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A consensus-based corporate governance paradigm for Islamic banks

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Abstract

Purpose – Islamic banking is a viable sustainable banking model that has shown resilience to financial crises. The aim of this research is to design a consensus-based ethical and market-driven corporate governance index (CGI) to boost financial performance and ensure compliance with Islamic rulings.

Design/methodology/approach – The design of the CGI is the outcome of the feedback obtained from a cross-country survey to measure bank efforts in enhancing corporate governance (CG) throughout the ten-year period of 2001-2011. The CGI is divided into six core CG themes and 40 sub-themes.

Findings – First, the results of the multiple regression analysis show a consistent positive relationship between CG and financial performance metrics. Second, the authors detect misaligned compensation structures for directors. Third, poor governance leads to higher risk exposures.

Research limitations/implications – CG in Islamic banks is yet an evolving discipline and infant practice. This research aims to introduce a CGI that should be updated and improved as the discipline evolves.

Practical implications – The research concludes by proposing a CG paradigm. The outcome of the research could also be of use to both Islamic banks and to the rapidly growing sustainable banking sector in designing a similar CGI and CG model incorporating the ethical features of sustainable finance.

Social implications – The core ethos of Islam are: avoiding the exploitation of the needy, avoiding excessively risky transactions, avoiding unethical transactions and justice, equity and income redistribution. If properly applied, Islamic banking will display all features of sustainable finance as well as enhance social welfare.

Originality/value – To the best of the authors' knowledge, this is the first CGI that is based on an ethical and all-inclusive input of all stakeholders.

Keywords Corporate governance, Islamic banking, Corporate governance index

Paper type Research paper

1. Introduction: the global community redefining the purpose of banking institutions

Until recently, advocates of the laissez-faire paradigm viewed the unregulated market mechanism as a powerful engine driving increased prosperity. But the global financial crisis (GFC) has raised questions on this formerly established conviction.

JEL classification – G21, G32, P43

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Imprecise credit ratings, complex derivatives and reckless trading were left unchecked, costing tens of millions of people round the world their jobs and homes and pulling the world into an economic downturn of a magnitude not experienced before (OECD, 2008). Yet, the GFC is far from being over. According to the forecasts of the United Nations, world gross product growth is expected to further decelerate, to reach 2.6 percent in 2012 and 3.2 percent in 2013, down from 4 percent in 2010 (United Nations Development Policy and Analysis Division, 2011).

There is a world of difference between Adam Smith's authentic free market model and its contemporary counterfeit form. While many policymakers propagate the laissez-faire model, they overlook that the progenitor of the invisible hand – a professor of moral philosophy – was apprehensive of episodes of economic downturn during which the ensuing unemployed "would either starve, or be driven to seek subsistence either by begging or by the perpetration perhaps of the greatest enormities" (Smith, 1759, 1976). While Smith was an advocate of moral sentiments, the new Keynesians believe that the "limitations of human rationality" legitimize a larger role for the government (Markwell, 2006). But in the wake of the global meltdown, a new sentiment was born among economists calling for an amalgam of adequately regulated markets, harmonized coordination of macroeconomic stabilization policies, enhanced roles of intergovernmental economic institutions and conformity with societal norms (Krugman, 2008).

The responses of the monetary agents to the crisis were confined to globally binding financial regulations, economic stimuli and generous bailouts of mega-banks using the public's money. This has left proponents of business ethics disheartened. Bailing out the emphatically "too big to fail" banks would give them no incentive to change their future behavior. Regulators are already contemplating breaking up financial conglomerates or creating fire walls between the various commercial, investment, asset management and corporate banking activities.

Undoubtedly, a less concentrated banking sector would undermine the power of oligarchic bankers. Suffice it to say that the total assets of the top 1,000 banks of the world amounted to $95.5 trillion in December 2011 (The Banker, 2011). However, the imminent peril is that global regulators continue to embrace the misconception that all risks could and would be eliminated by compliance, when reckless risk-takers consider regulatory loopholes golden profit opportunities (Shari, 2011). Thus, regulatory controls are only one of the key structural reforms that should be combined with macro-economic policies to foster sustained growth. As succinctly indicated by the World Economic Forum's (WEF, 2011) Global Agenda Council, what the global financial system truly requires is a "fundamental reboot" of its institutions. Thus, the world needs to redefine the central purpose of its core institutions to serve the communal interests and to re-establish the principles of sustainability and ethical responsibility.

Surely, the world is moving towards globalization and standardization, making it quite challenging to adopt a homogeneous paradigm. But in order to devise better rules for the globalised financial system, moral values must be included in financial decisions. On the demand side, consumers are becoming more ethics-conscious. Since the financial crisis the sustainable finance market in the UK grew from £14.35 billion in 2008 to £19.28 billion in 2009 (Cooperative Financial Services Group, 2010).

Islamic banking has also spread globally, whereby Islamic banking assets are forecasted to cross $1.1 trillion by 2012 (Ernst & Young, 2011). This is not solely

attributed to the inclination of customers to adhere to ethical practices, but is also due to the ability of Islamic banks to weather financial crises and to record high profits even amid the 1997 Asian Financial Crisis and the 2008 GFC (Čihák and Hesse, 2010). Hence, it is beneficial to investigate the prospect of borrowing some Islamic banking features to maintain financial stability worldwide.

Building a corporate governance index (CGI) and a corporate governance (CG) paradigm is essential to enhance the efficacy of internal governance, boost financial performance, and ensure the banks' compliance with ethical practice. In this paper, we design a CGI according to the feedback obtained from a cross-country questionnaire conducted from January 2010 to December 2011. To the best of our knowledge, this is the first attempt to produce a cross-country empirical survey of the precepts of good CG in Islamic banks. A cross-country analysis is quite helpful since the data on Islamic banking in individual countries is quite deficient.

The rest of the paper is organized as follows. Section 2 elucidates the edicts of the Islamic economics and finance. Section 3 portrays the growth of Islamic banking during the last two decades. Section 4 details the CGI. The final section concludes.

2. Islamic banking: bridging the gap between *Homo-Islamicus* and *Homo-Economicus*

Islam is more than a religion; it is a comprehensive way of living, which necessitates that Muslims fully embrace its rulings and traditions and apply them to all facets of their life: personal, social, economic, financial and communal (Chapra, 1992). The ethos of Islam dictates its application to economic theory and practice, since Islam views the economy as the field where profitable and socially responsible financial relations occur (Ramadan, 2009).

The "principles of the Islamic economy", a term coined by Choudhury (1986) are based on a number of building blocks. The first pillar is the concept of *tawhid* or the uniqueness of God (Quran, 4:1). The second is the principle of work and productivity, which is directly derived from divine unity. Salaries and profits have to be equivalent to the amount and quality of work exerted, otherwise they are considered as sinful (Choudhury, 1990). Third, since the abilities, skills and talents of people are endowments of God, Muslims should behave with humility and learn to live in moderation (Jalibi and Kadir, 1986). The fourth and final foundation of Islam is the principle of sharing and redistributive equity (Quran, 4:5; 8:41; 16:71; 38:24; 59:8-9 19).

But does this imply that Islam rejects capitalism? Naqvi (1981) elaborates that Islam maintains its own equilibrium between economic freedom and the preservation of the ideals of the organicistic society and commutative justice. Hence, Islam does not denounce profit-making, but regulates the way of making and using it (Hosseini, 1992). To realize his project of harmonic development, *Homo-Islamicus* – the Muslim Man – extends the time horizon beyond death and forfeits immediate earnings in return for promoting the interests of his community (Essid, 1995). In contrast, the essence of modern economics is built on the foundation of *Homo-Economicus* – the Economic Man – who "rationally" maximizes utility with little respect to altruism (Iqbal and Llewellyn, 2002). Hence, a stable core of concepts of conventional economics such as rationality, profit maximization, value neutrality, and Pareto optimality is widely accepted by Islam (Hassan and Lewis, 2007).

While Islam clearly defines the economic paradigm, the Islamic law (*Sharia'*) does not explicitly provide precise axioms on which Islamic financial operations could

depend (Asutay, 2007). The prominent Islamic economist, Kahf (1978) explains that, by combining the totality of the *Shari'a* precepts, Islamic banks must become as much investment oriented financial intermediaries as they are agencies of sustainability of the socio-economic order. In other words, the two conceptions of human nature should not be treated as alternatives, but must be combined. *Homo-Economicus-Islamicus* – the Economic Muslim Man – taking into account both present earthly satisfaction and hereafter benefits (Ramadan, 2009).

Islamic banking should serve as an ethical framework for regulating monetary transactions between people, enhancing socio-economic cohesion, uplifting poverty, and preserving the community (Warde, 2000). Ideally speaking, Islamic banks are not required by the *Shari'a* to push their utopianism to the limit. They are allowed to make profits as long as they abide by the following entwined and guiding principles that shape the *Homo-Economicus-Islamicus* paradigm:

- prohibition of the exploitation of the needy;
- avoiding excessively risky transactions;
- avoiding unethical transactions;
- justice; and
- equity and income redistribution.

Consistent with the preamble, Islamic economists explain that earnings must belong to one's own work or to its sharing, and not to speculative activities which exploit exclusively the labour of others (Usmani, 2002). The owners of capital can share profits with the contractor if a surplus occurs from the project itself or from a financial initiative – *istisna'a* principle – provided that the result coming from the use of this capital is not predetermined and that both parties share risks (Saddy, 2009).

To respect this principle Islam separates risk from uncertainty. Future risk can be partly gauged by the interest rate, but Islamic economics does not treat money as a commodity that could be rented out to earn usury money (Glaeser and Scheinkman, 1998). Conversely, uncertainty is consistent with the Islamic principle of *istisna'a* since it is obliges economic actors to operate in a context of symmetric information. But since the revenue from using capital is not predetermined, capital is considered as an input that could earn a surplus from the project or the financial initiative (Choudhury, 1990). Consistent with this theory, a new kind of relation evolves between the owners of capital (*rab-al-mal*) and providers of labor 3 (*mudarib*). Profits and losses are shared between the shareholders, depending on the participation in the economic activity and the investment profitability level (Choudhury and Hussain, 2005).

To bridge the gap between *Homo-Economicus* and *Homo-Islamicus*, Muslims should avoid the three main prohibitions (*haram*) of *riba* or usury; *gharar* or excessive risk exposure; and *maysir* or gambling and uncalculated speculation. Appendix I details the banking activities that the financial principles of the *Sharia'* (*fiqh el-muamalat*) prohibit. Accordingly, the following are the core Islamic banking instruments:

- trade financing and cost-plus mark-up (*murabaha*);
- hire/rental of purchased equipment (*ijara*), with the transfer of the usufruct of property without transfer of ownership;
- profit-sharing (*mudarabah*);

- equity participation (*musharakah*), involving cost-sharing among partners;
- sale and transfer of ownership (*bay*);
- gift (*hiba*), gratuitous transfer of the corpus of property;
- Islamic banking portfolio using secondary financing instruments, such as Islamic stocks and bonds (*sukuk*); and
- shared responsibility and mutual insurance (*takaful*).

Thus, Islamic banking – which basically rests on three broad principles: interest-free financial transactions, profit and loss sharing (PLS) and socially responsible investment – largely resemblances ethical and sustainable finance (Tripp, 2006). Sustainable banking has mutated during the last few decades, deriving its rules from a combination of the social conscience and the market. Even though Islamic banks derive their rules from the *Sharia'*, they combine a number of features that render them truly universal banks (Ariss, 2010). Islamic banks act as commercial banks that accept funds from depositors and deliver various financial services. Islamic banks act as venture capital firms that collect people's wealth, invest in the real economy, and then distribute the profits among customers. Islamic banks act as investment banks and investment partners, becoming partial owners of the business and sharing the consequential risk which constitutes a major relief to clients.

It is perhaps the great similarity in the transactions between Islamic and conventional banks that has prompted the claim that Islamic banking is no more than a mere justification to accept deposits and lend credibly under the Islamic banner (El Gamal, 2006; Zaman, 2008). Conversely, pundits posit that Islamic rules, which forbid the risky business ventures, could lead to a more robust financial system. But to understand the ethical ethos of Islam, it is imperative to analyze the factors that led to the evolution of Islamic banking.

3. The evolution of Islamic banking practices

During the dawn of Islam, financing trade and commercial transactions was characterized by the predominance of direct-equity participation. As Islam spread into new territories, Muslims gradually adopted the financial patterns of the new territories. Village lenders started the tradition of lending their predominantly poor customers at non-abusive and acceptable interest rates, whereby rates above the threshold of 10 percent were considered as usury (Gibb and Bowen, 1960). The first formal Islamic decree or *fatwa* was issued in 1556 allowing interest rates as long as they were within the norms of the society (Faroqhi, 1997). By the sixteenth century, usury was widely accepted and practiced in the provinces of the Ottoman Empire, albeit that it engaged Hindus and Jews (Iqbal and Abbas, 2007). However, pious Muslims refused usury altogether and a number of religious cooperatives were established in the eighteenth and nineteenth centuries to extend interest-free loans to the needy.

3.1 Establishing the precepts of Islamic banking practices

Islamic banking resurrected in the early-twentieth century in India as Muslims felt increasingly threatened by the Hindu rulers (Tripathi, 2004). Figure 1 details the development of Islamic banking since the twentieth century. Loan cooperatives were founded in various Islamic colonized nations as a natural and spontaneous

anti-colonial reaction to Western-style banks, which had no concern for the welfare and solidarity of the community (Kuran, 2004). Fighting the evils of the exploitative interest rates, Islamic financial experts pioneered the reorganisation of banking on the basis of PLS rather than interest (Siddiqui, 1948; Ahmad, 1952). In the predominantly socialist Nasser era, the Egyptian forerunner of Islamic banking, Al-Najjar, integrated the corporative model of the German social market economy in an Islamic juridical context and founded the Mit Ghamr Bank in 1963 (Siddiqui, 1988). A similar experiment was carried out by the Malaysian Government in 1963 when it established the non-banking financial institution Muslim Pilgrim Savings Corporation. But in order to regulate and meet the rising demand for Islamic banking operations, the 1970s marked the government-led and intra-government-led growth of Islamic banks. The Islamic Development Bank was founded in 1973 to act as a multilateral development financing institution that offers its 56 shareholding member states financial and technical assistance based on Islamic principles. While many nations started introducing interest-free banking, Sudan and Iran gradually migrated to a full-fledged Islamic banking system in 1980s.

Analysts attribute the initiation of universal Islamic banking at the turn of the millennium to two factors: the huge oil revenues and the discontent with both Western and socialist paradigms (Khan, 2010; Ayub, 2002). The recent hegemony of Islamic leadership and parliamentary representation in the Arab Spring nations points to the possibility of an increase in the demand for Islamic financial products. But the fact that non-Muslim countries contribute approximately 20 percent of Islamic operations indicates that the resilience shown by Islamic banks as well as the stringent internal governance have earned the confidence of non-Muslim savers (Čihák and Hesse, 2010). As displayed by Figure 2, Islamic assets have significantly surged after the GFC, exceeding US$1.1 trillion, with operations in 74 nations and over 300 financial institutions in 2011.

3.2 Similarities between traditional and Islamic banking practices

While conventional banking instruments are divided into: debt, equity, trade-based, and lease-based, Islamic finance dispenses with debt instruments. But some Islamic bankers are accused of merely changing the terminology for standard debt contracts substituting "profit rate" or "markup rate" for "interest rate" (Kuran, 2004; Healy, 2005). It is also contended that classical Islamic instruments are often adapted to modern needs –*ijara* for operating leases – while others conventional instruments are reverse engineered – *sukuks* derived from bonds – Zaman (2008).

Proponents of Islamic banking argue that in segmented markets the similarities are a necessary transition phase to provide clients with familiar banking products (Ahmad, 1994). But the Islamic financial arrangements invoke drastically different stockholder relationships. Islamic banks are more than financial intermediaries as they

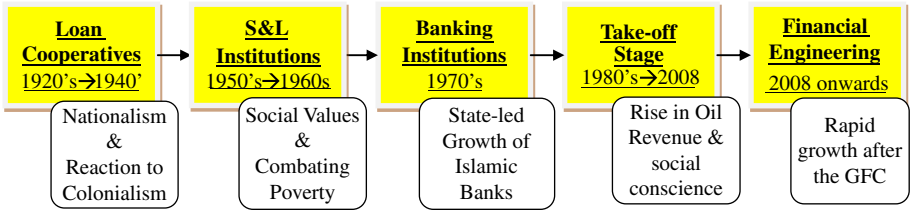
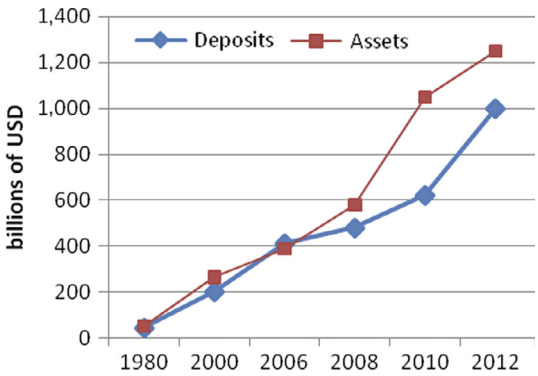


Figure 1.
Development of Islamic banking

Source: Figure prepared by the researchers



Source: Various annual reports of Islamic banks and central banks

Figure 2.
Growth of Islamic banking

enter into partnerships with customers. Depositors have a direct financial stake in the bank's investment and equity participations and are rewarded with profit-sharing for assuming risk. Yet, in the absence of deposit insurance, the CG structure of Islamic banks should be different from the conventional model.

3.3 Comparison between traditional and Islamic models of CG

CG models are created within peculiar epistemological contexts. At one end, the Anglo-American model emphasizes shareholders' interests; at the other extreme, the so-called "coordinated or multi-stakeholder models", associated with both Continental Europe and Japan and to some extent South Korea, recognizes the interests of workers, managers, suppliers, customers, and the community at large (Maasen, 1999). Accordingly, each model would adopt a different system of control. The Anglo-American model depends on a BoD comprising company executives and non-executive directors elected by shareholders. In multi-stakeholder CG models the system is organized on the codetermination of interests. Hence, there are two boards controlling managers' activities: an executive board responsible for supervising daily transactions and a supervisory board to protect the interests of other stakeholders.

Also, based on varying property approaches, each of these CG paradigms has adopted a different legal framework; in the Anglo-American model, executive and non-executive directors are fiduciaries of shareholders, while in others the executive and non-executive directors are fiduciaries of a variety of claimants. Since Islam places the *Shari'a* as the sovereign governing law of all affairs of the banking corporation, we would expect the Islamic CG to share some features with the stakeholders-oriented model (Hassan, 2009). Yet, it is generally protested that CG in Islamic banks does not travel beyond assessing the level of *Sharia'* compliance, at the time when it is meant to ensure that the bank is adequately maximizing well-being as well as shareholders' wealth (Choudhury and Hoque, 2006).

4. The proposed Islamic CGI

Since the Islamic banking sector is yet evolving, we find it functional to conduct an empirical survey to shed light on the level of maturity of the CG practices. Since the legal framework, supervisory regulations, and accounting standards differ from one nation to another,

we design a flexible CGI that includes the basic themes of good CG. We conducted a cross-country survey to measure Islamic banks' efforts in enhancing CG during 2001-2011. The field survey was piloted from January 2011 to December 2011, based on 1,440 mail, phone and internet questionnaires as well as 54 personal interviews with regulators, bank customers, managers and employees of 72 banks in 14 Middle East and Asian nations. The response rate was equal to 78. The financial data is collected from the web site of the Thomson-Reuters-Eikon for emerging markets, Islamic banks and financial institutions information, various central bank web sites and individual banks' financial statements.

4.1 CG mechanisms and themes

Based on the governance characteristics of the Islamic banks in our sample, we introduce the CGI that is entirely consensus-based. In order to avoid possible inaccuracies and subjectivity, it is advisable to base the weights of the CGI on the stakeholders' consensus (Bhagat *et al.*, 2008). Unlike the Glass-Lewis governance-enhanced S&P 500 Index and the FTSE-ISS CGI, our proposed framework is most helpful to the collective stakeholders of the banking firm, but not to the stock traders. An important principle of CG is the nature and scope of accountability of the bank management, and mechanisms that try to decrease the credit, market and operational risk exposure. The fact that bank customers share risks complicates the role of governance since an additional legal operational risk exposure and consumer protection angle have to be introduced.

With this understanding, our respondents gave weights to each of the six CG themes. Then, we gauge the compliance with the CG criteria in Table I. CG scores were collected and collated manually during the field survey and then aggregated as averages throughout the period of the study (2001-2011). Asian Islamic banks show the best CG practices, while the North African banks show the worst. In spite of the fact that Iran, Sudan and Pakistan have introduced full-fledged Islamic banking, their CG practices lag behind Asian Islamic banks.

The next step is to test the correlations between the various CG themes. The results presented in Table II are significant and show that CG themes are highly correlated, albeit that they cannot replace one another, which inspires the construction of a single composite CGI.

4.2 Relation between CG and bank efficiency

Unlike previous research, which is primarily concerned with measuring the relationship between CG practices and stock price performance, we examine the relationship between

CG themes	Attributes per theme	Weight	Average CG score of banks per region: North Africa	Gulf region	South East Asia	Iran, Sudan and Pakistan
Role/expertise of BoD	11	0.25	0.18	0.18	0.22	0.17
Equity structure	6	0.10	0.06	0.08	0.08	0.07
Ownership and control	7	0.20	0.15	0.09	0.15	0.16
Disclosure and transparency	6	0.20	0.11	0.18	0.17	0.17
Compensation schemes	4	0.15	0.10	0.08	0.13	0.13
Governance teams	6	0.10	0.06	0.08	0.08	0.08
Total	40	1	0.66	0.69	0.83	0.78

Table I.
CG scores

	BoD	Ownership and control	Disclosure	Compensation	Governance teams	Equity
BoD	1	0.188***	0.107**	0.251**	0.113*	0.001**
Ownership and control		1	0.331*	0.101	0.412**	0.213*
Disclosure and transparency			1	0.012*	0.229*	0.381*
Compensation schemes				1	0.119*	0.017**
Governance teams					1	0.281*
Equity						1

Note: Significant at: *10, **5 and ***1 percent levels

Table II.
Correlation coefficients

corporate governance (G_{it}) and the efficiency of Islamic banks (E_{it}). We include proxy measures of bank efficiency, which cover:

- growth and sustainability;
- intermediation efficiency;
- profit maximization; and
- reduction of risks.

As a means of checking *Sharia'* compliance we measure the ratio of deposits to the Islamic investment schemes. Table III presents coefficient estimates of equation (1), which examines the relationship between CG and proxies for financial performance within a multivariate context.

$$E_{it} = a_t + b_t G_{it} + c_t X_{it} + e_{it} \quad (1)$$

where, E_{it} is a vector of the efficiency measures of the Islamic bank comprising of:

- dividend yield (proxy for cost of capital);
- price/Earnings or the P/E value (proxy for growth prospects);
- deposits to sum of *musharka* + *mudarba* + *murabha* (proxy for bank's intermediation efficiency);
- Tobin's Q (proxy for wealth maximization);
- ROE (proxy for profit maximization);
- ROA (proxy for operating expenses and provisions);
- staff costs/operating expenses (proxy for labor efficiency);
- Basel II capital adequacy ratio (proxy for risk coverage and compliance with regulations); and
- directors' + executives' remuneration/risk exposure (proxy for risk aversion).

G_{it} is the CGI (0 if the bank scores below the mean threshold for the region and 1 if the bank scores above the mean for the region); X_{it} is a vector of bank control characteristics including:

- log assets' average book value;
- average percentage growth of deposits over the period of the study;

	Yield	PE value	Deposit/invest	Tobin's Q	ROE	ROA	Salaries/expenses	Basel II	Comp
Constant	−0.1643	−0.1833	0.6587	0.3602	0.3659	0.1611	−0.2339	−0.0023	0.7840
	(−1.415)	(−1.441)	(6.13)	(3.17)	(3.22)	(0.833)	(−3.41)	(−0.03)	(9.75)
CG score	−0.9807	−0.886	0.1712	0.8112	0.7328	0.8614	−0.0010	0.0181	−0.0028
	(−8.91)	(−3.20)	(1.02)	(2.98)	(2.88)	(3.01)	(−0.01)	(0.08)	(−0.02)
Log assets	0.1122	0.1152	0.657	0.1191	−0.0267	−0.0511	0.4615	−0.0012	−0.0010
	(9.76)	(10.46)	(5.41)	(8.21)	(−2.43)	(−5.31)	(3.45)	(−0.01)	(−0.01)
%Δ deposits	0.005	0.0019	0.4811	0.0019	0.0025	0.0015	0.0013	−0.0001	0.2466
	(2.61)	(2.05)	(5.18)	(2.3)	(3.12)	(1.68)	(1.67)	(−0.01)	(3.22)
%Δ investments	0.001	0.0022	0.5512	0.0023	0.0019	0.0021	0.0017	−0.0005	0.3178
	(1.96)	(2.79)	(5.99)	(2.11)	(3.33)	(2.01)	(2.31)	(00.02)	(4.26)
Leverage	−0.0029	−0.0025	0.9216	0.0026	−0.0003	−0.0026	0.0025	−0.2248	0.2355
	(−4.78)	(−4.52)	(3.26)	(4.88)	(−0.61)	(−3.87)	(4.35)	(−3.031)	(3.38)
Adj. R^2	0.4634	0.4157	0.4264	0.4194	0.4366	0.4999	0.4253	0.4206	0.4747

Note: *t*-statistics are shown in parentheses

Table III.
Regression analysis

- average percentage growth of sum of (*musharka* + *mudarba* + *murabha*); and
- leverage ratio.

We find a positive relationship between CG and bank performance (ROA, ROE, and Tobin's Q). There is also a positive relationship between CG and compliance with Basel II, indicating that internal governance leads to higher risk coverage. Moreover, the intermediation role of Islamic banks and their utilization of depositors' funds are enhanced by better CG. These results of the regression analysis are consistent with La Porta *et al.* (2002) and Ammann *et al.* (2011).

But we detect a negative relationship between CG and the dividend yield. Black *et al.* (2003) explain that banks with poor CG are forced to pay out high cash dividend because of higher risk exposure. We also detected a negative relationship between CG and directors' compensation schemes, which implies that CG improves misaligned compensation structures in the Islamic banks in the sample.

A perplexing finding is the negative relationship between P/E ratio and CG. This might be due to the fact that stockholders do not fully appreciate the potential gains from enhancing governance practices. There is a negative relationship between CG and the ratio of salaries to expenses, possibly due to the higher costs acquainted with introducing CG.

To test the robustness of the results, we run the regressions separately for each year from 2000 to 2010 with a control factor for each of the four groups. The coefficient results are consistent with the pooled results. Thus, in general, the CGI is financially meaningful and is positively correlated with the financial performance of Islamic banks.

5. Concluding remarks: CG framework

Since the outbreak of the global financial meltdown, there has been a growing demand for ethics and compliance. Islamic banking may serve as a means of imbuing the banking sector with ethical norms. The results of our study show consistent positive relationships between good CG levels and market-based financial performance metrics in Islamic banks. But to ensure an efficient implementation, we propose a three-tier CG framework that serves all stakeholders of Islamic banks.

Figure 3 outlines the structure of the proposed framework that places the societal ethical demands as the core pillar at the very first layer. The required outputs by all stakeholders is decreasing risks, maximizing productivity, enhancing living standards and ensuring an equitable income distribution. The inputs needed for ethical financial transactions are the strict conformity with the Islamic ethos of avoiding risk and unethical transactions whilst going into limited partnerships such that risks and profits/losses are fairly shared.

The second layer of the framework is to reach a consensus or *shura* between all stakeholders and to institute full transparency and responsibility by managers. This entails building up technical and human resources and creating an organizational culture that fosters critical attitude and a disciplined implementation of ethical and *Sharia'*-compliant transactions. The multi-tier internal control system should comprise of:

- The *Sharia'* supervisory board that must give advice and guidance to ensure that all transactions fully comply with the *Sharia'*.
- The BoD should be endowed with technical qualifications to enable it to draft the overall guiding principles, codes of conduct and strategic objectives of the bank.

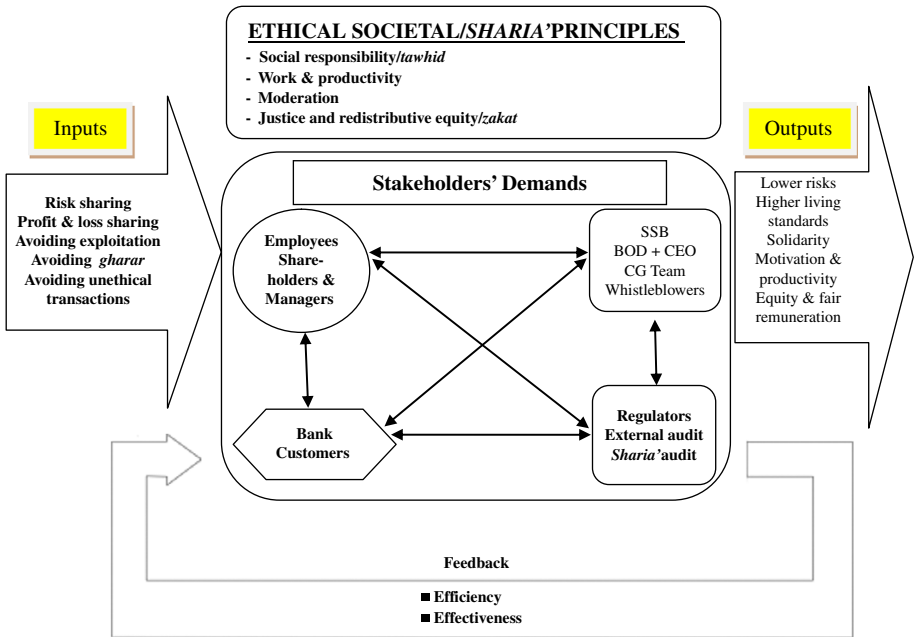


Figure 3.
The proposed CG framework for Islamic banks

Source: Figure produced by the researchers

- The CG team should ensure that there is a transparent procedure for electing the executive and non-executive BoD and overseeing the strict abidance with the codes of CG.
- Whistleblowers should act as the last buffer of the internal control system that sends early warnings of unauthorized operations or of any procedures that do not comply with the regulatory laws of internal rulings.

The final layer of the proposed CG model introduces the component that is imperative for the viability and sustainability of the proposed framework, which is the constant interaction and feedback between stakeholders. This would guarantee a continuous improvement in order to efficiently and effectively meet the societal objectives. However, the success of this framework hinges on the creation of an enabling environment that promotes legal protection for stakeholders, including minority shareholders and depositors. Equally important is the level of morality of the directors and *Sharia'* supervisors. Finally, without an autonomous socio-political environment and a robust economic environment all efforts to enhance governance will indeed prove to be fruitless.

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Appendix 1. Prohibition of *haram* transactions

The following are *haram* (prohibited) transactions by Islamic banks:

(1) Directly investing in alcoholic beverages and tobacco products.

(2) Operations with supermarkets and grocery stores dealing in *haram* goods such as pork, alcohol, and tobacco.

(3) Operations with restaurants and hotels with bars, gambling or other prohibited activities.

(4) Operations with firms or individuals providing unethical amusement and recreational services.

(5) Life insurance.

(6) Operations with financial institutions which directly or indirectly have the following dealings:

- interest income ratio of more than 5 percent;
- leverage ratio of more than 33 percent; and
- liquid assets less than 60 percent of total assets.

Appendix 2. CG themes

Role, expertise and composition of BoD

(1) Annual selection of BoD.

(2) Prohibition of simultaneously acting as CEO and chairman.

(3) No former CEO should be allowed to be a the member of BoD.

(4) 50 percent of BoD are external and independent qualified members.

(5) Size of BoD should range between 9 and 13 members.

(6) A maximum of two terms for each of the CEO and BoD.

(7) Mandatory retirement age for the CEO and BoD.

(8) At least one member should be qualified with *Sharia'* precepts.

(9) At least one member should be qualified with CG guidelines.

(10) No staggered board.

(11) External advisors for the BoD comprising of business, legal and financial experts.

Structure of equity ownership

(12) All executives should own 1-5 percent of shares.

(13) Limiting block ownership to two individuals/entities.

(14) The top five directors should not own over 15 percent of bank stock.

(15) The same three rulings apply to shareholders' relatives till second degree.

(16) Executive and director traditional stock ownership guidelines.
(17) Executive and director "retention" and "holding period" stock ownership guidelines.

Separation of ownership and control

(18) BoD cannot amend laws/bylaws without consent of shareholders.
(19) Cumulative voting rights.
(20) One vote per ordinary share.
(21) No shareholder/groups of shareholders granted majority voting rights.
(22) Performance of BoD is annually reviewed at the annual general meeting (AGM).
(23) Shareholders are allowed to call for special meetings.
(24) Forbidding related-party transactions for directors, executives, managers and auditors.

Disclosure and transparency

(25) Publishing financial details of the bank.
(26) Disclosure of auditors' reports during the AGM.
(27) Disclosure of strategic and operating plans.
(28) Disclosure of major decisions of audit, governance and remuneration committees.
(29) Disclosure of donations of revenue from non-compliant transactions.
(30) Disclosure of the bank's CG guidelines.

Compensation schemes

(31) Remuneration of directors solely decided by a committee of external directors.
(32) Remuneration of SSB members solely decided by a committee of external directors.
(33) Remuneration approved by shareholders.
(34) Shareholders' votes on re-pricing stock options.

Auditors and supervisors

(35) *Sharia'* supervisory board has at least three highly accredited scholars.
(36) Members of bank's SSB should not serve on SSB of another bank.
(37) Detailed religious analysis of decisions have to be published by SSB.
(38) *Sharia'* auditors must countercheck decisions of SSB.
(39) No equity ownership by any of auditors.
(40) CG team checks compliance with CG procedures.

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