well the shareholders. While another rating agency reported to the researcher, that in addition to the board of directors, rating agencies should play a role in assessing the management on behalf of the IAH.

Another rating agency claimed that the role played by IFSB and AAOIFI is very important in assisting rating agencies in assessing Islamic banks, provided that such role is supported by the bank supervisors.

### 8.4.3 Report on the Interviews held with the Bank Supervisors

The supervisors of Mohammed Bank believe that developing a regulation for corporate governance that takes into consideration the special status of the IAH, similar to the one developed by IFSB, will enhance market discipline and protect the interest of the IAH.

The supervisors are also in favour of a public awareness effort, targeting the clients of Islamic banks, particularly IAH, to encourage them to take more pro-active role in their relation with their banks. So far the IAH are unsophisticated and passive investors, and rely on others like the SSB and bank supervisors to protect their interests.
The supervisors of Mohammed Bank indicated that their supervisory role is limited to the bank's financial status and they have no directly supervisory role over the SSBs since this is difficult role to conduct.

However, in case the bank fails to comply with Shari'ah it is the responsibility of the SSB to declare it in the SSBs report.

The supervisors of Mohammed Bank argued that the bank’s board of directors and the supervisors are responsible for protecting the interest of the IAH.

The bank’s supervisors believe that IFSB should play an instrumental role in developing specific regulations to protect the interests of the IAH. It is worth noting that IFSB has developed guidelines for corporate governance for Islamic banks (IFSB, 2006b). The main purpose of these guidelines is to protect the interests of the stakeholders other than shareholders and make the bank’s activities more compatible with Shari'ah precepts.

Furthermore, supervisors of Mohammed Bank argued that enhancing transparency will constitute developing a market discipline.

8.4.4 Report on the Interview held with the Internal Shari'ah Review (ISR)

The ISR claimed that it is accountable to the SSB. Its role and responsibilities are delegated by the SSB, and it is independent from the management. By reviewing the bank’s by-laws, there is no reference made pertaining to the establishment of the ISR.

The ISR in Mohammed Bank is independent from the management and is accountable exclusively to the SSB. However, the ISR is an integral part of the organs of governance of the bank and operates under the policies established by the IFI. The salaries and other benefits is decided by the management based on the recommendation of the SSB.
The ISR's main function is to carry out an *ex post Shari'ah* audit, i.e. reviewing the bank's transactions to ascertain whether the bank obtained the SSB instructions before implementing them. Such an audit also includes checking the bank's contracts to see whether if they have been implemented in accordance with the instructions of the SSB. However, there is no written policies and procedures for the ISR.

It is worth noting that AAOIFI Auditing Standard No. 4 requires the auditor to attest in its audit opinion as to the bank's compliance with *Shari'ah*. However, the auditor's make no such reference in its report. The external auditors conduct no testing on the ISR procedures to determine the effectiveness of the system.

It is also worth noting that AAOIFI Standards Auditor's Report Standard (AAOIFI, 1998) requires the external auditor to include in the auditor's opinion the following statement:

"The report should include a statement that the financial statements and the financial institution undertaking to operate in accordance with Islamic *Shari'ah* Rules Principles are the responsibility of the financial institution management and a statement that the responsibility of the auditor is to express an opinion on the financial statements". The Bank's Auditors' opinion is in line with the AAOIFI Standard.

The ISR claimed that it also conducts a *Shari'ah* audit with respect to the bank's policy of profits allocation between the shareholders and IAH. As indicated above with the high percentage of dividend yield paid to shareholders compare to IAH rate of returns, this will question whether the ISR has the right to report on such discrepancy to the SSB. The ISR *Shari'ah* audit includes the bank's compliance with the instructions of the SSB.

**8.4.5 Report on the Interview held with the *Shari'ah* Supervisory Board (SSB)**

The SSB's activities include reviewing the bank's transactions, new contracts and products, and other activities to make sure that they are in accordance with the *Shari'ah* rules and principles. It can be noted that such activities are *ex ante Shari'ah* audit. The
ISR carry out an *ex post* Shari'ah audit on behalf of the SSB. The SSB’s obligations include, responding to the queries of the bank’s clients. Furthermore, the by-laws under Article 4 refer to the establishment of the SSB to act as advisor to the board of directors on Shari'ah matters.

The SSB remuneration is decide by the board of directors based on the recommendation of the management.

The report of the ISRs audit is submitted to the SSB with a copy to the management. The SSB discusses the report with the ISR and advice the management based on the findings of the report.

The SSB pointed out that presently the bank has internal Shari'ah procedures to assist the ISR in carrying out their tasks.

The SSB’s report of Mohammed Bank states that:

"The SSB monitored the operations and transactions and contracts related to transactions carried out by the bank throughout the year ended xxxx to express opinion on the bank’s commitment to the provisions and principles of Islamic Shari'ah in its activities and investments in accordance to the guidelines and decisions issued by the SSB. The SSB believes that ensuring the conformity of the bank’s activities and investments with provision of Islamic Shari'ah is the sole responsibility of the bank’s management, while the SSB is only responsible for expressing an independent opinion and preparing a report thereabout". 

The SSB monitoring functions included the checking of documents and procedures to scrutinize operation carried out by the bank, either directly or through the (ISR). The SSB plans with the Shari'ah Internal Audit Department (SIAD) to carry out its monitoring functions. This is executed through the acquisition of all information and clarifications that are deemed necessary to confirm that the bank did not violate the principles and provisions of Islamic Shari'ah. The Shari'ah Internal Audit Department carries out its functions of auditing the bank’s transactions and submitting a report to
the SSB, which indicated the bank’s commitment and conformity to the SSB’s opinions.

The SSB obtained data and clarifications that it deemed necessary to confirm that the bank did not violate the principles and provisions of Islamic Shari‘ah. The SSB then held several meetings throughout the year ended 31, December xxxx and replied to enquiries, in addition to approving a number of new products presented by the management. The Shari‘ah Board then discussed with the bank’s officials all transactions and applications carried out by the management throughout the year ending 31, December xxxx, and reviewed the bank’s record of conformity with the provisions and principles of Islamic Shari‘ah, as well as the resolutions and guidelines set out by the SSB.

The SSB believes that:

- Contracts, operations, and transactions conducted by the bank throughout the year, ending 31, December xxxx were made in accordance to the standard contracts pre-approved by the SSB.
- A distribution of profits and losses on investment accounts was in line with the basis approved by SSB in accordance with principles pre-approved by the SSB.
- No gains resulted from sources or by means prohibited by the provisions and principles of Islamic Shari‘ah.
- Zakat was calculated according to the provisions and principles of Islamic Shari‘ah. The bank distributed Zakat on statutory reserve, general reserve, and retained earnings. The shareholders declared their proportion of Zakat on their shares as stated in the financial report.
- The bank was committed to the Shari‘ah standards issued by AAOIFI.

The report exceeded their disclosure, beyond what is required under AAOIFI. The AAOIFI Shari‘ah Supervisory Board No. 1 requires the Islamic banks to state that:

- The Islamic bank contracts and related documentation are in compliance with the Islamic Shari‘ah rules and principles.
The contracts, transactions and dealings entered into by the Islamic bank during the year ended xxxx that we have reviewed are in compliance with the Islamic Shari'ah rules principles.

The allocation of profit and charging of losses relating to investment accounts conform to the basis that had been approved by the SSB in accordance with Islamic Shari'ah rules and principles.

(Where appropriate, the opinion paragraph shall also include the following matters):

- All earnings that have been realized from sources or by means prohibited by Islamic Shari'ah rules and principles have been disposed of to charitable causes; and
- The calculation of Zakat is in compliance with Islamic Shari'ah rules and principles.

The SSB claimed that in order to make sure that ISR staffs are qualified and capable of doing the job; the SSB interviews the staff candidate to work in the ISR and makes recommendation on their appointment to the management.

The SSB members indicated that since the appointment of new management in 2003, the SSB was much more powerful than it used to be during the time that the bank was under the previous management. For example, under the more empowered SSB, all transactions, new products must be presented to the Shari'ah Board for its endorsements and opinion.

The appointment of SSB members is the responsibility of the General Assembly based on the recommendation of the Board of Directors.

The SSB's main responsibility is to carry out Shari'ah reviews of bank's contracts (ex ante) to ensure compliance with Shari'ah.

Article 4 of the bank's by-laws states that the bank is obliged to implement the Shari'ah rules and principles in all its activities, with the assistance of the Shari'ah Supervisory
Board, if it so requires. The SSB confirmed that it is also their role to examine the bank's profit allocation policy between the shareholders and IAH. It is within this role that it has to make sure that the policy is fair to IAH. This will be analysed in detail in the analysis section.

The SSB's that is mainly of issuing *fatwas* and responding to the queries of the management and the public. It seems that the SSB does not diligently review the bank's contracts with the IAH. This is validated by the fact that the contracts explicitly do not mention important information with respect to will receive returns will be generated from invested the amounts set aside for liquidity and that such amounts are guaranteed by the bank. These views are shared by the rating agency who claims that they are not fully satisfied with the role played by SSBs in making sure that Islamic banks operate in accordance with *Shari'ah* principles.

### 8.4.6 Report on the written responses received from the External Auditors

The auditors are required by the bank supervisors to make sure that Mohammed Bank operates in compliance with *Shari'ah* (regulations, 2001). In this respect it's important to understand the role of the auditors to attain to such opinion.

The auditors claimed that ASIFI 4 (Accounting Standard for Islamic Financial Institutions) "testing for compliance with *Shari'ah* rules and principles by external auditors" requires auditors to test the bank's compliance with Islamic *Shari'ah* rules and principles, including the examination of all new *fatwas* and rulings that affect the bank.

As part of their audit programme, the auditors meet with the ISR and study their reports. They also meet with the SSB to discuss the bank's compliance with *Shari'ah* rules and principles. However, the external auditors do not themselves carry out any detailed checks of the bank's *Shari'ah* compliance.
8.5 Concluding Remarks

The bank’s ownership is divided among financial institutions and small shareholders. Till 2003, no shareholder held more than 10% of bank’s capital. In 2003, a single institution acquired 40% of the bank’s capital. In the same year, new management is appointed. Till 2003, the bank used to pay a 10% dividend to shareholders.

Also, in 2003 the bank has changed its method of distribution of profits between the shareholders and IAH by moving from the commingling method to separation method. The changed had resulted in doubling the dividends year. The IAH rate of return is lower than the interest rate and the rate paid by competitor bank.

The SSB’s Shari’ah review is limited in conducting ax ante Shari’ah audit and relies on the ISR to conduct the ex post Shari’ah audit. The role and responsibilities of the ISR responsibilities are delegated by the SSB, and that it is independent from the management. The bank adopted AAOIFI Shari’ah Standards, including the appointment of the SSB members, Shari’ah review, Shari’ah internal review.

With regard to the relations between the ISR and external auditors, the external auditors can have excess to the reports of the ISR to assist the auditors on the bank’s compliance with Shari’ah. The SSB’s report state that the ISR carries out its functions of auditing the bank’s transactions and submitting a report to the SSB.

However, protecting the IAH is the prime responsibility of the IAH themselves; this requires IAH to be pro-active role in their relation with the bank. So far, IAH rely on others like the SSB and the supervisors to protect their interest. This is because IAH are passive and unsophisticated investors and in the absence of market discipline.
Chapter 9
The Case Study of Khalifa Bank

9.1 Introduction

Khalifa Bank was established in 19xx to conduct banking activities in accordance with Shari'ah principles.

The bank is required to adopt accounting, Shari'ah and auditing standards issued by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

9.1.1 Asset Quality

The bank has a good banking franchise. The principal activities include Murabaha financing (cost plus profit margin), Musharaka (joint venture), and Leasing and Ijara (lease financing). On the liability side of the balance sheet, investment (customer) accounts are managed on the basis of Mudaraba. Current accounts are treated as qard (free loan) to the bank and it is a liability.

It is worth noting that around 58% of the asset-side financing was in the form of low-risk Murabaha financing. Generally, Murabaha represent a major financing of Islamic banks especially International commodities Murabaha (Financial statements, 2005).
Chapter 9

Khalifa Bank

Table 9.1: Snap-shot of the financial highlights in millions (The bank’s financial statements, 2005)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Share Capital</td>
<td>61</td>
<td>60</td>
<td>63</td>
<td>62</td>
</tr>
<tr>
<td>Total Investment A/c Holders</td>
<td>256</td>
<td>345</td>
<td>392</td>
<td>478</td>
</tr>
<tr>
<td>Current Accounts</td>
<td>13</td>
<td>21</td>
<td>29</td>
<td>37</td>
</tr>
<tr>
<td>Ratio of Total Share Capital to IAH</td>
<td>1:5</td>
<td>1:6.75</td>
<td>1:6</td>
<td>1:7.7</td>
</tr>
<tr>
<td>Ratio of Total Share Capital to Current Accounts</td>
<td>1:0.2</td>
<td>1:0.3</td>
<td>1:0.5</td>
<td>1:0.6</td>
</tr>
<tr>
<td>Net Income</td>
<td>3.2</td>
<td>1.1</td>
<td>0.3</td>
<td>2.7</td>
</tr>
<tr>
<td>Total Assets</td>
<td>305</td>
<td>405</td>
<td>454</td>
<td>511</td>
</tr>
<tr>
<td>Total Share Capital</td>
<td>61</td>
<td>60</td>
<td>63</td>
<td>62</td>
</tr>
<tr>
<td>Return on Average Equity %</td>
<td>5.2</td>
<td>1.8</td>
<td>0.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Return on Average Assets %</td>
<td>1.0</td>
<td>0.27</td>
<td>0.06</td>
<td>0.5</td>
</tr>
</tbody>
</table>

9.2 Ownership Structure

The bank is a subsidiary of a large financial group that holds 78.3% of the bank’s capital. The remaining is owned by other Islamic financial institutions (Capital Intelligence, 2005). The banking arm of the group exists in various countries including Jordan, Turkey, Tunisia and Algeria.

There are seven board members, five of which represent the financial group (dominant shareholder). This suggests that the financial group controls majority ownership (and decision making) of the bank, thereby classifying the bank as having a controlling majority (concentrated shareholder).

The profitability picture improved in 2005 but remains dim, as Return on Assets (ROA) and Return on Equity (ROE) is much lower in comparison to the other three banks.

9.3 Types of Account-Holders

There are three main types of account holders in the bank which are described as follows:
9.3.1 Current Accounts

These accounts bear no risk of loss and earn no return, as the bank guarantees to pay the outstanding balance on demand. These accounts are considered as Qard (free loan) from the account holder to the bank.

9.3.2 Un-Restricted Investment Accounts (General Mudaraba Agreement)

There are different types of unrestricted investment accounts based on General Mudaraba Agreements, with maturity tenors of 3, 6, 12 or 24 months.

The contract for all three types of accounts is a standard one; the standard contract makes no reference to the Mudarib rate, as, clause (6) of the agreement with respect to the IAH share of the profit and the bank’s share as Mudarib has been left blank. As reported by a senior official of the bank, the two parties will agree on the bank’s share as Mudarib which will be filled in when signing the contract. Also the contract makes no reference to the level of discretion given to the Mudarib, with respect to the investments which it makes, which is in accordance with the concepts of financial accounting for Islamic banks and financial institutions issued by AAOIFI (Oct. 1993):

"Unrestricted Investment Accounts refer to funds received by the Islamic bank from individuals and others on the basis that the Islamic bank will have the right to use and invest those funds without restrictions including the Islamic banks right to commingle those invested funds with its own investments in exchange for proportionate participation in profits and losses after the Islamic bank receives its share of profit as a Mudarib (para. 24)".

9.3.3 Restricted Investment Account (Specific Mudaraba)

The contract of the restricted investment accounts is very similar to the contract of the unrestricted investment accounts (General Mudaraba). However, the restricted contract makes no reference to the level of discretion given to the Mudarib. Such a
difference is instrumental in differentiating restricted investment accounts from unrestricted investment accounts, in accordance with the concepts of financial accounting for Islamic banks and financial institutions issued by AAOIFI (Oct. 1993):

"Restricted Investment Accounts are not assets of the Islamic bank and should not be reflected on the bank’s statement of financial position since the bank does not have the right to use or to dispose of those investment except within the conditions of the contract between the Islamic bank and holders of restricted investment accounts (para. 18)."

However, the bank failed to comply fully with AAOIFI Standards. In this respect, the bank did not make any reference to the note to the accounts as required in AAOIFI Standard No. 6 to the percentage of funds of unrestricted investment accounts holders which the bank had agreed with them to invest in order to produce returns on to them (para. 15).

Furthermore, in spite of the requirements as stated in AAOIFI Standard on Disclosure of Bases for Profit Allocation between owners' and IAH, the bank failed to state in their accounting policies the bases applied by them in the allocation of profits between owners' equity and unrestricted investment account-holders (para. 2, Oct. 1996).

Furthermore, although this is required by AAOIFI Standard No. 1 on General Presentation and Disclosure in the Financial Statements of Islamic banks and Financial Institutions, Mohammed Bank did not make disclosures of the method used to allocate investment profits (losses) between unrestricted investment account-holders or their equivalent and the bank as a Mudarib, or as an investment manager whether or not participating in the investments with its own funds (AAOIFI, 1993).
### Table 9.2: Snap-shot on the distribution of yield dividend on IAH 2002 - 2005

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
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<tbody>
<tr>
<td>a)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Returns Distributed to Investment Account-holders for 4 years</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(financial statements, 2003 - 2005)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5.48%</td>
<td>2.74%</td>
<td>2.63%</td>
<td>4.35%</td>
</tr>
<tr>
<td>b)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual Interest rates for the same period (source of information is Reuters)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2.1%</td>
<td>1.3%</td>
<td>2.0%</td>
<td>3.9%</td>
</tr>
<tr>
<td>c)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends distributed to shareholders for 4 years (bank’s financial statements 2003 - 2005)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5%</td>
<td>-</td>
<td>-</td>
<td>5%</td>
</tr>
</tbody>
</table>

#### The bank’s profit distribution formula to IAH

The bank policy is to separate investment pools (separation method) financed by for the IAH from those of shareholders. Returns on the following items will be paid to shareholders (bank’s financial statements, 2005):

- Investments in real-estate (long-term) ......
- Capital investment in other institutions ......
- Bank fees ......
- Returns on assets financed by current accounts ......
- Profits allocated to shareholders ......

Returns on the following items will be paid to IAH (bank’s records):

- International Commodities ......
- Deposits with other Islamic Banks ......
- *Murabaha* financing ......
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- **Musharaka** financing
- Investment short-term
- Securities short-term
- Total: the above assets financed by IAH
- Less: direct expenses related to the pool and specific provisions related to the IAH pool
- Less **Mudarib** share (it ranges from 30% to 40% based on a decision from the Board of Directors)
- Less profit equalisation reserve, at a percentage to be specified by the Board of Directors
- IAH entitlement to returns

(Source: obtained from the bank's records)

The method of distribution of profits to shareholders and IAH is similar to the method used by Mohammed Bank, except that its Khalifa Bank a share of profits on assets set aside for liquidity management is paid to IAH, while in the case of Mohammed Bank such profits will be paid just to the shareholders.

9.4 Report on the Interview held with the Management of Khalifa Bank

The management of Khalifa Bank claimed that it is accountable to the shareholders and IAH. This means providing the shareholders and the IAH with attractive rates of returns.

Claiming that the bank is accountable to both the shareholders and IAH is difficult to comprehend since the management is appointed by the board of directors and the board of directors are accountable to the shareholders who appointed them to represent their interest.

One rating agency argued that the board of directors should play a role in assessing the performance of the management on behalf of the IAH. So far the supervisors of
Islamic banks have not developed legislation or specific regulations to address the interests of the IAH.

On the other hand, the bank's management indicated that their policy is different from other Islamic banks in respect to the level of returns distributed to shareholders and IAH.

It's worth noting that Mohammed Bank and Khalifa Bank are regulated by the same central bank and audited by the same auditors, therefore the views of their auditors and supervisors are the same and as stated in the case study of Mohammed Bank.

9.5 Report on the Written Response from the Shari'ah Supervisory Board (SSB)

The SSB's main responsibility is to carry out Shari'ah reviews of bank's contracts to ensure compliance with Shari'ah.

Article 58 (1984) of the bank's by-laws state, that the board of directors should appoint one or more Shari'ah scholars with experience with financial services. Article 60 (1984) state that the board of directors or the management can obtain the SSB's views on Shari'ah matters. The SSB consists of three board members.

The SSB submits its report to the board of directors. AAOIFI's Governance Standard No. 1 on Shari'ah Supervisory Board: Appointment, Composition and Report, states that the SSB's report shall be appropriately addressed as required by the circumstances of the engagement and local laws and regulations.

The SSB conducts mainly an ex post review which includes the approving of new contracts and/or products and endorsing new banking services (e.g. debit card services). The ex ante review is carried through the Internal Shari'ah Review (ISR) on behalf of the SSB. The role of the ISR is to make sure that the bank has implemented the SSB instructions.
The supervisors of Khalifa Bank indicated that their supervisory role is limited to the bank's financial statues and they have no directly supervisory role over the SSB.

If the bank fails to comply with SSB instructions, usually the SSB will discuss it with the management, and if it is not convinced by the management response, it will qualify the report. This indicated in the SSB's report when it has decided to put qualification in the report for several consecutive years.

It is important to mention, that ISR is an integral part of the organs of governance of the bank and operates under the policies established by the bank. The staff and benefits of the ISR are decided by the management. However, there is no written policies and procedures for the ISR.

It is also worth noting that the SSB remuneration is decided by the board of directors based on the recommendation of the management.

It is worth noting that AAOIFI Auditing Standard No. 4 requires the auditor to form an opinion on the auditor SSB's on the bank's compliance with Shari'ah. The auditor's opinion makes no such reference in the opinion, which makes it short of what is required in AAOIFI Standard No. 4. The external auditors conduct no testing on the ISR procedures to determine the effectiveness of the system.

The bank is required to adhere to AAOIFI Governance Standards (central bank regulations, 21 November 2001) which include the following standards:

1. Shari'ah Supervisory Board: Appointment, Composition and Report
2. Shari'ah Review
3. Internal Shari'ah Review
4. Audit and Governance Committee for Islamic Financial Institutions
The SSB's report to the shareholders of the bank contains the following opinion:

"We have reviewed the principles applied in contracts related to transactions and practices which were launched by the bank during the year ended 31/12/xxxx. We have conducted the monitoring which is required to express our opinion whether the bank is compatible with the rules and principles of Islamic Shari'ah and also fatwas (religious opinions), decisions and guidelines which were issued by our board.

The appointment of SSB members is the responsibility of the General Assembly based on the recommendation of the board of directors.

The responsibility of ensuring that the bank works in accordance with the rulings and principles of Islamic Shari'ah lies with its management. Our responsibility is limited in expressing an independent opinion on the basis of our review of the bank's operations and in preparing our report to you.

Our review included checking documents and procedures followed by the bank on the basis of testing each type of operations. We have planned and implemented our review in order to obtain all information and explanation deemed necessary by us in order to obtain reasonable evidences that the bank did not violate the rulings and principles of Islamic Shari'ah.

In our opinion:

1. The contracts, operations and transactions carried out by the bank ending 31st, December, xxxx, which we have examined were all compliance with the rules and principles of the Islamic Shari'ah.

2. As to the bank branches in..........., it appears to us that a number of investments interred with some of the banks were not Shari'ah compatible in their underlying operations, and therefore, we decided that the management has to cease these investments to which we have presented alternative Shari'ah compatible ones.
The management has set aside a sum of PR212,235/- out of the earnings generated from the said operations to expend it in charitable purposes to be decided by us. However, since part of these earnings has been received by the owners of the investment accounts as part of distributions made to them, the SSB has asked the management to notify the investors of the percentage of such earnings to the total amounts distributed to them and advise them to spend this percentage in charitable purposes.

3. The distribution of profits and losses on the investment accounts is compatible with the standards adopted by us according to the rules and principles of the Islamic Shari'ah.

4. The Management has to expend the amount which is earned from sources or through means prohibited under the rules and principles of the Islamic Shari'ah in charitable ways".

The qualification of the SSB’s report as indicated above shows the SSB enjoys independence from the management and board of directors, as such a qualification could negatively impact the bank’s reputation. It is worth noting, however, that the same qualification continues to appear in the SSB’s report for four consecutive years from 2002 to 2005.

The external auditors fails to state in its report as to whether the financial statements give a true and fair view in accordance with Islamic Shari'ah Rules and Principles.

The market did not react to such qualifications. On the contrary, total deposits increased from 197 mn in 2002 to 374 mn in 2005.

This indicates how the market fails to react in the absence of effective and efficient market discipline.
9.6 Concluding Remarks

Khalifa Bank is a subsidiary of a large financial group that holds 78.3% of the bank’s capital. The remaining is owned by other Islamic financial institutions. There are seven board members, five of which represent the financial group.

The method of distribution of profits to shareholders and IAH is similar to the method used by Mohammed Bank, except that Khalifa Bank distributes profits on assets set aside for liquidity management to both the shareholders and IAH, while in the case of Mohammed Banks such profits will be paid just to the shareholders.

Although the majority of the capital is held by one institution, the bank continued to pay returns to IAH even in years where no dividends were distributed to shareholders. The SSB conducts mainly an *ex post* review which includes the approving of new contracts and/or products and endorsing new banking services (e.g. debit card services).

The *ex ante* review is carried through the Internal *Shari’ah* Review on behalf of the SSB. The SSB’s report makes no reference to the role play by the ISR.

With regard to the relations between the ISR and external auditors, the external auditors can have access to the reports of the ISR to assist the auditors on the bank’s compliance with *Shari’ah*.

However, the bank’s policy is to provide the shareholders and the IAH with attractive rates of returns. One rating agency argued that the board of directors should play a role in assessing the performance of the management on behalf of the IAH.
Chapter 10
The Case Study of Sara Bank

10.1 Introduction

Sara Bank (henceforth also referred to as the "Bank") was established in May 19xx, which made it the second Islamic bank in the country. Along with the provision of standard banking activities, its main activities include, maintaining different kinds of deposits, opening and confirming letters of credit, issuing securities and letters of guarantee, dealing in foreign currencies and financing foreign trade, and issuing credit cards, travellers' cheques, and other financial instruments (Article 1, Article of Association, 1990).

The bank is required by the Central Bank to implement AAOIFI accounting standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). The bank is not required to adopt AAOIFI Shari'ah and auditing standards. The board of directors are obliged to seek the assistance of a religious supervisory committee for religious counsel in matters related to the various banking activities (Article 49, Article of Association, 1990). The appointment of the SSB members is the responsibility of the Board of Directors.

10.1.1 Asset Quality

The bank registered a significant growth in its activities in 2005. While financing growth has remained robust, on the back of higher local demand, exposure to housing finance and consumer finance sectors has increased by 20% and 32% respectively.

It is important to note that this research uses the period from 2002 to 2005 as an indicator as well as a benchmark period for comparison with other case studies. Furthermore, in order to disguise the bank's identity the table will not mention the currency that the figures represent.
Table 10.1: Snap-shot of the financial highlights in millions (The bank’s financial statements, 2002 – 2005)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Share Capital</td>
<td>230</td>
<td>280</td>
<td>449</td>
<td>882</td>
</tr>
<tr>
<td>Total Investment A/c Holders</td>
<td>2695</td>
<td>3465</td>
<td>4359</td>
<td>5076</td>
</tr>
<tr>
<td>Current Accounts</td>
<td>482</td>
<td>891</td>
<td>997</td>
<td>1762</td>
</tr>
<tr>
<td>Ratio of Total Share Capital to IAH</td>
<td>1:11.7</td>
<td>1:12.3</td>
<td>1:9.7</td>
<td>1:5.7</td>
</tr>
<tr>
<td>Ratio of Total Share Capital to Current Accounts</td>
<td>1:0.4</td>
<td>1:3.2</td>
<td>1:2.2</td>
<td>1:1.9</td>
</tr>
<tr>
<td>Net Income</td>
<td>50</td>
<td>64</td>
<td>88</td>
<td>465</td>
</tr>
<tr>
<td>Total Assets</td>
<td>3039</td>
<td>3906</td>
<td>4962</td>
<td>6335</td>
</tr>
<tr>
<td>Return on Average Equity %</td>
<td>22</td>
<td>23</td>
<td>26</td>
<td>59</td>
</tr>
<tr>
<td>Return on Average Assets %</td>
<td>1.6</td>
<td>1.6</td>
<td>1.7</td>
<td>7.3</td>
</tr>
</tbody>
</table>

As indicated by table 10.1 above, the bank’s net income increased by 428% in 2005. The major increase came from the gain on sale of equities, as the local stock market witnessed its best year (financial statements, 2005). The market index advanced from 6,493 to 11,053. 2005 was an outstanding performance for all banks operating in the same country.

10.2 Ownership Structure

A significant share of the bank’s capital is owned by one family, which is represented by four out of the eight board members\(^ {28} \).

The percentage of shares held by the family is disclosed neither in the audited accounts nor in the Capital Intelligence Report. However, determined from their representation in the board, it can be suggested that the family holds majority control and the bank can be considered to have concentrated shareholding (with the family owning 50% or higher).

\(^ {28} \) Capital Intelligence, June, 2005.
Chapter 10

10.3 Types of Investment Account-Holders

The accounts maintain different types of investment account holders as follows:

10.3.1 Current Accounts

These accounts bear no risk of loss and give no return to holders, as the bank guarantees to pay the outstanding balance on demand. These accounts are considered as Qard (free loan) to the bank.

10.3.2 Saving Accounts

The contract states clearly that this is a Mudaraba contract between the IAH and the bank. The bank also states that it guarantees the principal in case the bank has acted with proven negligence or misconduct.

10.3.3 Time Deposit

The contract states clearly that this is a Mudaraba contract between the IAH and the bank. The bank also states that it guarantees the principal if the bank has acted with proven negligence or misconduct.

However, all bank contracts with IAH that do not indicate the bank’s share of profits as Mudarib. This share is decided by the board of directors at the end of the financial year, based on the maturity profile of the deposit base. Maximum Mudarib for 2005 is 39.4%. For time deposit lower Mudarib rate will be charged.

In spite of the requirements as stated in AAOIFI Standard on Disclosure of Bases for Profit Allocation between owners’ and IAH, the bank failed to state in their accounting policies the bases applied by them in the allocation of profits between owners' equity and unrestricted investment account-holders (para 2, Oct. 1996).
Table 10.2: Snap-shot on Interest rates paid from 2002 – 2005 and on the dividends distributed to shareholders for 4 years

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rates for the same period (Reuters)</td>
<td>1.48%</td>
<td>3.27%</td>
<td>3.75%</td>
<td>6.51%</td>
</tr>
<tr>
<td>Dividends distributed to shareholders for 4 years (bank’s financial statements 2003 - 2005)</td>
<td>-</td>
<td>1.0%</td>
<td>2.1%</td>
<td>3.89%</td>
</tr>
</tbody>
</table>

The bank’s profit distribution formula (The bank uses the commingling approach between its shareholders and IAH):

- Net realised profit entitled for shareholders and IAH from after deducting all expenses
- Deducting the shareholders share in the profit
- Share of holders of unrestricted investment account-holders in the profit
- Deduct-profit equalisation reserve
- Deduct-Bank’s Mudarib fees
- Share of holders of unrestricted investment accounts in the profit

(Source: obtained from the bank’s records)

The bank’s share as Mudarib as indicated in the bank’s financial statements are as follows:

Table 10.3: The bank's share as Mudarib for 2003 – 2005

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not obtained</td>
<td>-</td>
<td>44.6%</td>
<td>45.5%</td>
<td>39.4%</td>
</tr>
</tbody>
</table>
The bank uses the commingling approach, which means investing the funds of the shareholders with those of the IAH. All revenue generated is shared between the shareholders and IAH proportionately. This approach differs from the one used by Mohammed Bank, where some of the assets are financed by the shareholders and others by the IAH. This also differs from the approach used by Khalifa Bank, where some of the expenses are borne by the IAH and others by the shareholders. In the case of Sara Bank all expenses will be shared between the shareholders and IAH.

The supervisors require all Islamic banks to abide by the above formula which is required to be disclosed in the bank’s financial statements. The supervisor of Sara Bank is the only Central Bank of the three Central Banks (as indicated in the methodology chapter, the research is conducting case studies of four banks operating in three countries) that requires such information to be disclosed in the bank’s financial statements(29).

Islamic banks are required by the supervisor to state the method of profit allocation and the maximum Mudarib ratio in the contract, where the Mudarib ratio should be declared at the beginning of each year along with the modifications in the contract(30). The Islamic banks are permitted to forego part of their share of profits (the Mudarib fee) in order to increase the rate of return for the IAH, after obtaining the approval from the general assembly, followed by a disclosure of the same in the bank’s financial statements(31). Banks are not allowed to allocate or announce the profit allocation to the IAH unless they have obtained the approval of the Central Bank and before meeting the rest of the criteria that govern this allocation(32).

(29) Instruction to banks, 2005 p.225.
(30) Instruction to banks, 2005 p.226.
(31) Instruction to banks, 2005 p.226.
The regulations also indicate that the IAH shall bear no losses, except what is decided by the supervisors. The supervisor is the entity that dictates that the Islamic bank as Mudarib will bear the responsibility of such losses in line with the rules of the Islamic law\(^{(3)}\). As per the Shari'ah law the Mudarib e.g. the Islamic bank is responsible for the IAH losses only in case of negligence or mis-conduct.

The Central Bank governing Sara Bank, is quite progressive in regulating Islamic banks, by not only enhancing transparency and disclosure rules, but also addressing other very important issues which affect the returns distributed to the IAH and the shareholders.

10.4 Report on the Interviews Conducted with the Management

The management of Sara Bank claimed that they have a fiduciary responsibility but no accountability as IAH have no governance rights.

The bank’s management asserted that the bank’s stability and confidence in the market depends to large extent on the service it provides to the IAH. Following from this, the management stated that it was against providing the IAH any representation in the bank’s committees, since it is in the interest of the board of directors and management to protect the interest of the IAH. In the event that the IAH decided to withdraw their funds, it will put the board of directors and management under severe pressure which may result in losing their positions. Hence, the management indicated that regardless of the bank’s ownership structure, it is in the interest of the board of directors and management to protect the interest of the IAH.

The researcher shares the view that it is in the interest of the board of directors and management to protect the interest of the IAH. For this reason, the board of directors and management may decide to give up part of the Mudarib share of profit for the benefit of the IAH.

\(^{(3)}\) Instruction to banks, 2005 p.226.
One rating agency maintained that it is the responsibility of the board of directors to monitor the performance of the management on behalf of the IAH. While another rating agency claimed that it is the responsibility of the board of directors and rating agencies to assess the performance of the management on behalf of the IAH.

The supervisors of Sara Bank argued that in order to achieve financial stability, bank supervisors have an obligation to develop a robust supervisory framework in order to protect the interest of the IAH, as any losses incurred by IAH will negatively impact on the bank’s reputation and the overall confidence in the banking system.

In this regard, the bank’s supervisors believe that the IFSB should work closely with the supervisors in helping to develop supervisory standards for Islamic banks which give confidence to the IAH and other stakeholders with respect to the management of Islamic banks. The supervisors of Sara Bank also believe that financial intermediaries such as rating agencies also play an important role in protecting the interest of the IAH through their assessment of the bank’s financial strength. This is achieved when there is adequate level of disclosure. This calls for AAOIFI and other accounting standards setting bodies to develop accounting standards that help financial intermediaries to effectively assess Islamic banks.

The supervisors of Sara Bank indicated that their supervisory role is limited to the bank’s financial statues and they have no supervisory role over the SSBs.

However, in case the bank fails to comply with Shari'ah it is the responsibility of the SSB to declare it the SSBs report.

Two rating agencies that rate Islamic banks claim that the level of information disclosed in the financial reports of Islamic banks is less than satisfactory. This will certainly not help in developing market discipline and allowing the IAH to take the appropriate decisions on their investments.
10.5 Report on the Written Response

10.5.1 Report on the written response from the Internal Shari'ah Review (ISR)

The role of ISR is to review and audit all banking activities to make sure that they are compatible with Shari'ah. The ISR conduct ex ante and ex post reviews. The ex ante reviews include the examination of documents or contracts before their implementation, in order to make sure that they are in compliance with Shari'ah principles. The ex post reviews are conducted on contracts after implementation to make sure that contracts were implemented in accordance with the instruction of the Shari'ah Executive Committee (SHEC).

The ISR audit also includes conducting a Shari'ah audit on the rate of Mudarib fee charged by the bank. The audit assesses if the fees charged are in line with the percentage agreed upon by the SSB. The ISR also responds to the staff queries/questions on Shari'ah matters relating to their units or responsibilities.

The Head of the ISR meets very often with the Head of the Internal Audit to discuss with him the ISR report since this will assist the Internal Audit Unit (IAU) to conduct their audits. The Head of the IAU also discusses its report with chairman of the SEC.

The ISR is conducted through a separate unit within the bank. The Shari'ah Executive Committee (SEC) consists of three Shari'ah members, while the chairman of the SEC, who is a full-time staff member of the bank, is accountable to the SEC and to the board of directors.

The members of the SEC are different from those of the Shari'ah Supervisory Board (SSB) except that the chairman of the SEC is also a member of the SSB. The SSB members (including the chairman of the SEC) are appointed by general assembly of the bank and the SEC (other the chairman) members are appointed by the SSB. Members of the SEC meets more frequently than the SSB, the duties of the SEC include the issuance of fatwas/instructions which need urgent decisions. The SSB has
delegated the SEC to make certain decisions on their behalf. This is because most of the SEC members have had experience and exposure in such matters while serving as SSB members in number of Islamic banks.

The ISR prepare a quarterly report which is sent to the chairman of the SEC, as he is responsible for the ISR. Copies of the report are also sent to the managing director and general manager of the bank. The SEC discusses the report with the management, provide comments and give instructions to the management regarding the relevant transactions, and also provide alternatives where necessary.

It is worth noting that AAOIFI Auditing Standard No. 4 requires the auditor to form an opinion on the [auditor opinion on] the bank’s compliance with Shari'ah. The auditor’s opinion includes no such opinion which makes it short of what is required in AAOIFI Standard No. 4. The external auditors conduct no testing on the ISR procedures to determine the effectiveness of the system.

10.5.2 Report on the Interview held with the Shari'ah Supervisory Board (SSB)

The SSB’s main responsibility is to carry out Shari'ah reviews of bank’s contracts to ensure compliance with Shari'ah. However, SSB has delegated some of its duties to the SEC.

Article 49 of the bank’s by-laws states that the board of directors can seek the assistance of a religious supervisory board for consultation on Shari'ah matters. The article does not make it mandatory on the board of directors and management to implement the instructions (fatwas) of the SSB.

The SSB consists of four members. The SSB report states the following (and it does not state to whom the report is addressed):

"The SSB for xxxx has monitored the bank’s activities and transactions and their adherence to Islamic Shari'ah. The SSB has reviewed contracts, agreements, and documents presented
to it and implemented changes where appropriate to assure compliance with the Islamic *Shari'ah* principles. The SSB answered questions presented by the bank's management and assisted in finding solutions for implementation difficulties. The SSB, through its executive member, has directly supervised operational execution to ensure compliance.

It is the SSB opinion that issues presented for its review are generally in compliance with *Shari'ah* guidelines. Further, the SSB has reviewed the bank's financial reports for the year xxxx and confirms no deviation from the rulings of Islamic *Shari'ah*.

The SSB affirm it is the bank management responsibility to apply the *Shari'ah* guidelines. The SSB responsibility is to give "fatwa" (religious opinion) and monitor transactions through the religious review department within the bank".

Although the report makes reference to the role played by the chairman of the SEC who is also a member of the SSB, it has passed over the role of the SEC and ISR. The SSB's role is to discuss the annual report of the bank and issue *fatwas* or directions to the management on all issues relating to the bank's affairs when the SEC members are not in agreement among themselves or in cases where the *Shari'ah* matters are complicated and need the input of the SSB.

10.6 Concluding Remarks

The bank's capital is significantly held by one family. There are 8 board members, 4 members represent the family holding the major stake of the capital. However, determined from their representation in the board, it can be suggested that the family holds majority control.
The bank paid very high dividend yield as indicated above, compared with moderate rate of returns paid to IAH.

The bank uses the commingling method. All revenue generated is shared between the shareholders and IAH proportionately. This is required by the bank’s supervisors.

Islamic banks are required by the supervisors to state the method of profit allocation and the maximum Mudarib ratio in the contract, where the Mudarib ratio should be declared at the beginning of each year along with the modifications in the contract. However, the actual Mudarib rate is decided at the end of the financial year.

Regarding the bank’s compliance with Shari’ah. The SSB’s role is to discuss the annual report of the bank and issue fatwas or directions to the management when the SEC members are not in agreement among themselves or in cases where the Shari’ah matters are complicated and need the input of the SSB.

The role of ISR is to review and audit all banking activities to make sure that they are compatible with Shari’ah. The ISR conduct ex ante and ex post reviews. The ex ante reviews include the examination of documents or contracts before their implementation, in order to make sure that they are in compliance with Shari’ah principles.

The ex post reviews are conducted on contracts after implementation to make sure that contracts were implemented in accordance with the instructions of the SEC.

The SSB’s report makes reference to the role played by the chairman of the SEC who is also a member of the SSB, but it has ignored the role of the SEC and ISR.

However, the bank indicated that regardless of the bank’s ownership structure, it is in the interest of the board of directors and management to protect the interests of the IAH.
One rating agency argued that it is the responsibility of the board of directors to monitor the performance of the management on behalf of the IAH. Another rating agency claimed that it is the responsibility of the board of directors and rating agencies to assess the performance of the management on behalf of the IAH.

The supervisors of Sara Bank also claim that information intermediaries such as rating agencies also play an important role in protecting the interests of the IAH through their assessments of the bank’s financial strength. This is achieved when there is an adequate level of disclosure. This calls for AAOIFI and other accounting standards setting bodies to develop accounting standards that help information intermediaries to effectively assess Islamic banks.
Chapter 11

Analysis and Comparison of the Case Studies

11.1 Introduction

This chapter aims to analyze the four case studies in relation to the following research proposition and questions identified in chapter 5:

1. The principal-principal relationship between shareholders and IAH and the possible effects of shareholder concentration

Unlike the shareholders in an Islamic bank, the IAH do not have the right to appoint and monitor the performance of the board of directors and executive management. They also do not have a say in the appointment of the SSB members or the external auditors. Archer & Karim (2006) suggest that there may be 'vicarious monitoring' by shareholders in the interests of IAH, but its effectiveness is primarily dependent on there not being any significant conflicts of interest between the shareholders and the IAH. Such conflicts of interest are arguably more likely to occur where there is a concentration of shareholders. In such a situation, the shareholders may pursue their own interests (via their control the board of directors) which may differ from those of the minority shareholders and the IAH.

Hence, we formulate Research Proposition No. 1 as follows: There is a correlation between the extent of shareholder concentration and the ratio of the shareholder return on equity to the IAH return on equity - the higher the concentration of shareholders, the higher the ratio of the shareholders return on equity to the IAH return on equity.

2. Compliance with Shari'ah Rules and Principles

The role of SSB has typically been defined in terms of ex ante compliance of contracts with Shari'ah, but not ex post compliance of transactions with the fatwas issued by the SSB (which requires an audit process to verify compliance). This highlights the need for internal Shari'ah review as proposed by the AAOIFI Governance Standard No. 2. However, AAOIFI Auditing
Standard No. 2 requires the external auditors to report on \textit{Shari'ah} compliance. One way of measuring the effectiveness of internal \textit{Shari'ah} review is by the external auditors when they perform their audit to report on the bank's compliance with \textit{Shari'ah} rules and principles. On the other hand, given that they do not perform their \textit{ex post} audit, the SSBs will tend to depend on the findings of internal \textit{Shari'ah} review to issue their report to the shareholders.

Hence, we formulate Research Proposition No. 2 as follows: The findings of the ISR will be reflected in the wording of the SSB's report that is included in the Islamic bank's annual report.

3. The Information Environment and the Role of Industry Supervisors

There is substantial empirical support for the proposition that small investors (of whom IAH are a category) do not pay much (if any) attention to financial reporting information of companies in which they invest. Rather, they rely on \textit{information intermediaries} to study such information. Hence, in the absence of adequate information intermediaries (e.g. financial analysts publishing report, or rating agencies) covering Islamic banks, the issue arises of the role of banking industry supervisors in protecting the interests of investors, especially small investors.

4. The Role of the Bank Supervisors In Improving the Information In the Financial Reports

The weak information environment in which IIFS operate tends to have implications for this issue. Arguably, there is a 'chicken and egg' situation in which information intermediaries are rare because there has been a lack of good quality information, while AAOIFI Standards should have improved this situation (Al-Baluchi, 2006). Hence, there is a need for a 'bootstrapping' of the information environment by supervisory authorities, i.e. by enforcing AAOIFI and IFSB Standards that promote the provision of better financial reporting and governance. But to what extent do supervisors recognize this.

The banking industry supervisors will play an important role in protecting minority shareholders as well as the IAH. Among other things, banking supervisors recognize the need to improve financial reporting of Islamic banks, even if there is currently only a very limited amount of information intermediation.
11.2 The Impact of Shareholders Concentration

By examining the four case studies we see that in two banks (Khalifa Bank and Sara Bank) there is shareholders concentration [This mean that more than 50% of the share capital is held by one institution or by one family]. In the other two banks (Ahmed Bank and Mohammed Bank) there are no shareholders concentration.

In the case of Ahmed Bank (see table 11.1) and Mohammed Bank (see table 11.2) shareholders did earn a relatively higher rate of return when compared to the returns of the IAH.

In Khalifa Bank (see table 11.3) shareholders are receiving returns almost equal to the IAH. In Sara Bank (see table 11.4), there is shareholders concentration; shareholders are receiving returns more than IAH.

The above suggests that the shareholders concentration (or the existence of a dominant shareholder) is not necessarily the main factor that enables the shareholders to be paid a higher rate of return compared to IAH. The PDF and the level of the Mudarib share of IAHI profit are the factors that result in the distribution of higher rates of return to shareholders compared to IAH. Yet, these factors do not seem to be influenced by the degree of shareholder concentration. The PDF is discussed in more detail in Section 11.3 below.

These issues are discussed in more detail below.

11.3 Analyses of the Impact of Shareholders Concentration on the Dividend Yield and IAHI Returns

11.3.1 Ahmed Bank

The following table shows in more details the situation in Ahmed Bank with the impact of level of shareholders concentration in relation to returns paid to shareholders and IAH:
TEXT BOUND INTO THE SPINE
Table 11.1: Percentage of ownership vis a vis shareholders and the IAH.

CM: controlling majority. SS: significant shareholding.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total share capital (in mn)</th>
<th>% Shareholding of CM/SS in share capital</th>
<th>% Return to IAH</th>
<th>% Return to Shareholders (SH)</th>
<th>Ratio of SH % return to IAH % return</th>
<th>No. of Board Members</th>
<th>No. of Board Members represented by CM/SS</th>
</tr>
</thead>
<tbody>
<tr>
<td>002</td>
<td>230</td>
<td>43</td>
<td>4.5</td>
<td>47</td>
<td>10.4:1</td>
<td>9</td>
<td>2</td>
</tr>
<tr>
<td>003</td>
<td>249</td>
<td>43</td>
<td>4.5</td>
<td>50</td>
<td>11.1:1</td>
<td>9</td>
<td>2</td>
</tr>
<tr>
<td>004</td>
<td>287</td>
<td>43</td>
<td>4.8</td>
<td>50</td>
<td>10.4:1</td>
<td>9</td>
<td>2</td>
</tr>
<tr>
<td>005</td>
<td>540</td>
<td>43</td>
<td>6.8</td>
<td>55</td>
<td>08.08:1</td>
<td>9</td>
<td>2</td>
</tr>
</tbody>
</table>

As shown in the table 11.1 above, the bank paid very modest returns to IAH compared to the dividend yield paid to shareholders. The Government holds a significant interest (43%), but its representation in the Board does not reflect its actual holding in the bank’s share capital. The Government is usually a passive shareholder, and hence would tend not influence the management for its own interest.

We can see that in the case of Ahmed Bank, even in the absence of shareholders concentration, shareholders receive much higher returns than IAH.

11.3.2 Mohammed Bank

Table 11.2 below shows in more details the situation in Mohammed Bank with regard to the impact of level of shareholder concentration in relation to returns paid to shareholders and IAH.
Table 11.2: Percentage of ownership vis a vis returns to shareholders and the IAH.

<table>
<thead>
<tr>
<th>Year</th>
<th>Share capital (in mn)</th>
<th>% Shareholding of CM/SS in share capital</th>
<th>% Return to IAH</th>
<th>% Return to Shareholders (SH)</th>
<th>Ratio of SH % return to IAH % return</th>
<th>No. of Board Members</th>
<th>No. of Board Members represented by CM/SS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>38</td>
<td>no more than 5%</td>
<td>1.48</td>
<td>10</td>
<td>06.7:1</td>
<td>13</td>
<td>Not applicable</td>
</tr>
<tr>
<td>2003</td>
<td>40</td>
<td>40</td>
<td>1.02</td>
<td>10</td>
<td>09.8:1</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>2004</td>
<td>53</td>
<td>40</td>
<td>1.26</td>
<td>22</td>
<td>17.4:1</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>2005</td>
<td>72</td>
<td>40</td>
<td>2.76</td>
<td>27</td>
<td>09.7:1</td>
<td>10</td>
<td>3</td>
</tr>
</tbody>
</table>

Table 1.2 above shows that in Mohamed Bank even in the absence of a controlling majority, of shareholders, the bank pays the shareholders a very attractive dividend yield and a very low rate of returns to IAH. In 2003, one single institution acquired 40% of the capital. In 2004 we noticed a jump in the rate of dividend yield. But historically this bank always pays a dividend yield much higher than the rate paid to IAH.

In 2005 the interest rate in the country where Mohammed Bank operates went up from 2.00% in 2004 to 3.84% and in the same period the competitor of Mohamed Bank increased the IAH rate of return from 2.10% in 2004 to 4.00% in 2005.

This suggests that the decision by Mohammed Bank to increase the rate of return for IAH was mainly to satisfy IAH, although such an increase was much lower than that of the competitor bank. Also during the same period, the total IAH funds increased in 2005 to 198mn from 169mn in 2004. Such a situation tends to exist when the IAH act as passive investors and do not move their funds around to seek the best available returns.
11.3.3 Khalifa Bank

Table 11.3 shows in more details the situation in Khalifa Bank with regard to the impact of level of shareholder concentration in relation to returns paid to shareholders and IAH.

Table 11.3: Percentage of ownership vis a vis returns to shareholders and the IAH

<table>
<thead>
<tr>
<th>Sr</th>
<th>Share capital (in mn)</th>
<th>% Shareholding of CM/SS(34)</th>
<th>% Return to IAH</th>
<th>% Return to Shareholders (SII)</th>
<th>Ratio of SII % return to IAH % return</th>
<th>No. of Board Members</th>
<th>No. of Board Members represented by CM/SS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>61</td>
<td>78.3</td>
<td>5.48</td>
<td>5</td>
<td>0.9:1</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>3</td>
<td>60</td>
<td>78.3</td>
<td>2.74</td>
<td>---</td>
<td>---</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>4</td>
<td>63</td>
<td>78.3</td>
<td>2.63</td>
<td>---</td>
<td>---</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>5</td>
<td>62</td>
<td>78.3</td>
<td>4.35</td>
<td>5</td>
<td>1.1:1</td>
<td>7</td>
<td>5</td>
</tr>
</tbody>
</table>

In the case of Khalifa Bank, in spite of the presence of a controlling majority (CM) or dominant shareholder (DS) (5 out of 7 seats on the board of directors represent the controlling majority shareholder), the total return paid to the shareholder during the four year period was 10% compared to 15.2% paid to the IAH during the same period. In the case of Khalifa Bank, in spite of there being a DS (which held 78.3% of the share capital), the shareholders and the IAH earned an almost equivalent rate of return.

It is worth noting that in 2003 the net profits reached 1.1 mn compared to 3.2mn in 2002, and in 2004 the net profits declined to .318mn. However, it seems that the bank decided to pay the IAH as good a rate of return as possible, in order to reduce the risk of the IAH withdrawing their funds, and at the same time it postponed distributing dividends to the shareholders. Such a practice suggests that the shareholders gave up their Mudarib share of profit to IAH.

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(34) Significant shareholding (SS) represents shareholding between 20% and 49% of the voting power. SS has the ability to influence the Board of Directors but does not have the ability to control the Board (IAS 27 & 28).
It can therefore be argued that in spite of the presence of a dominant shareholders, this did not result in the shareholders to pursuing their interests at the expense of the IAH by influencing the way in which profits were allocated, at least in the short term. Rather, the management recognised that it is in the shareholders' longer-term interests to retain the funds of the IAH.

11.3.4 Sara Bank

Table 11.4 below shows in more detail the situation in Sara Bank with regard to the impact of level of shareholder concentration in relation to returns paid to shareholders and IAH.

Table 11.4: Percentage of ownership vis a vis returns to shareholders and the IAH

<table>
<thead>
<tr>
<th>No.</th>
<th>Share capital (in mn)</th>
<th>% Shareholding of CM/SS</th>
<th>% Return to IAH</th>
<th>% Return to Shareholders (SH)</th>
<th>Ratio of SII % return to IAH % return</th>
<th>No. of Board Members</th>
<th>No. of Board Members represented by CM/SS</th>
</tr>
</thead>
<tbody>
<tr>
<td>02</td>
<td>230</td>
<td>50</td>
<td>1.48</td>
<td>35</td>
<td>23.6:1</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>03</td>
<td>280</td>
<td>50</td>
<td>3.27</td>
<td>35</td>
<td>10.7:1</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>04</td>
<td>449</td>
<td>50</td>
<td>3.75</td>
<td>40</td>
<td>10.6:1</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>05</td>
<td>882</td>
<td>50</td>
<td>6.51</td>
<td>100</td>
<td>15.3:1</td>
<td>8</td>
<td>4</td>
</tr>
</tbody>
</table>

Table 11.4 shows that the shareholders of Sara Bank have earned a much higher rate of return than the IAH. Fifty percent of the shares are held by a group of concentrated shareholders who control half of the board of directors. This might suggest that the control exercised by this group resulted in the shareholders receiving a much higher rate of return than the IAH.

However, taken together the above four cases do not suggest that the degree of shareholder concentration is the main factor that results in the shareholders being paid a higher rate of return compared to the IAH, by influencing the PDF and the Mudarib share of profit which have a direct influence on the shareholders' dividend payout and the IAH rate of return. To see this in more detail, we analyse below the PDFs and Mudarib shares applied by the four banks.
11.4 Profit Distribution Formula between the Shareholders and IAH

Ahmed Bank used the partial commingling approach such that some assets will be financed by both the shareholders and IAH, including investment in commodities, consumers finance and Murabaha financing. Accordingly, returns generated on these investments are shared between the shareholders and IAH in proportionate to their investments. All other assets were solely financed by the shareholders, including investment in other Islamic institutions and real-estate, and accordingly returns generated on these investments were paid to shareholders only.

Also returns generated from investing IAH funds set-aside for liquidity are allocated to shareholders. The rationale of this, is that these funds are considered to be liabilities of the bank, similar to current accounts. Such information is not disclosed in the bank’s contract with IAH.

On one hand, it might be argued that the method of asset allocation of Ahmed Bank is biased towards shareholders since it allowed the shareholders funds to be invested in assets that generated higher rate of returns. However, it may be said that the bank was prudent in recognizing that IAH are risk-averse and investing the IAH funds in assets that were not highly risky.

The bank invests around 57% of its assets in short-term commodities which are highly liquid and carry low risk, but the returns earned on such investments are very modest. In spite of that, the bank was able to pay an attractive return to shareholders, thanks to the leveraging effect with the Mudarib share, the mechanism of which is described below.

Prior to 2003, Mohammed Bank commingled the assets financed by the shareholders and the IAH. At the end of that financial year the profits of the bank were distributed between the shareholders and the IAH in proportion to their share in the investments. In 2004 the bank changed to the separation approach, whereby returns generated from investment in real-estate, which have generated higher returns than other sources of investments but are also risky, are paid to shareholders only. In addition to excluding IAH funds from investments in real-estate, the bank's fee income and returns generated from investing the excess funds in current accounts are allocated to shareholders only. Also any returns generated from investing IAH funds set-aside
for liquidity are paid to shareholders, following the rationale mentioned above in connection with Ahmed Bank. Such information is not disclosed in the bank’s contract with IAH.

It can be inferred that the new management of Mohammed Bank decided to change to its profit allocation policy to take account of the greater risk appetite of the shareholders and the lower risk appetite of the IAH, by allowing only the shareholders to receive returns generated from real-estate which usually generates high returns but is also relatively risky. It may also be supposed that the new management decided to change the PDF so as to increase the dividend yield in order to show that they were able to pay better returns to shareholders than the previous management. Yet there was no control of the board of directors by concentrated shareholders, as they were represented by only 3 out of 10 members of the board.

The method used by Khalifa Bank is similar to Mohammed Bank, except that in Khalifa Bank a share of the returns on IAH funds set aside for liquidity was paid to IAH, while in the case of Mohammed Bank (like Ahmed Bank) it was paid entirely to shareholders.

In the case of Sara Bank, all revenues including bank fees and revenues generated from investing funds of current accounts were shared between shareholders and the IAH. While in the other three banks, fees and revenues generated from funds of current accounts were paid to shareholders only. Although the method used by Sara Bank appears to be more equitable when compared with the other three banks, the shareholders return is nevertheless considerably higher than the returns paid to IAH. This may be attributed to the level of the Mudarib share, as explained below.

Sara Bank allows the IAH to share on all profits generated from all assets (excluding Mudarib share). But there is also the issue of whether funds are 100% commingled or not, and whether IAH funds are invested in more risky assets such as real-estate. Although this bank uses a “full commingling” PDF formula, the shareholders nevertheless received in 2005 100% dividend yield (the largest among the four banks) which can attributed to the level of the Mudarib share of IAH profits which can be very high (up to 60% in some cases). In all four banks Mudarib fees from managing the IAH funds were paid to shareholders. For a comparison between the four PDF (see Appendix 2).
It can be noted that there is a major common feature in the PDF of the four banks, namely that in all four banks the *Mudarib* share was paid to shareholders and that shareholders benefited from the leveraging of IAH. This seems to be the main factor that allowed the shareholders in three out of the four cases to receive a much higher rate of dividend yield compared to the rate of returns paid to IAH. To understand the leveraging effect of the *Mudarib* share, we will now analyse it more detail, using the illustration in table 11.5.

**Table 11.5: The following example shows the leverage effect:**

<table>
<thead>
<tr>
<th>Shareholders' funds</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>IAH funds</td>
<td>90</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
</tr>
<tr>
<td><em>Mudarib</em> share</td>
<td>40%</td>
</tr>
<tr>
<td>Return on assets</td>
<td>3%</td>
</tr>
<tr>
<td>Shareholders' profit ($\text{3% \times 10} + (\text{40% \times 3% \times 90})$)</td>
<td>1.38</td>
</tr>
<tr>
<td>Rate of return on shareholders' funds</td>
<td>13.8%</td>
</tr>
<tr>
<td>IAH profit ($\text{3% \times 60% \times 90}$)</td>
<td>1.62</td>
</tr>
<tr>
<td>Rate of return on IAH funds</td>
<td>1.9</td>
</tr>
</tbody>
</table>

From the above table, we can observe that 10 is the total shareholders funds and 90 is the IAH funds and the total assets are 100. For simplicity, it is assumed that there are no current accounts. (As noted in the case studies above, in most cases, the returns from investing current account funds are allocated to the shareholders, but this is not invariably the case, e.g. for Sara Bank).

In this example net profits are 3 (3\% of 100). The shareholders will be allocated 1.08 (40\% \times 3\% of 90) as *Mudarib* share plus 0.3 which is the profit on their 10\% share in the investments. This means the shareholders' total share in the profits is 1.38, which is equivalent to a 13.8\% return on their investment of 10. The IAH share of the profit after deduction of the *Mudarib* share is 1.62, which represents a return of 1.9\% on their investment of 90. This means that shareholders of Islamic banks will receive a rate of return more than 7 times the rate paid to IAH.
From the above example, we note a major difference in the rate of distribution between the shareholders and IAH. This can be attributed to the fact that shareholders are benefiting from IAH funds through a combination of a high ratio of IAH funds to shareholder funds (9:1) and also a high Mudarib share of 40%. So what we have is a form of leverage, not in the conventional sense of a ratio of debt to total capital, but what we can call Islamic leverage, e.g. a ratio of IAH funds to shareholders funds combined with a Mudarib share of the profits on the IAH funds. This will typically enable the shareholders to receive a dividend yield much higher than the rate of returns paid to IAH (see also Al-Deehani et al, 1999).

Thus, with a relatively small invested capital, shareholders receive proportionately a large portion of the profits. It is not that their absolute share of profits is bigger than the IAH share of profits, but because their investment is much smaller they end up with a much higher rate of return on their capital.

We can thus conclude that generally shareholders of Islamic banks earn a higher rate of return compared to IAH due to the leverage ratio of IAH funds to shareholders funds and the Mudarib rate.

11.5 Compliance with Shari'ah Rules and Principles

11.5.1 The Role of the SSB

As mentioned in the case studies, the role of the SSB is different from one bank to another. In Ahmed Bank, the SSB’s duties as mentioned in the bank’s by-law are more than an advisory one, since the by-law states clearly that the SSB responsibility is to make sure that the bank’s activities are in line with Shari'ah.

However, the role of the SSB in the other three banks is more of an advisory one. Theoretically at least this means that the management can influence the SSB’s report.
However, in practice as indicated particularly in Khalifa Bank, the *fatwas* of the SSB are mandatory on the management. If the bank fails to comply with SSB *fatwas*, the SSB is expected to mention in its report the bank’s shortfall on the issue of compliance with *Shari’ah*.

It is worth noting that there was no apparent market reaction to such qualification, in spite of the supposed importance of *Shari’ah* matters to stakeholders. Rather, as in the case study of Khalifa Bank, we noted an increase in deposits during the four years of qualification. This can be attributed to weak market discipline.

As noted in the case studies, each bank published an SSB report different from the others. This would make it difficult for the readers of the SSB report to compare between one bank to another on the level of *Shari’ah* compliance (for more details see Appendix 3).

Furthermore, the appointment of the SSB members differs from one bank to another. The appointment of SSB members in Ahmed Bank, Mohammed Bank and Khalifa Bank is the responsibility of the general assembly. In the case of Sara Bank, the appointment of the SSB members is the responsibility of the board of directors. This would subject the SSB to influence by the board of directors, thereby challenging their independence.

In the case of Sara Bank, the appointment of SSB members conflicts with the AAOIFI *Shari’ah* Standard which requires Islamic banks to appoint SSB members by the general assembly based on the recommendation of the board of directors (AAOIFI, 1993).

The remuneration of the SSB members of all four banks is decided by the board of directors based on the recommendation of the management. This will tend to question the independence of the SSB members since they may be subject to the influence of the management, which could lead to weak governance.

The SSB members in all four banks claimed that their role is to ensure that the banks operate in accordance with *Shari’ah*. In reality, the SSB’s function was limited to reviewing the bank’s contracts before their implementation (*ex ante*); however, they do not verify the implementation
of the contracts (ex post) since they tend to rely on the ISR to conduct this function on their behalf.

11.5.2 The Role of the ISR

In all four cases, each bank has established an Internal Shari'ah Review (ISR). In spite of the important role that in principle is played by the ISR, only Mohammed Bank refers to it in its report, while Ahmed Bank, Khalifa Bank and Sara Bank have made no such reference. The ISR mainly conducts an (ex post) Shari'ah audit, since the SSB rely on the ISR to perform this function on their behalf. So any failure on part of the ISR to detect instances of Shari'ah non-compliance will affect the accuracy of the SSB report.

It can be inferred from the case studies that the ISR focussed on Shari'ah audit, rather than on checking whether all stakeholders are treated equitably. In fact, it is not the role of the ISR as such to have such a focus, but the issue might be expected to be a concern of the SSB. For example, the size of the Mudarib rate and the PDF are issues with regard to whether the arrangements between shareholders and IAH are equitable. In three out of our four cases, it may be questioned whether such arrangements were indeed equitable.

This would lead to us question the role of the SSB in such matters. There is also the matter of the independence of the ISR. In the case of Mohammed Bank and Khalifa Bank, the salaries of the ISR are decided by the management. This would jeopardise the independence of the ISR. In the case of Sara Bank, the salaries of the ISR are decided by the chairman of the SEC who is also a member of the SSB. Compared to Mohammed Bank and Khalifa Bank, the ISR of Sara Bank would be perceived to be more independent from the influence of the management.

However, the salaries of the ISR of Ahmed Bank are decided by the SSB. This supports the independence of the ISR more than in the cases of Mohammed Bank and Khalifa Bank because Ahmed Bank's ISR, like that of Sara Bank, will not be under the influence of the management.

AAOIFI has issued an auditing standard requiring external auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the
Chapter 11 Analysis and Comparison of the Case Studies

**Shari'ah Rules and Principles (AAOIFI, Jan, 1998).** This requires the external auditors to question whether the financial statements are prepared, in all material respects, in accordance with the *Shari'ah* Rules and Principles.

The above suggests that any failure on the part of the ISR to carry out their *Shari'ah* audit would lead to weak governance, especially when the SSB tend to rely on the audit conducted by them.

### 11.5.3 The Role of the External Auditors

Only Mohammed Bank and Khalifa Bank required their external auditors to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the *Shari'ah* Rules and Principles. In the absence of any proper assessment by the external auditors of the ISR procedures, as indicated in the case studies of Mohammed Bank and Khalifa Bank, to determine its ability to conduct an effective *Shari'ah* audit, this could lead to weak governance.

In reviewing the auditors' opinion of the two banks that are subject to AAOIFI Standards, one notes that the auditors' opinion makes no reference to the bank's compliance with *Shari'ah*. This is contrary to the requirements of the AAOIFI Auditing Standard No. 1 on Objective and Principles of Auditing (Jan, 1998 p.17) which states that:

"The auditor's report should clearly state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with the Islamic *Shari'ah* Rules and Principles as determined by the SSB of the Islamic bank".

Furthermore, in all four cases, the SSB relies on the findings of the ISR on the bank's compliance. For example, in the case of Khalifa Bank, a *Shari'ah* violation by the bank was discovered by the ISR which reported the case to the SSB. However, the external auditors of Khalifa Bank made no reference to this in their report, which would not appear to be consistent with their duties under the AAOIFI Standards. Specifically, this suggests that the external auditors failed in their duties to express an opinion as to whether the financial statements are
prepared, in all material respects, in accordance with the Shari‘ah Rules and Principles, as required by the Auditing Standard No. 4.

Moreover, unlike accounting standards where the auditors are expected the report the violation if the amounts involved are material in relation to the financial statements, the AAOIFI Shari‘ah and Auditing Standards relating to the bank’s compliance with Shari‘ah are silent on the issue of materiality. This suggests that in the case of Shari‘ah violation, the external auditors and SSB should report it even if the amount involved is not substantial. However, the SSB and the relevant standard setting bodies should be transparent about this matter.

Moreover, quite apart from the AAIOFI Standards, it should be recognised that since Shari‘ah violations may constitute misconduct or negligence, they may have serious financial consequences, namely the transformation of IAH funds into liabilities.

In all four banks, no formal communication is established between the Audit Committee and the SSB. In contrast, the IFSB Standard on Guiding Principles on Corporate Governance, which was issued in December of 2006, requires the Audit Committee of Islamic banks to communicate and coordinate with both the SSB and the proposed Governance Committee (IFSB, 2006b).

It is worth noting that 50% of the respondents of the survey conducted on IAH said that the SSBs report is a tool to provide them with adequate assurance that the bank’s transactions are in compliance with Shari‘ah precepts.

11.5.4 The Role of the Bank Supervisors

The case studies suggest that the supervisors of the banks did not take an active role with regard to the extent of their compliance with Shari‘ah rules and principles, which may have encouraged the external auditors not to comply with AAOIFI Auditing Standards (in the case of Mohammed Bank and Khalifa Bank). In addition, in the case of Ahmed Bank the SSB report is inadequate and lacks important information; this shows the importance for the supervisors to urge their banks to implement AAOIFI Shari‘ah Standards or to improve on the SSB’s report. In the case
of Sara Bank, the appointment of SSB is the responsibility of the board of directors this is a clear conflict of interest. This also shows the importance of implementing AAOIFI Standards.

11.6 The Information Environment and the Role of Industry Supervisors

11.6.1 The Role of the IAH in Assessing the Management Performance

As indicated by the survey, IAH do not give much attention to the financial statements in order to assess the performance of the management. In addition, 53.2% of the IAH provided an answer on the type of contractual relationship between the IAH with the Islamic bank that suggests they were not familiar with such a relationship. This shows that the majority of IAH lack adequate knowledge of the nature of their transactions with Islamic banks.

Furthermore, as indicated in the case studies, in spite of the low rate of return paid to IAH compared to the shareholders, during the period 2002 - 2005 there was an increase in IAH funds in all four banks, including Mohammed Bank.

It is worth noting that the survey indicated that with regard to the level of satisfaction on the returns paid to IAH 13% of the respondents indicated that they were fully satisfied, 37% fairly satisfied, 27% less satisfied, 15% fairly unsatisfied, 8% totally unsatisfied. Thus, 50% were either fully or fairly satisfied and 50% were less, fairly or totally unsatisfied.

Furthermore, the survey indicated that 52% of the IAH stated that the prospective rate of returns is the main factor that influences their decision to place their funds with an Islamic bank, compared to 21% indicating that the main factor for deciding to place their funds is the level of Shari’ah compliance by the Islamic bank.

These findings help to explain why in the case of Khalifa Bank, IAH did not react negatively to non Shari’ah compliance by the bank since the majority of IAH (52%) seems to have given the prospective rate of returns more importance than the issue of Shari’ah compliance in placing their funds with the bank. This highlights the issue of the clientele of the bank whether they are predominantly economic minded or religiously sensitive (Karim, 1990).
However, taking into consideration the importance of the prospective rate of returns to the IAH (52%) and the relatively low rate of returns paid to IAH as shown in the four cases (very low in one case), we would expect that the majority of the IAH responses on the level of satisfaction on their returns to be unsatisfied. As such the survey indicates that majority of IAH not only lack the basic knowledge about their transactions with Islamic banks but are also passive and non informed investors.

It can be argued that because IAHS are passive investors this seems to have encouraged the management to look after the interest of the shareholders at the expense of the IAH. This is clearly noted in analyzing the ratio of shareholder return on equity to IAH return on equity, where it can be seen that the shareholders are benefiting from IAH funds through a high leverage ratio of shareholder funds to IAH funds combined with a large Mudarib percentage share of the profits from investing IAH funds.

It is worth remembering that, in the survey the IAH were not in agreement in their responses as to who should monitor the performance of Islamic banks on their behalf. 27% of the IAH indicated that SSB should monitor the management on their behalf, 25% claimed that it is the responsibility of bank's supervisors to monitor the management of the bank on their behalf, 19% claimed it the responsibility of the external auditors, and 11% indicated it is the responsibility of the rating agency.

11.6.2 The Role of the Financial Intermediaries In Assessing the Bank’s Performance

In the absence of active IAH investors, any assessment made by rating agencies may not have any major impact on the treatment of IAH by the management of Islamic banks. As such, an intervention by the bank's supervisors may be required to assess the information provided in order to hold management accountable. The intervention of bank's supervisors to monitor the management would also tend to encourage good governance.

Hence, even with an adequate number of information intermediaries, effective market discipline with respect to IAH funds may not be brought about as the IAH are generally passive investors and do not tend to react to the information provided to them as indicated in the case studies.
Sara Bank is in a country where the banking supervisor requires its approval to be obtained by an Islamic bank before transferring any loss to IAH. This provides important protection to the IAH and helps to mitigate the possible principal-principal conflict of interest between shareholders and IAH with regard to risk appetite. Such conflicts of interest may arise because shareholders may prefer the bank to invest in assets with a relatively high risk-return profile, as they would benefit from sharing in profits through the Mudarib share, but would not share in IAH losses as the Mudarib does not do so, while IAH may be more risk averse.

The interference of the supervisors is very critical in safeguarding the IAH particularly when there is passive IAH, weak governance and ineffective market discipline.

11.6.3 The Level of Disclosures in the Financial Reports by Islamic Banks

As we noted in the case studies of at least three banks (Ahmed Bank, Mohammed Bank and Sara Bank) they were able to charge a very high, and arguably excessive, Mudarib rate. This situation may be partly attributed to the absence of any disclosure of the Mudarib rate actually charged in the financial statements (which is not required even by AAOIFI Standards) or in the IAH contracts. (As noted below, the Mudarib rate disclosed in the Mudaraba contract is a maximum rate).

Furthermore, even in the cases where the banks have failed to disclose certain information as per the requirements of AAOIFI Standards, they were able to obtain a clean opinion from their external auditors that their financial statements are in accordance with AAOIFI Standards.

For example, in spite of the requirements by AAOIFI Standard on Disclosure of Bases for Profit Allocation between owners' and IAH, Mohammed Bank and Khalifa Bank failed to state in their accounting policies the bases applied by them in the allocation of profits between owners' equity and unrestricted investment account-holders.

Furthermore, both banks failed to comply fully with AAOIFI Standard No. 6 relating to Equity of Investment Account-Holders and their Equivalent. The two banks made no reference in the
notes to the accounts to the percentage of funds of unrestricted investment account-holders which the banks had agreed with them to invest.

From the financial reporting of at least Mohammed Bank and Khalifa Bank, which didn't fully comply with AAOIFI Standards, it seems that there is a failure on the part of the concerned supervision authorities to check on the Islamic banks' proper implementation of AAOIFI's Standards as well as those issued by the IFSB on transparency and market discipline.

Enhancing transparency would involve improving the disclosure of relevant information not only in the financial statements and notes, but also in the IAH contracts with respect to the PDF. As the case studies indicate, the Islamic banks appear to have taken advantage of the lack of disclosures to work primarily for the benefit of the shareholders, to the detriment of the interest of the IAH. Thus, as a result of the information asymmetry the agency problems between the two categories of principals (shareholders and IAH), and between the IAH and the management, worked very much to the disadvantage of the IAH.

11.7 The Role of the Bank Supervisors in Improving the Information in the Financial Reports

As indicated to the researcher by the supervisors of the four banks, they do recognise the importance of developing financial reporting of IIFS in order to develop market discipline and good governance. However, such a claim was not supported by the case studies.

Indeed, if the supervisors of the four banks truly believe in good governance and transparency, they need to improve the quality of information in the IAH contract. This would enable the IAH to assess the performance of the management and to take the appropriate actions which include sanctioning the management by withdrawing their funds once the returns they receive is below the risk they take. This is important to establish good governance.
Islamic banks are required to state in their contracts with IAH the maximum rate of Mudarib rate, which in some Islamic banks can reach 60% of the IAH profits. However, due to lack of transparency and the absence of market conduct, this would tend to give the management of the banks an opportunity to manipulate the rate of Mudarib from one year to another in favour of the shareholders and without informing the IAH.

For example, in years where the bank profits decline, it is likely to give up part of the Mudarib to IAH to avoid IAH withdrawal. This would not enable the IAH to ascertain the actual returns generated on their investments, which in turn would not enable them to assess in an effective manner the performance of the management in managing their funds.

In addition, as the case studies indicate, although the adoption of AAOIFI Standards and participating in the IFSB technical committee would signal to the market that the supervisors do recognise the need to improve financial reporting, nevertheless, the case studies show that in practise the supervisors are passive in enhancing transparency. This could have encouraged the management to work primarily for the interest of the shareholders.

11.8 Concluding Remarks

This chapter has analysed the four case studies with a view to ascertain if there is support to the four propositions put forward in this thesis.

With respect to Proposition 1, the theme emerging from the analysis of the case studies suggests that the existence of concentrated shareholders does not necessarily enable the shareholders to get higher returns. While, the PDF and the Mudarib rate play a determining role in influencing the distribution of returns between the shareholders and IAH to the benefit of the shareholders, their overall effect does not seem to be influenced by the extent of shareholder concentration or the existence of a dominant shareholder.

With respect to Proposition 2, the theme emerging from the analysis of the case studies suggests that SSBS tend to depend on the findings of internal Shari'ah review to issue their report to the shareholders. This means that attention should be given by both the supervisory authorities and
the market players to the work carried out by the ISR since, any failure on the ISR report will affect the SSB report to the shareholders.

With respect to Proposition 3 and proposition 4, the theme emerging from the analysis of the case studies would lead us to expect the supervisors to play an important role to protect small investors such as minority shareholder and particularly the IAH particularly in a market where the IAH are passive investors. However, the theme emerging from the analysis of the case studies does not support the proposition that banking supervisors do recognise the need to improve financial reporting of ITS even if there is currently only a very limited amount of information intermediation since the supervisors are passive in enhancing transparency which encouraged the management to work primarily for the interest of the shareholders.

However, it needs to be recognised that in banking supervision great emphasis is placed on depositor protection, which differs from IAH protection in some crucial respects. IAH are not depositors and do not benefit from the legal protection afforded to creditors. They are a category of equity investor (profit-sharing and loss-bearing) and need the kinds of protection appropriate to the latter. Some banking supervisors such as that of Sara Bank partially assimilate IAH to depositors (i.e. a type of creditor) in giving them some protection from losses of their capital, but this raises the question of whether a cross-sectional approach which recognises the juristic status of IAH as equity investors would not be more appropriate. We will return to this issue in the concluding chapter.
Chapter 12

Implications and Conclusions

12.1 Introduction

This chapter examines the implications of the findings of the four case studies for the literature on corporate governance, so far as Islamic banks are concerned, and presents the concluding remarks of the thesis.

12.2 The Impact of Shareholders Concentration

The findings that emerged from the case studies suggest that the existence of a concentration of shareholders does not necessarily have an impact on the agency problems (principal-principal and principal-agent) between IAH and shareholders on the one hand and IAH and management on the other. In particular the findings indicate that the issue of concentration of shareholders is not the influencing factor that leads to the high dividend yields enjoyed by shareholders compared to the very modest rates of return paid to IAH. The mediating factors are the PDF and the Mudarib rate, but these do not appear to be affected by shareholder concentration or the existence of a dominant shareholder. Managements of Islamic banks adopt policies that produce much higher rates for return for shareholders than for IAH whatever the degree of shareholder concentration. The exception to this among the four banks was, in fact, one that had a dominant shareholder.

There are reasonable grounds to argue that management has an incentive to adopt a PDF and Mudarib rate in such a way as to serve the interest of the shareholders because it is the latter that have the benefit of corporate governance arrangements whereby they appoint the management and monitor its performance.

This has implications for the general corporate governance literature reviewed in Shleifer and Vishny (1996) who argued that concentrated shareholders would manage the agent (management) more effectively in order to protect the interest of all
shareholders and for specific corporate governance issues relating to Islamic banks (Archer and Karim, 2006).

In examining in what way does the PDF and Mudarib rate serve the interest of the shareholders, we come across the phenomenon of leverage in Islamic banking, Al-Deehani, et al (1999) provide theoretical explanations which show how the shareholders tend to benefit through a kind leverage effect, in spite of the fact that unlike in conventional banks where deposits are mobilized on the basis of a creditor relationship with the bank, IAH are profit sharing contracts.

The IAH accounts do not increase the liabilities of the bank because according to the contract that governs the IAH, it does not expose the bank to a financial risk except possibly in the case of misconduct and negligence. Accordingly, the bank would attempt to keep its equity at a minimum and maximize IAH funds because this enables the bank to benefit from the leverage effect as was demonstrated by the case studies.

However, in order to continue benefiting from the IAH, funds, the shareholders make sure that the IAH are satisfied with the bank in terms of the returns paid to them. This is what Archer and Karim (2006) call vicarious monitoring. But the effectiveness of such monitoring from the IAH point of view depends on there being no conflict of interest between the shareholders and IAH.

One situation where there is an apparent conflict of interest is where the bank commingles the funds of shareholders and IAH and invests them in the same asset pool as was the case with Sara Bank. This assumes that the risk appetites of the IAH and the shareholders are similar, which is not necessarily the case. In fact, it is likely that IAH are more risk averse than shareholders. Nevertheless, if both parties are exposed to the same risk of the asset pool, they should be entitled to returns that are commensurate with their risks. However, we have seen from the findings of the case studies that is not the case. The main reason for the discrepancy in the returns of IAH compared to those of the shareholders is the leverage effect which is incorporated in
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the PDF in conjunction with the high percentage of IAH profits that are payable as Mudarib fees. The supervisory authority of Sara Bank attempts to mitigate this situation by requiring Islamic banks in its jurisdiction to obtain its approval before passing losses on to IAH. The use of separate asset pools for shareholders and IAH (i.e. no commingling or only partial commingling) provides an opportunity for taking account of the differing risk appetites of shareholders and IAH. However, owing to the lack of transparency about such matters, it is not clear to what extent, if at all, this works for the benefit of the IAH.

The management of the bank sets out the PDF and the Mudarib rate and is motivated by the governance arrangements to favour the shareholders' interests (whether shareholders are concentrated or not) Islamic banks are usually opaque about the PDF and provide little disclosure about it, as indicated by the case studies.

These findings support the theoretical model in Al-Dehaani et al (1999) which suggests that an increase in IAH funds enables the Islamic bank to increase shareholders' rate of returns through a leverage effect. It is very much in the shareholders' interest that IAH funds be attracted and retained by the bank, but IAH appear to be passive and to tolerate a situation in which their rates of return are low, especially when compared to those enjoyed by shareholders. IAH do not appear to search for the best rates of return available to them on a Shari'ah compliant basis. This would appear to be a feature of an immature market in which the IAH have not learned to seek the most competitive returns from the Islamic banks. Consequently, the latter have little or no incentive to offer them more attractive returns, and every incentive to favour the shareholders. Moreover, the fact that generally there are only a small number of Islamic banks in any one country means that these banks do not have to compete much between themselves to attract IAH funds.
12.3 Compliance with *Shari'ah* Rules and Principles

The findings from the case studies suggest that with respect to the issue of the banks' compliance with *Shari'ah* rules and principles, the structure of the governance mechanism that is entrusted to provide this assurance is rather weak.

In particular, the findings suggest that the independence of both the SSB and ISR can be compromised because of their appointment and remuneration process. Borrowing from the auditing literature, if the SSB and ISR are to perform their duties in a satisfactory manner they should be both competent and independent (Watts and Zimmerman, 1986; Karim, 1990). They should be competent in terms of having the technical knowledge to identify any *Shari'ah* breaches. They should be independent so that they are free to report these breaches.

If the SSB and ISR lack both characteristics, this would not give assurance to the clients of the bank that it is adhering to the cardinal rules on the basis of which it was established. However, one case study (Khalifa Bank) suggests that even when the SSB reported *Shari'ah* breaches for four consecutive years, this did not have a negative impact on the bank in terms of clients withdrawing their funds. Rather, the bank's deposits increased during this period, which suggests a lack of effective market discipline. This could mainly be attributed to the passive attitude of the IAH as investors, which highlights the need for an active role by the supervisors.

However, this is not a straight forward issue because supervisors in different jurisdictions take different approaches to banks' compliance with *Shari'ah*. There are also wide variations in the degree of implementation of the standards issued by AAOIFI (and possibly the recently standards issued by the IFSB).

For example, the supervisory authority in a Gulf country believes *Shari'ah* compliance is the responsibility of the banks. As such, it does not require banks to establish a SSB, but rather leaves it to the market to put pressure on Islamic banks to establish an SSB.
In Bahrain, the Central Bank of Bahrain (CBB) does not only require Islamic banks to establish an SSB, but also requires banks to comply with AAOIFI Governance Standards, e.g. Shari'ah Standards, which means that Islamic banks have to form an SSB.

However, CBB has issued guidelines for Mudaraba contracts and require Islamic banks to implement them. These guidelines require Islamic banks to state in their contract with IAH the maximum rate of Mudarib, the type of expenses that will be borne by the IAH, etc.

Countries such as Sudan, Pakistan, and Malaysia have established higher Shari'ah boards in their respective central banks. The Financial Services Authority (FSA) in the United Kingdom and the Dubai International Financial Centre (DIFC) require banks to establish an effective Shari'ah compliance system. Such a system includes, among others, the establishment of an SSB and an effective Shari'ah internal review.

However, the lack of reaction by the IAH to Shari'ah qualification tends to encourage the management not to take the issue of Shari'ah compliance seriously. This is a sign of weak market discipline. This is exacerbated by the external auditors failing in carrying out their duties and the absence of supervisory authorities enforcing sanctions on banks that do not fully comply with the AAOIFI Standards, even in jurisdictions where these standards are supposed to be enforced by the banking supervisory authority.

The IFSB addressed the issue of Shari'ah non-compliance as part of the operational risk\(^{(35)}\) in its Capital Adequacy Standard (IFSB, 2006a).

\(^{(35)}\) Operational Risk: is defined as the risk of losses resulting from inadequate or failed internal processes, people and systems or from external events, which includes but it not limited to, legal risk an Shari'ah compliance risk. The proposed measurement of capital to cater for operational risk in Islamic bank may be based on either the Basic Indicator Approach as set out in Basel II This definition excludes strategic and operational risks (IFSB, 2006b).
Supervisors may need to play a monitoring role on the work carried out by the SSB and ISR, including the vetting of SSB and ISR members and adopting AAOIFI Governance Standards. We noted from the research that passive reaction by the regulations will lead to weak governance.

**12.4 The Information and the Role of Industry Supervisors**

The purpose of Pillar 3 - market disciplines - is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to react to information provided by banks. The Basel Committee recognizes that market discipline is increasingly important in a world where banking activities are becoming more complex and opaque (Baumann and Nier, 2003, p.134).

SiJben (2002 p.55) argued that a banking system raises an important issue related to the availability of information and transparency both for supervisors and market participant aiming at an appropriate judgment of the soundness of the bank.

Because, unlike conventional bank depositors, IAH place their funds on a profit-sharing and loss-bearing basis, the issue of transparency is more important for Islamic banks than conventional banks. The absence of any control rights for IAH enabling them to intervene in the bank's investment policies (Archer and Karim, 2006 p.136) in no way reduces the importance of transparency, as they need this to be able to make decisions about placing and withdrawing their funds.

The findings of the case studies suggest, however, that IAH are passive and information intermediaries are weak. In addition, there is lack of implementation of AAIOFI Standards and possibly of IFSB Standards. This combination of passive investors and a weak information environment leads to very weak market discipline.

This situation has encouraged the management to work primarily for the interest of the shareholders by using mechanisms of financial leverage that give the shareholders far better returns than the IAH. Furthermore, while IAH, like any investors, are
expected to monitor the bank's choice of risk because their capital is exposed to losses, the lack of adequate disclosure of relevant information makes this a difficult task for IAH, thereby further reducing their ability to exercise market discipline (Archer and Karim, 2006 p.143).

However, as a result of weak governance, the management of Mohammed Bank changed the PDF method; this resulted in paying high divided yield compared with very modest IHA returns.

Furthermore, Islamic banks charge excessive Mudarib rate. This aim to increase the shareholders returns and reduces the IAH returns. Such practices exist in a weak governance and ineffective market discipline. In a well established financial market an effective market discipline exist we would expect that the IAH to withdraw their funds and place their funds with another Islamic bank charging lower Mudarib rate.

Archer and Karim (2006) further argue that IAH lack the means of signaling to the market their assessment of the risks taken by the Islamic bank in order to put pressure on the bank's management via the capital market.

It can be argued that applying regulations that are designed primarily for conventional banks on Islamic banks may have encouraged banks to treat IAH as normal deposits (although the IAH contract says its profit sharing) and hence, pay them returns below the risk that they are taking.

Furthermore, the lack of the ingredient of closer monitoring in Islamic banks does not exist to help the market to regulate itself or to react to the information provided by the Islamic banks. The findings of this study suggest that the weakness of the market discipline means that the supervisors cannot take light supervisory approach, as supposed by Pillar 3 of Basel II. In other words, whereas Pillar 3 assumes that while the market is good enough to discipline the banks through more disclosures and market discipline, in the case of Islamic banks this would not seem to be a realistic
assumption as is demonstrated by the four case studies. Rather, the implication is that bank supervisors would have to play a more active role.

Basel II does not address the issue of investor protection for IAH because it is oriented towards conventional banks which have depositors whose contracts with the bank are debt contracts, not IAH with profit-sharing contracts. The supervisors of conventional banks are concerned with depositor protection. However, due to the nature of Islamic banks, banks' supervisors should be concerned with both depositor protection and investor protection, which implies a broader, more cross-sectoral, approach to supervision. However, this raises the question of the balance to be struck by supervisors between these two kinds of concern. The issue also affects the capital adequacy of Islamic banks, since insofar as IAH are treated as being similar to depositors, the assets financed by their funds need to be included (on a risk-weighted basis) in the Islamic banks' risk weighted assets for the calculation of their capital adequacy ratio (CAR). Hence, in its Capital Adequacy Standard (IFSB, 2006b), the IFSB introduced a factor 'alpha' into the 'supervisory discretion' formula for calculating the CAR. The value of 'alpha' may range from 0 to 1. If the supervisor opts to treat IAH as pure depositors, i.e. the bank is required to make good any losses of their capital, then alpha = 1. If the supervisor opts to treat IAH as pure profit-sharing and loss-bearing investors, then alpha = 0. However, alpha may take a value between these two extremes, depending on the supervisory treatment of IAH.

On the role of financial reporting, even with the full implementation of AAOIFI Standards, it is difficult to claim that an effective market discipline will be developed unless AAOIFI improves its standards. This is because the existing standards don't require important information, including the expenses to be borne by the IAH and the actual returns generated on IAH funds in addition to information required by IFRS 7 which the IFSB Transparency and Market Discipline Standard recommends its disclosure.

In addition, in order to develop market discipline there is a need to enhance transparency. This requires a proper mechanism to act as a watchdog on the
implementation of both AAOIFI and IFSB Standards by the Islamic banks since any shortfall in applying these standards would not help the IAH and shareholders to assess the performance of the management.

IFSB and AAOIFI recognise the importance of obtaining wider acceptance of their standards. This requires the regulators to recognize these standards. So far only four countries use AAOIFI Standards, namely Bahrain, Sudan, Qatar, and Jordan.

12.5 Why the Findings of this Research are Highly Significant

The background to this study is the Basel II document, and especially its Pillars 2 and 3. The Basel II approach to the supervisory review process (Pillar 2) and to transparency and market discipline (Pillar 3) is based on a number of assumptions about the operation of market forces and the information environment which are generally justifiable in the case of developed market economies, but this may not be the case in the emerging market environments in which the vast majority of Islamic banks are situated, including the four banks used in this study.

In fact, the findings of this study cast considerable doubt on the applicability of these assumptions in emerging market environments, with particular reference to:

1. The ability and/or willingness of IAH to carry out monitoring of management on their own behalf, and of shareholders to do so on behalf of the IAH;

2. The attention paid by IAH and shareholders in at least one of the four countries studies to failures of Shari'ah compliance.

In both of these areas, it was clear from the case studies that market discipline was ineffective. Hence, it is not clear that even a major improvement in transparency would lead to effective market discipline. This has major implications for the supervisory review process and the role of banking supervisors in such countries. It is concluded that while they should insist on improvements in transparency, they also
need to play a more active, hands-on role in supervision than that which may be implied by Basel II (and than the role that they may have been playing up till now).

In addition, this research provided empirical evidence pertaining to some major issues in the corporate governance of Islamic banks, with respect to the position of the IAH. Attention to these issues has been drawn in the literature, notably by Archer and Karim (1998, 2005 and 2006) as well as in the IFSB's Corporate Governance Standard for Islamic banks (IFSB, 2006b). However, the findings of this research clearly illustrate how problematic these issues can be from the IAH point of view, and arguably from the banking supervisor's perspective also.

12.6 Research Limitations

The essential limitation of the research performed for this study lies in its exploratory nature. The mainstream literature on corporate governance is only very partially applicable to Islamic banks, which raised problems in constructing the theoretical basis for this study, although the Agency Theory framework provided a valuable starting point, and the literature also contains a few more specialised publications on the corporate governance of Islamic banks that were highly relevant. In addition, the issues to be researched required data, much of which was not available from secondary sources. For these reasons, a case study approach was chosen. Case studies, even when carried out using a multiple embedded case design, as in this research, do not provide a basis for empirical generalisations. Instead, they permit generalisation to theory. This is much more feasible if there is already a relatively well-developed body of theory. However, this was not the case for the corporate governance of Islamic banks.

Notwithstanding this limitation, the research was able to reach the significant findings that were noted above.
12.7 Recommendations for Future Research

This research covers only four banks in three countries. Future research should increase the sample of Islamic banks in different countries. Such research would assist in determining the extent to which the PDF, the excessive Mudarib rate, and the leverage of the IAH have an impact on the distribution of returns to shareholders and IAH.

Furthermore, the survey of this research covers IAH in four banks. Future research also is needed to extend the survey on IAH in more banks in different countries to determine whether the IAH in countries like Malaysia, where the financial market is relatively more developed, would react differently to the information from the sample of IAH in the four banks of this research.

Also future research is needed to cover countries like the UK where at least one Islamic bank is operating in order to that the research proposition in developed markets discipline tend to exist, whether the management strategy in such environment would also work primarily for the interest of the shareholders like in the case of immature markets.

12.8 Concluding Remarks

The concentrated shareholders not necessarily influencing factor that enable the shareholders to work for their own interest.

Rather, there are other factors such as the PDF and the excessive Mudarib rate. This has implications for the general corporate governance literature reviewed and for specific corporate governance of Islamic banks particularly with regard to the importance of leveraging effect to enhance the returns paid to shareholders.

However, lack of transparency encouraged the management to establish PDF to favour the shareholders. Also the passive reaction of the IAH to the very modest
returns paid to them by withdrawing of their funds to research for better returns encouraged the management to continue paying very modest returns to IAH and pay very high dividend yield to shareholders.

Islamic banks operate in a weak governance and ineffective market discipline. In such environment, the bank supervisors needs to take an active role to protect the interest of the IAH; this is important to establish some discipline to the market and gives signal to the management of the Islamic banks that any failure in their fiduciary duties towards the IAH will result in certain measure against the bank.

Such approach is against the Basel Committee new approach which encourages less government intervention in regulating banks and be replaced with adequate disclosures, good governance and effective market discipline.
APPENDICES
Appendix 1.1

Interview Questions with the Management of Islamic bank

1. Given that you have a statutory duty to shareholders and a fiduciary duty to Investment Account Holders, to whom are you accountable? Please explain.
   A. To the shareholders  B. To the Investment Account Holders  C. To all stakeholders

2. Do you rely on the rating agencies in assessing other Islamic banks performance?

3. Do you think the shareholders interest differs from the interest of the Investment Account Holders? Please explain.

4. What is the percentage of concentrated shareholders in your bank?

5. How many of the board members in your bank represent the concentrated shareholders?

6. How do you manage your liquidity? Is the liquidity invested for the shareholders or the Investment Account Holders?

7. Can you explain the formula you use in allocating the return of the Investment Account Holders from those allocated to shareholders?

8. How important is allowing a block of shareholders “concentrated shareholders” to monitor the management of the bank on behalf of Investment Account Holders? Please tick the one which you think is appropriate and explain why:
   1. Very important
   2. Fairly important
   3. Less important
   4. Not very important
   5. Not at all important
Appendix 1.2

Interview Questions with Shareholders

1. What is the contractual relationship between the shareholders and the Islamic bank? Please tick the one which you think is appropriate and explain why:

2. Are you satisfied with the amount of dividends you receive on your investment? Please tick the one which you think is appropriate and explain why:
   1. Fully satisfied
   2. Satisfied
   3. Less satisfied
   4. Not satisfied
   5. Undecided

3. Since the Investment Account Holders bear the risk of loss like shareholders, do you think it is important for the Investment Account Holders to be given a monitoring role like the shareholders to monitor the management to cater for the interest of the Investment Account Holders which is as important as that of shareholders, given that both are equity holders? Please tick the one which you think is appropriate and explain why:
   1. Very important
   2. Quite important
   3. Undecided
   4. Not very important
   5. Not at all important

4. To what extent do you think it is important to allow a block of shareholders "concentrated shareholders" instead of small shareholders "dispersed shareholders" to monitor the management of the bank on behalf of all other stakeholders including the small shareholders & Investment Account Holders? Please tick the one which you think is appropriate and explain why:
   1. Very important
   2. Fairly important
   3. Less important
   4. Not very important
   5. Not at all important

5. Because the salaries and other incentives of the management are decided by the Board of Directors/Shareholders. Do you think this will make the management more bias to the shareholders? Please explain.
6. Do you think the ownership structure, e.g. concentrated shareholders, will have influence on the management to take decisions for the benefit of the concentrated shareholders? Please explain.

7. Do you think the appointment of non-executive Board Members will be for the benefit of the Investment Account Holders? Please explain.

8. Do you think the ownership structure, e.g. concentrated shareholders, will have an influence on the level of disclosures on the financial statements of the Islamic bank? Please explain.

9. What are the following factors you will consider before investing in an Islamic bank? Please tick the one which you think is appropriate and explain why:

   1. The main shareholders
   2. The main Investment Account Holders
   3. The percentage of dividends
   4. The level of compliance with Shari'ah
   5. None of the above. Please specify and explain

10. Since the management is appointed by the shareholders, which of the following is more important for the management to meet?

    1. The management primarily will try to meet the expectations of the shareholders and the Investment Account Holders;
    2. The management primarily will try to meet the expectations of the shareholders;
    3. The management primarily will try to meet the expectations of the Investment Account Holders;
    4. The management will try to meet the expectations of all stakeholders;
    5. Undecided.

11. How important are the financial statements as a tool to provide you with adequate level of information to enable you to assess the performance of the management e.g. Return on Equity, Return on Asset? Please tick the one which you think is appropriate and explain why:

    1. Very important
    2. Fairly important
    3. Less important
    4. Not very important
    5. Not at all important
12. Have you heard of AAOIFI as standard setting body for Islamic financial Institutions? With regard to your investment with the bank, to what extent are you satisfied with the level of information disclosed by the bank prior to the adoption of AAOIFI standards, particularly with no information disclosed on illegitimate funds, priority of investments, expenses charged to Investment Account Holders, smoothing of income? Please tick the one which you think is appropriate and explain why:

1. Fully satisfied
2. Fairly satisfied
3. Less satisfied
4. Fairly unsatisfied
5. Totally unsatisfied

13. With regard to your investment with the bank, to what extent are you satisfied with the level of information disclosed by the bank after the adoption of AAOIFI standards? Please tick the one which you think is appropriate and explain why:

1. Fully satisfied
2. Fairly satisfied
3. Less satisfied
4. Fairly unsatisfied
5. Totally unsatisfied

14. In case the bank has not fully complied with AAOIFI standards, to what extent will effect your assessment on the bank? Please tick the one which you think is appropriate and explain why:

1. Will effect considerably
2. Will effect to a fair extent
3. A little effect
4. No effect
5. Don’t know

15. How important is the role which the Shari'ah Supervisory Board plays in ensuring that the bank’s transactions are in accordance with Shari‘ah precepts? Please tick the one which you think is appropriate and explain why:

1. Very important
2. Fairly important
3. Less important
4. Not very important
5. Not at all important
16. Do you read the Shari'ah Supervisory Board's report on the bank's compliance with Shari'ah principles in its operations? How important is the report as a tool to provide you with adequate assurance that the bank is in compliance with Shari'ah precepts? Please tick the one which you think is appropriate and explain why:

1. Very important  
2. Fairly important  
3. Less important  
4. Not very important  
5. Not at all important

17. How important are the composition and duties of the Shari'ah Supervisory Board in providing stakeholders with adequate assurance that Islamic banks comply with Shari'ah rules and principles? Please tick the one which you think is appropriate and explain why:

1. Very important  
2. Fairly important  
3. Less important  
4. Not very important  
5. Not at all important

18. To what extent does the adoption and proper implementation of the governance standards issued by AAOIFI that relate to the duties and responsibilities of the Shari'ah Supervisory Board give you confidence that the Islamic bank operates in accordance with Shari'ah rules and principles? Please tick the one which you think is appropriate and explain why:

1. Fully satisfied  
2. Fairly satisfied  
3. Less satisfied  
4. Fairly unsatisfied  
5. Totally unsatisfied

19. How important do you think is the role of the external auditors in giving assurance that the accounts represent a true and fair view of the financial status of the bank? Do you think that the external auditor of Islamic banks should also give assurance that transactions conducted by the bank are in accordance with Shari'ah? Please tick the one which you think is appropriate and explain why:

1. Very important  
2. Fairly important  
3. Less important  
4. Not very important  
5. Not at all important
Appendix 1.3

Interview Questions with Internal *Shari'ah* Reviewers (ISR)

1. Can you explain what are the responsibilities of the internal *Shari'ah* unit?

2. To whom are you accountable?
   
   A. Management  
   B. Board of Directors  
   C. *Shari'ah* Supervisory Board

3. Do the bank’s by-laws allow you to carry out a *Shari'ah* review to ensure that the bank’s operations are in accordance with *Shari'ah*?

4. Do you carry out an ex ante review, an *ex post* review, or both, of the bank’s compliance with *Shari'ah*?

5. To whom do you submit your report?

6. Does the bank’s report state that the *Shari'ah* Supervisory Board carries out its duties in coordination with the internal *Shari'ah* unit?

7. Please explain your relationship with the *Shari'ah* Supervisory Board and external auditors.

8. Do you review the bank’s policy and practice of profit distribution between the shareholders and Investment Account Holders?

9. Do you review the bank’s liquidity management policy and practices?

10. Do you discuss the content of the annual report with the external auditors?

11. Have you adopted the AAOIFI internal *Shari'ah* review standard, and if so did it help you in performing your *Shari'ah* audit?

12. The internal *Shari'ah* review or unit is an integral part of the organs of governance of the bank, does this achieve independence for the unit?

13. What is your role if the bank practices income smoothing, use of Profit Equalization Reserve and foregoing *Mudarib* share? Please explain.

14. Do you agree that the *Shari'ah* Supervisory Board’s role is to protect the interest of the Investment Account Holders since the interest of the shareholders are protected by the Board of Directors? Please explain.
Appendix 1.4

Interview Questions with External Auditors of Islamic bank

1. As an external auditors to whom are you accountable? Please tick one of the following which you think is appropriate and explain why:

   A. To the shareholders  
   B. To the Investment Account Holders  
   C. To all stakeholders.

2. Do you think that the management of an Islamic bank considers the interest of the Investment Account Holders as important as the shareholder's interest? Please explain.

3. Do you think that the interest of the management differ from those of the shareholders and Investment Account Holders? Please explain.

4. Do you think by allowing a certain group of shareholders (concentrated shareholders) to hold a significant stake that will enable it to have a monitoring role on the management will work for the interest of the Investment Account Holders and minority shareholders in a way better than a group of dispersed shareholders, and why?

5. Do you think the appointment of non-executive Board Members will be for the benefit of the Investment Account Holders? Please explain.

6. How do you assess your relationship with the Shari'ah Supervisory Board with regard to the bank’s compliance with Shari'ah? Please explain.

7. Do you review the internal systems and procedures of the internal Shari’ah unit?

8. Given that the articles of association of most Islamic banks state that the bank shall conduct its business in accordance with Shari’ah rules and principles, to what extent are you concerned with the level of Shari’ah compliance by the Islamic bank? Please explain.

9. In a conventional banking system, the role of the external auditors is to ensure that the accounts represent a true and fair view of the financial status of the bank? Do you think the external auditor that audits Islamic banks should also ensure that the transactions conducted by the bank is in accordance with Shari'ah concepts to provide such a true and fair view, and why?

10. Do you audit the profit allocation between shareholders and Investment Account Holders, if so how?
11. What is your role with regard to income smoothing, use of Profit Equalization Reserve and foregoing *Mudarib* share? Please explain.
Appendix 1.5

Interview Questions with the Supervisors of Islamic bank

1. What are your main responsibilities in supervising Islamic banks and in what ways do they differ compared to conventional banks?

2. How do you see your role as supervisor in protecting the interests of Investment Account Holders, especially unrestricted Investment Account Holders, given the potential conflicts of interest between Investment Account Holders and shareholders?

3. Insofar as the Investment Account Holders bear a risk of loss (like the shareholders), do you think Investment Account Holders via one or more representatives should be given an opportunity to monitor the bank’s performance? If so, how do you think this monitoring role should be carried out?

4. How do you evaluate the significance of information intermediaries such as rating agencies play in drawing attention to the performance of Islamic banks:
   1. For shareholders
   2. For Investment Account Holders
   3. Minor role

5. Do you think financial intermediaries e.g. rating agencies play a significant role in protecting the interest of the Investment Account Holders (e.g. by Investment Account Holders reading their ratings)?

6. In the absence of an External Credit Assessment Institution (ECAI) rating, or reports from other information intermediaries, what alternative means are available to Investment Account Holders to help them in assessing the bank’s performance? How important do you think banks’ financial reports are for this purpose? How do you see the supervisor’s role in this?

7. How do you see the role of AAOIFI accounting standards in
   • protecting the interests of the Investment Account Holders
   • facilitating the task of External Credit Assessment Institution (ECAI)
Appendix 1.6

Interview Questions with the member of the Shari’ah Supervisory Board

1. What are the responsibilities of the Shari’ah Supervisory Board?

2. To whom are you accountable?
   
   A. Management  B. Board of Directors  C. Shareholders  D. Stakeholders.

3. Does the bank by-law allows you to carry out a Shari’ah review to ensure that the bank’s operation is in accordance with Shari’ah?

4. Do you carry out an ex ante Shari’ah review?

5. Do you carry out an ex post review on the bank’s compliance with Shari’ah?

6. To whom do you submit your report?

7. Is the bank’s Shari’ah report state the role played by Internal Shari’ah Review?

8. Do you review the bank’s formula of distribution between the shareholders and Investment Account Holders?

9. Do you review the liquidity policy of the bank?

10. To what extent do you rely on the bank’s internal Shari’ah audit?

11. To what extent do you rely on the service of the external auditors on issues relating to the bank’s compliance with Shari’ah?

12. What is your role if the bank practices income smoothing, use of Profit Equalization Reserve and foregoing Mudarib share? Please explain.
Appendix 1.7

Interview Questions with Investment Account Holders

1. What is the contractual relationship between you as an Investment Account Holders and the Islamic bank? Please tick the type of contract which you think is appropriate and explain why:


2. Are you satisfied with the level of returns paid on your investments? Please tick one of the following which you think is appropriate and explain why:

   1. Fully satisfied
   2. Fairly satisfied
   3. Less satisfied
   4. Fairly unsatisfied
   5. Totally unsatisfied

3. What criteria or benchmark do you use to decide whether you are satisfied?

   1. Previous years' returns
   2. Other banks' returns
   3. Return on your funds
   4. Level of service
   5. Other criteria

4. If you are unsatisfied, what do you do about this situation?

   - Withdraw most or all of your funds?
   - Other actions?

5. Do you think it is important for the Investment Account Holders [or their representative] to be given a monitoring role like the shareholders in order to ensure that the management gives adequate consideration to the interest of the Investment Account Holders as it does to the shareholders? Please tick one of the following which you think is appropriate and explain why:

   1. Very important
   2. Fairly important
   3. Less important
   4. Not very important
   5. Not at all important
Appendix 1.8

Interview Questions with Investment Account Holders

1. What is the contractual relationship between you as an Investment Account Holders and the Islamic bank? Please tick the one which you think is appropriate and explain why:


2. What is the contractual relationship between the Investment Account Holders and the Islamic bank? Please tick the one which you think is appropriate and explain why:


3. Are you satisfied with the level of returns paid on your investments? Please tick one of the following which you think is appropriate and explain why:

   1. Fully satisfied
   2. Fairly satisfied
   3. Less satisfied
   4. Fairly unsatisfied
   5. Totally unsatisfied

4. Do you think it is important for the Investment Account Holders to be given a monitoring role similar to the shareholders in order to ensure that the management gives adequate consideration to the interest of the Investment Account Holders as it does to the shareholders? Please tick one of the following which you think is appropriate and explain why:

   1. Very important
   2. Fairly important
   3. Less important
   4. Not very important
   5. Not at all important

5. Which of the following factors will you consider before placing your funds with an Islamic Bank? Please tick the one which you think is appropriate and explain why:

   1. The main shareholders
   2. The main Investment Account Holders
   3. The level of returns on your investment
   4. The level of compliance with Shari'ah
   5. None of the above. Please specify and explain
6. Do you read the financial statements of your bank? How important are the financial statements as a tool to provide you with adequate level of information to enable you to assess the performance of the management? Please tick the one which you think is appropriate and explain why:

1. Very important
2. Fairly important
3. Less important
4. Not very important
5. Not at all important

7. In case you do not read the financial statements, whom of the following, do you think should monitor the bank's performance on your behalf?

1. Bank supervisors
2. Rating agencies
3. External auditors
4. Shari'ah Supervisory Board
5. Board of Directors
6. None of the above

8. Do you read the Shari'ah Supervisory Board's report on the bank's compliance with Shari'ah principles in its operations? How important is the report as a tool to provide you with adequate assurance that the bank is in compliance with Shari'ah concepts? Please tick the one which you think is appropriate and explain why:

1. Very important
2. Fairly important
3. Less important
4. Not very important
5. Not at all important
## Survey on Investment Account Holders (IAH)

### 1- What is the contractual relationship between you as an Investment Account Holders and the Islamic bank? Please tick the one which you think is appropriate and explain why:

<table>
<thead>
<tr>
<th>Contract Type</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>a- Mudaraba</strong></td>
<td>48%</td>
</tr>
<tr>
<td><strong>b- Agency (Wakala)</strong></td>
<td>12%</td>
</tr>
<tr>
<td><strong>c- Debt</strong></td>
<td>21%</td>
</tr>
<tr>
<td><strong>d- Unaware</strong></td>
<td>19%</td>
</tr>
</tbody>
</table>

### 2- Are you satisfied with the level of returns paid on your investments? Please tick one of the following which you think is appropriate and explain why:

<table>
<thead>
<tr>
<th>Satisfactory Level</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>a- Fully satisfied</strong></td>
<td>13%</td>
</tr>
<tr>
<td><strong>b- Fairly satisfied</strong></td>
<td>37%</td>
</tr>
<tr>
<td><strong>c- Less satisfied</strong></td>
<td>27%</td>
</tr>
<tr>
<td><strong>d- Fairly unsatisfied</strong></td>
<td>15%</td>
</tr>
<tr>
<td><strong>e- Totally unsatisfied</strong></td>
<td>8%</td>
</tr>
</tbody>
</table>

### 3- What criteria or benchmark do you use to decide whether you are satisfied?

<table>
<thead>
<tr>
<th>Criteria/ Benchmark</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>a- Previous year's returns</strong></td>
<td>20%</td>
</tr>
<tr>
<td><strong>b- Other bank's returns</strong></td>
<td>31%</td>
</tr>
<tr>
<td><strong>c- Return on your funds</strong></td>
<td>16%</td>
</tr>
<tr>
<td><strong>d- Level of service</strong></td>
<td>25%</td>
</tr>
<tr>
<td><strong>e- Other criteria</strong></td>
<td>8%</td>
</tr>
</tbody>
</table>

### 4- If you are unsatisfied, what do you do about this situation?

<table>
<thead>
<tr>
<th>Action</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>a- Withdraw most or all of your funds?</strong></td>
<td>51%</td>
</tr>
<tr>
<td><strong>b- Other actions?</strong></td>
<td>49%</td>
</tr>
</tbody>
</table>

### 5- Do you think it is important for the Investment Account Holders [or their representative] to be given a monitoring role like the shareholders in order to ensure that the management gives adequate consideration to the interest of the Investment Account Holders as it does to the shareholders? Please tick one of the following which you think is appropriate and explain why:

<table>
<thead>
<tr>
<th>Importance Level</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>a- Very important</strong></td>
<td>44%</td>
</tr>
<tr>
<td><strong>b- Fairly important</strong></td>
<td>29%</td>
</tr>
<tr>
<td><strong>c- Less important</strong></td>
<td>13%</td>
</tr>
<tr>
<td><strong>d- Not very important</strong></td>
<td>10%</td>
</tr>
<tr>
<td><strong>e- Not at all important</strong></td>
<td>4%</td>
</tr>
</tbody>
</table>
6- Which of the following factors will you consider before placing your funds with an Islamic bank? Please tick the ones which you think are relevant and explain why:

<table>
<thead>
<tr>
<th>a- The prospective level of returns on your investment</th>
<th>b- The identity of main shareholders</th>
<th>c- The identity of the main IAH. [Could they know this?]</th>
<th>d- The level of compliance with Shari'ah</th>
<th>e- Other. Please specify and explain</th>
</tr>
</thead>
<tbody>
<tr>
<td>52%</td>
<td>16%</td>
<td>11%</td>
<td>21%</td>
<td>0%</td>
</tr>
</tbody>
</table>

7- Do you read the financial statements of your bank? How important are the financial statements as a tool to provide you with adequate level of information to enable you to assess the performance of the management? Please tick the one which you think is appropriate and explain why:

<table>
<thead>
<tr>
<th>a- Very important</th>
<th>b- Fairly important</th>
<th>c- Less important</th>
<th>d- Not very important</th>
<th>e- Not at all important</th>
</tr>
</thead>
<tbody>
<tr>
<td>35%</td>
<td>33%</td>
<td>14%</td>
<td>7%</td>
<td>11%</td>
</tr>
</tbody>
</table>

8- In case you do not read the financial statements, which of the following do you think should monitor the bank’s performance on your behalf?

<table>
<thead>
<tr>
<th>a- Bank Supervisors</th>
<th>b- Rating Agencies</th>
<th>c- External Auditors</th>
<th>d- Shari'ah Supervisory Board</th>
<th>e- Board of Directors</th>
<th>f- None of above</th>
</tr>
</thead>
<tbody>
<tr>
<td>25%</td>
<td>11%</td>
<td>19%</td>
<td>27%</td>
<td>11%</td>
<td>7%</td>
</tr>
</tbody>
</table>

9- Do you read the Shari'ah Supervisory Board’s report on the bank’s compliance with Shari'ah principles in its operations? How important is the report as a tool to provide you with adequate assurance that the bank is in compliance with Shari'ah a precepts? Please tick the one which you think is appropriate and explain why:

<table>
<thead>
<tr>
<th>a- Very important</th>
<th>b- Fairly important</th>
<th>c- Less important</th>
<th>d- Not very important</th>
<th>e- Not at all important</th>
</tr>
</thead>
<tbody>
<tr>
<td>50%</td>
<td>20%</td>
<td>15%</td>
<td>8%</td>
<td>7%</td>
</tr>
</tbody>
</table>

Survey covered 350 IAH. 164 respond. Represent 47%
Interview Questions with the Supervisors of Islamic bank

1. What are your main responsibilities in supervising Islamic banks and in what ways do they differ compared to conventional banks?

2. What would be your responsibility if the Islamic bank undertakes to give priority to meeting the shareholders' expectations over those of Investment Account Holders?

3. Unlike conventional banks, the Investment Account Holders bear the risk of loss like the shareholders, do you think Investment Account Holders should be given a monitoring role in the bank like the shareholders e.g. representation on the board, appointing of management etc.?

4. Are you satisfied with the role financial intermediaries play in assessing the performance of Islamic banks?
   1. Fully satisfied
   2. Satisfied
   3. Less satisfied
   4. Not satisfied
   5. Undecided

5. How important is the role of financial intermediaries in protecting the interest of the Investment Account Holders?
   1. Very important
   2. Quite important
   3. Undecided
   4. Not very important
   5. Not at all important

6. In case Investment Account Holders do not use the service of the rating agency to help them in assessing the bank's performance, who should play that role?
   1. Board of Directors
   2. Shareholders
   3. Shari'ah Supervisory Board
   4. External Auditors
   5. None of the above
7. How important is the role of financial reports of Islamic banks in monitoring the performance of management?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important

8. How important do you think the role plays by AAOIFI financial reports plays a role in protecting the interest of the Investment Account Holders?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important

9. How important is the role played by AAOIFI accounting standards in protecting the interest of Investment Account Holders?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important

10. How important is the role played by the banks supervisors in protecting the interest of the Investment Account Holders?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important

11. In order to supervise the Islamic banks more effectively, how important is it for Islamic banks to adopt AAOIFI and Islamic Financial Services Board standards on disclosures?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important
12. How important is the role played by AAOIFI and Islamic Financial Services Board standards in assisting the rating agencies?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important

13. How important is the adoption of AAOIFI Shari'ah standards in assisting the role of the rating agencies?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important
Appendix 1.11

Interview Questions with the Rating Agency

1. Do you think Islamic banks should be rated differently than conventional banks? If so, what are the main differences?

2. Islamic banks do not have debt (except for current accounts). Is the concept of 'default' applicable to Islamic banks? If so, how is it to be applied? If not, is there another concept that can be used in its place?

3. If the Islamic bank fails to pay Investment Account Holders their profits, would you consider the Islamic bank to be in default?

4. Are you satisfied with the level of information disclosed in the financial reports of Islamic banks?
   1. Fully satisfied
   2. Satisfied
   3. Less satisfied
   4. Not satisfied
   5. Undecided

5. Are you satisfied with the role played by the bank's supervisors in terms of enforcing sound and prudent practices?
   1. Fully satisfied
   2. Satisfied
   3. Less satisfied
   4. Not satisfied
   5. Undecided

6. Are you satisfied with the role that other financial intermediaries play in assessing the performance of Islamic banks? (Please explain more):
   1. Fully satisfied
   2. Satisfied
   3. Less satisfied
   4. Not satisfied
   5. Undecided
7. How important do you think financial intermediaries e.g. rating agencies are in assessing the ability of an Islamic bank to meet its obligations and fulfill its fiduciary duties?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important

8. How important do you think financial reports play in monitoring the performance of management?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important

9. How important do you think financial reports play in protecting the interest of the Investment Account Holders?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important

10. Who should play a monitoring role in assessing the performance of management on behalf of the Investment Account Holders?

1. Board of directors
2. Shareholders
3. Rating agencies
4. Bank supervisors
5. None of the above

11. Are you satisfied with the role played by Shari'ah Supervisory Boards of Islamic banks in giving assurance that Islamic banks operates in accordance with Shari'ah?

1. Fully satisfied
2. Satisfied
3. Less satisfied
4. Not satisfied
5. Undecided
12. How important is the adoption of AAOIFI *Shari’ah* standards by Islamic banks?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important

13. How important is it for the Investment Account Holders to use the services of the rating agencies in assessing the performance of Islamic banks?

1. Very important
2. Quite important
3. Undecided
4. Not very important
5. Not at all important

14. What should be the role of rating agencies in enhancing Market discipline, taking into consideration that Investment Account Holders are not sophisticated investors?
**Appendix 2**

**Comparison between the Four PDFs**

<table>
<thead>
<tr>
<th>Mohammed Bank¹</th>
<th>Khalifa Bank²</th>
<th>Sara Bank³</th>
<th>Ahmed Bank⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The Average Balance</strong></td>
<td>Total Profit ..................................</td>
<td>Net realized profit from after deducting all expenses. ...........</td>
<td>Total Income allocated to IAH proportionate to their investments in the different assets classes ...........</td>
</tr>
<tr>
<td><strong>Less:</strong> the percentage used for liquidity (10%) ...............</td>
<td><strong>Less:</strong> direct expenses related to the pool and specific provisions related to the IAH pool ...............</td>
<td><strong>Less:</strong> the shareholders share in the profit (as fund owner). ...............</td>
<td><strong>Less:</strong> provision for non-performing advances. ...............</td>
</tr>
<tr>
<td><strong>Less:</strong> the reserve kept with Central Bank (5%) ...............</td>
<td><strong>Less:</strong> <em>Mudarib</em> share (it ranges from 30% to 40% based on a decision from the Board of Directors). ...............</td>
<td>Share of holders of unrestricted investment account holders. ...............</td>
<td><strong>Less:</strong> Specific provision. ...............</td>
</tr>
<tr>
<td><strong>The Amount invested for the IAH.</strong> ...............</td>
<td><strong>Less:</strong> profit equalization reserve, at a percentage to be specified by the Board of Directors ...............</td>
<td><strong>Less:</strong> profit equalization reserve. ...............</td>
<td><strong>Less:</strong> Direct expenses relating to IAH investments e.g. feasibility study. ...............</td>
</tr>
<tr>
<td><strong>Profit achieved</strong> ...............</td>
<td><strong>Net profit entitle for distribution to IAH.</strong> ...............</td>
<td><strong>Less:</strong> bank’s <em>Mudarib</em> fees. ...............</td>
<td><strong>Less:</strong> <em>Mudarib</em> share (decided by the Board of Directors). ...............</td>
</tr>
<tr>
<td><strong>Less:</strong> profit equalization reserve. ...............</td>
<td>.............................................</td>
<td>.............................................</td>
<td>.............................................</td>
</tr>
<tr>
<td>Distributable profits. ..................................</td>
<td>.............................................</td>
<td>.............................................</td>
<td>.............................................</td>
</tr>
<tr>
<td><strong>Less:</strong> banks share as <em>Mudarib</em> (up to 65%). ...............</td>
<td>.............................................</td>
<td>.............................................</td>
<td>.............................................</td>
</tr>
<tr>
<td><strong>Less:</strong> the investment risk reserve. ..................................</td>
<td>.............................................</td>
<td>.............................................</td>
<td>.............................................</td>
</tr>
<tr>
<td><strong>Net profit entitle for distribution to IAH.</strong> ...............</td>
<td>.............................................</td>
<td>.............................................</td>
<td>.............................................</td>
</tr>
</tbody>
</table>
1 In 2003 the Bank has changed its method of distribution of profits between the shareholders and IAH from the commingling approach to the separation approach. Under the new method, the IAH will be only entitled for the returns generated from the different form of financing including Murabaha Financing, Leasing, Musharaka.

The bank’s contract states that as Mudarib, it would charge up to 65% of the profit attributable to the IAH. It can also set-aside up to 10% of the IAH funds for maintaining its liquidity.

2 The method of distribution of profits to shareholders and IAH is similar to the method used by Mohammed bank, except that Khalifa bank distributes profits on assets set aside for liquidity management to IAH.

3 The bank uses the commingling approach, which means investing the funds of the shareholders with those of the IAH. All revenue generated is shared between the shareholders and IAH proportionately.

4 The profit distributed to IAH is based on the sharing of profits generated from Murabaha with other banks, including investments in international commodities, consumer finance, and Murabaha financing. All other assets are solely financed by the shareholders and profit are exclusively entitled to them.
## Comparison to the Role and Duties of the SSB

<table>
<thead>
<tr>
<th>Functions</th>
<th>Mohammed Bank</th>
<th>Khalifa Bank</th>
<th>Sara Bank</th>
<th>Ahmed Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Responsibilities</td>
<td>The by-laws under article 4 refer to the establishment of the SSB to act as advisor to the board of directors on <em>Shari'ah</em> matters.</td>
<td>Article 58 (1984) of the bank’s by-laws state that the board of directors should appoint one or more <em>Shari'ah</em> scholars with experience with financial services. Article 60 (1984) state that the board of directors or the management can obtain the SSB’s views on <em>Shari'ah</em> matters. The SSB consists of three board members.</td>
<td>Article 49 of the Bank’s by-laws states that the board of directors can seek the assistance of a religious supervisory board for consultation on <em>Shari'ah</em> matters.</td>
<td>The Bank’s articles state clearly that the SSB will be responsible for monitoring the conformity of the activities conducted by the management to ensure that they are in line with Islamic guidelines as approved by the <em>Shari'ah Supervisory Board</em>.</td>
</tr>
<tr>
<td>2. Appointment of SSB members</td>
<td>The SSB members are appointed by the general assembly following the recommendation of the BOD. This is short of AAOIFI <em>Shari'ah</em> standards. 1- which requires the appointment of SSB members is the responsibilities of the general assembly.</td>
<td>The appointment of the SSB members is the responsibilities of the Board of Directors.</td>
<td>The appointment of the SSB members is the responsibilities of the Board of Directors.</td>
<td>The SSB members are appointed by the general assembly of the bank, whereas the SEC members other than the chairman is appointed by the SSB.</td>
</tr>
<tr>
<td>Functions</td>
<td>Mohammed Bank</td>
<td>Khalifa Bank</td>
<td>Sara Bank</td>
<td>Ahmed Bank</td>
</tr>
<tr>
<td>-----------</td>
<td>--------------</td>
<td>--------------</td>
<td>-----------</td>
<td>------------</td>
</tr>
<tr>
<td>4. Level of Disclosures in the Auditors opinion in relation to auditing standard No. 4</td>
<td>The auditors make no reference in the opinion statement whether the transactions of the Islamic bank are in compliance with the fatwa’s and guidance issued by the SSB of the Islamic bank. Mohammed Bank is required to adopt AAOIFI Shari’ah and auditing standards. This indicates that the external auditors fails to comply with standard No 4.</td>
<td>The auditors make no reference in the opinion statement whether the transactions of the Islamic bank are in compliance with the fatwa’s and guidance issued by the SSB of the Islamic bank. Mohammed Bank is required to adopt AAOIFI Shari’ah and auditing standards. This indicates that the external auditors fails to comply with standard No 4.</td>
<td>The auditors make no reference in the opinion statement whether the transactions of the Islamic bank are in compliance with the fatwa’s and guidance issued by the SSB of the Islamic bank. This bank is not required to adopt AAOIFI Shari’ah and auditing standard.</td>
<td>The auditors make no reference in the opinion statement whether the transactions of the Islamic bank are in compliance with the fatwa’s and guidance issued by the SSB of the Islamic bank. This bank is not required to adopt AAOIFI Shari’ah and auditing standard.</td>
</tr>
<tr>
<td>Functions</td>
<td>Mohammed Bank</td>
<td>Khalifa Bank</td>
<td>Sara Bank</td>
<td>Ahmed Bank</td>
</tr>
<tr>
<td>---------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>5. Reporting line of ISR</td>
<td>ISR reports to SSB. ISR is independent from the management. However, the ISR is an integral part of the organs of governance of the bank.</td>
<td>ISR reports to SSB. ISR is independent from the management. However, the ISR is an integral part of the organs of governance of the bank.</td>
<td>The ISR is conducted through a separate unit within the organ of the bank. The ISR prepare a quarterly report to the chairman of the SEC who is also a member in the SSB.</td>
<td>ISR reports to SSB. The ISR is an integral part of the organs of governance of the bank and it is reporting to SSB.</td>
</tr>
<tr>
<td>6. Salaries of ISR</td>
<td>The salaries and other benefits is decided by the management based on the recommendation of the SSB.</td>
<td>The salaries and other benefits is decided by the management.</td>
<td>The salaries of ISR is decided by the chairman of SEC.</td>
<td>The ISR salaries and other benefits are decided by the SSB.</td>
</tr>
<tr>
<td>7. SSB/ISR Relationship/contact with the External Auditors*</td>
<td>No relation exist between the ISR and the external auditors.</td>
<td>The external auditors of the bank have access to the reports of the ISR to assist them on the bank’s compliance with Shari’ah.</td>
<td>There is no indication to suggest that there is some interaction between the SSB/ISR and the external auditors.</td>
<td>The relationship between the external auditors is limited in discussing the financial reports when the SSB ask for some clarifications on the financial statements.</td>
</tr>
</tbody>
</table>

* All SSB of the four banks use and rely on the work and findings of the ISR on the banks' compliance with their (SSB) instructions.
REFERENCES
References


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