

## Best practice in bank corporate governance: The case of Islamic banks<sup>1</sup>

*Bchr Alatassi<sup>2</sup>, Steve Letza<sup>2</sup>*

**Abstract:** Islamic banks are growing rapidly with annual growth rates of 17.6% between 2009 to 2013 and 19.7% from 2014 to date. This level of growth is projected to continue into the future. Islamic banks now operate in more than 75 countries with a value of approximately \$920 trillion of bank assets. Islamic banks are increasingly being seen as good long-term value propositions and are serving both Muslim and non-Muslim customers across international markets. Despite the rapid growth in Islamic finance, the underpinning corporate governance rules and regulations are at an embryonic stage of development with little attention having been paid to them. The purpose of this paper is to help fill that gap by exploring a conceptual model of corporate governance for Islamic banks based on both Islamic finance principles while fused with elements of corporate governance standards from Western theories and codes, primarily the UK, and thereby ensure that good governance is in place in Islamic banks. The paper links the predominant corporate governance theories of Principal/Agent, Stakeholder and Stewardship with practice based corporate governance codes and explores the potential of applying stewardship theory to Islamic banks. Islamic principles emphasis is on real assets rather than debt as is the case in Western Banks and as a consequence this paper offers the conclusion that the more prudent approach to banking used by Islamic banks could be used as a model for Western banks and thereby deliver a more sustainable future and maintain confidence in banks and substitute for the need for taxpayer support, such as the guaranteed deposit scheme, which acts as a backstop under the Western approach.

**Key words:** corporate governance, Islamic banking, stewardship theory.

**JEL codes:** G30, G39, G34, G21.

---

<sup>1</sup> Article received 13 May 2018, accepted 24 September 2018.

<sup>2</sup> Bournemouth University, Executive Business Centre, Bournemouth, 89 Holdenhurst Road, BH18 8EB, United Kingdom, sletza@bournemouth.ac.uk.

## Introduction

In an article in the Guardian newspaper (2014 December 4) entitled “Could Islamic finance save capitalism?” Irfan (2013) posed the question: Where is there a place for ethics and morality in the global economy? He went on to question whether it is sufficient to rely on governments and central banks to tweak at the margins of financial regulation or whether the global economy is in need of a root and branch reformation, effectively a revolution in capitalism. At around the same time London became the first non-Muslim city to host the world Islamic economic forum at which David Cameron, the then prime minister of the UK, announced the intention to create a £200 mln Islamic bond. With this backcloth it may be opportunistic for the UK to further develop Islamic finance as part of a bigger post-Brexit strategy as post-Brexit UK becomes a reality.

Islamic banking is different from its Western counterparts primarily due to a difference in focus. Islamic banks focus on asset values, viewed as actualities, while Western banks are credit focused, essentially future potentialities. Western banks attempt to assess future income streams when assessing whether to loan money, a case of potentialities rather than actualities. Islamic principles have been suggested as a solution to the failings in western banking, failings which manifested themselves in the 2007/8 banking crisis. Unpalatable as the idea of religion and dogma may seem at first sight to scientific focused eyes, leaving the religious aspects to one side and instead focusing on the principles and philosophy developed over hundreds of years in the Islamic tradition provides a reassuringly prudential approach to decision making which resonates well with sound economic thinking.

Modern banks began offering sharia-compliant products in the mid-1970s. Since then it has grown into a global industry with total assets of around \$920 trillion (Ernst and Young, 2016). The spectacular growth in Islamic banks over the last 10 years with annual growth rates averaging 17.6% between 2009 to 2013 and 19.7% from 2014 onwards (Ernst and Young, 2015) suggests that Islamic banks have a value proposition that is attractive to the global investing community from both Muslim and non-Muslim persuasion. To date, corporate governance in the banking sector has been researched almost exclusively in terms of conventional, western banking systems. Despite the rapid growth of Islamic finance over the last two decades, research into corporate governance in Islamic banks is still at an early stage (Archer & Karim, 2007; Mollah & Zaman, 2015).

The aim of this paper is to fill a gap in the knowledge and understanding by exploring the idea of fusing principles of Islamic finance with elements of mature Western corporate governance codes and established theories underpinning corporate governance in order to model existing Corporate Governance practice in Islamic banking and to propose a conceptual model of best prac-

tice for future discussion amongst interested parties. The paper considers fully-fledged Islamic banks it does not consider Islamic windows which have been developed by some Western banks as an extension to their conventional banking offerings.

This paper begins by considering both corporate governance theorising in general, then examines Islamic finance, Sharia and other forms of Islamic legal and moral systems. The methodology adopted in the paper follows a qualitative philosophy with an exploratory focus on conceptualising Stewardship theory as the principle theory of relevance to corporate governance in Islamic banks. The paper goes on to develop and discuss a proposed conceptual framework which is intended to be helpful in understanding the gaps between practice in Islamic and western banking systems, and points towards the conditions needed for development of a code of best practice aimed specifically at Islamic banks.

Early in the development of European corporate governance standards Cadbury (1992, p. 15) defined corporate governance as "...the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place."

While the literature on corporate governance has widened considerably beyond this 25 year old definition, in a narrow sense the above definition incorporates the mechanisms used internally within corporations to monitor managerial decisions and evaluate firms' performance. In moving beyond the financial aspects in which Cadbury is set, it is helpful to consider contextual issues. Solomon (2013) says, for example, that corporate governance is affected by the local culture and regulation and consequently corporate governance might differ from one country to another (Nordberg, 2011; Solomon, 2013). The cultural impact on corporate governance is at the heart of this paper and the premise that one-size does not fit all.

Drawing on the above, Islamic Financial Institutions (IFIs) were outlined by Warde (2000, p. 5) as "those that are based, in their objectives and operations, on Koranic principles. They are thus set apart from 'conventional' institutions, which have no such preoccupations."

In particular, Khan and Mirakhor (1989, p. 40) defines Islamic banks as ones in which "...depositors are treated as if they were shareholders of the bank. Consequently, depositors are not guaranteed the nominal value, or a predetermined rate of return, on their deposits. If the bank makes profits, then the shareholder (depositor) would be entitled to receive a certain proportion of these profits. On the other hand, if the bank incurs loss the depositor is expected to share in these as well, and receive a negative rate of return."

The Central Bank of Malaysia (2014, p. 3) defines Investment Account Holders (IAHs) as "Investment Accounts such as Islamic deposits on current account, deposit accounts, savings accounts or other similar accounts (e.g. general

investment account and specific investment account) under any Sharia contract which is non-principal guaranteed”. Drawing upon the ideas above, this paper investigates the extent to which stewardship theory is appropriate for Islamic banks and specifically of relevance to the investment account holders (IAHs).

The paper is structured as follows: firstly, this paper provides a literature review drawing on the received wisdom in corporate governance in terms of the fundamental theories underpinning corporate governance rules and principles and the significance of corporate governance in banks with a specific focus on Islamic banking. This section concludes with the literature of active shareholding and their role in enhancing a stewardship culture. Secondly, the paper presents two models. Figure 1 provides a conceptual model based on the UK Stewardship Code published by the Financial Reporting Council, initially in 2010 in response to the collapse of major banks in the UK, and then revised in 2012. To our knowledge no other researchers have attempted to provide a diagrammatic presentation of this code. In addition, Figure 2 provides the main conceptual model introduced by this research. The model engages with the unique requirement of Islamic banks’ governance in general and the case of Investment account holders in particular. Moreover, it utilizes three leading theories of corporate governance: Agency theory, Stakeholder theory and Stewardship theory, the last of these being the distinguishing theory. After, a discussion of the limitations of this research and recommendations for future research will be provided. The paper concludes with a summary of the main ideas and an elaboration of its potential significance for practice and policy. The principle contribution lies in examining the unique position that IAHs play in Islamic banks.

## **1. Literature review**

### **1.1. The importance of corporate governance**

The interest in corporate governance has increased rapidly over the last two decades driven by catastrophic scandals all around the world such as Enron in the US, Royal Bank of Scotland in the UK, Parmalat in Italy, China Aviation oil and many others (Letza, Kirkbride, Sun & Smallman, 2008; Letza, 2017; Mallin, 2013). Therefore, there is a perceived universal need for robust and effective governance structures in order to protect all stakeholders from such collapses.

Cadbury (2002) argued that corporate governance is a key driver in the world’s economic and political strategies due to the significant growth of international businesses. Supporting Sir Adrian Cadbury’s contention are several research projects that conclude that countries with developed corporate governance structures attract more investors. Moreover, corporate governance plays a key role not only in protecting the interest of existing shareholders but also

in attracting potential investors. Thus, corporations need a robust and transparent internal governance structure and a sound regulatory environment in order to sustain and compete in international markets (Cadbury, 2002; Abu-Tapanjeh, 2009; Mallin, 2013).

## **1.2. Theoretical underpinning**

'Corporate Governance' as a term and its daily usage in both the press and academic literature is a relatively new phenomenon of the last three decades (Mallin, 2013). However, the main theories which participated in evolving and shaping the contemporary corporate governance models could be traced back to earlier years (Clarke, 2004; Mallin, 2013). Additionally, Mallin (2013) highlighted that corporate governance theories were influenced by different aspects including; finance, economics, accounting, law and organizational behaviour. According to Mallin choosing the appropriate theory in corporate governance is affected by various aspects such as the corporations' culture, activities, time frame, and ownership structure and notably in which country/ countries the corporation operates.

Two theories dominate the literature on corporate governance, principal/agent theory and stakeholder theory. These theories are often presented by their relative supporters as the fundamental model underpinning corporate governance. This has resulted in the debate on corporate governance being polarised into two camps, the shareholding theory camp with an emphasis on principal/agent theory and stakeholder theory camp emphasising a wider range of interested parties such as; customers, employees, suppliers, lenders, society and shareholders (Jensen, 2001; Letza, Sun & Kirkbride, 2004; Mallin, 2013), with each camp claiming superiority over the other. The debate presents a seemingly natural division between the two, either one or the other, with apparently no opportunity for consideration of merge between the two. However, an alternative view is presented by Letza and Sun (2004). They suggest that instead of a clear-cut stable boundary between the two theories where a static and entitative conception is presented in the real world of Boardrooms, decisions will be made and policies agreed based on a dynamic analysis of the constantly changing organisational environment where both the shareholder and stakeholder perspectives are constantly being debated and considered. Consequently, the perceived theoretical division between shareholders and stakeholders exists only in theory and not in practice. They proposed a processual approach to the understanding of corporate governance where both the shareholder theory and the stakeholder theory are seen as relevant and applied in practice when circumstances dictate their application. Thus, it is concluded that there is no one "best fit all" theory for all countries and corporations. In conclusion, many scholars such as (Jensen & Meckling, 1976; Davis, Schoorman & Donaldson, 1997; Jensen, 2001; Clarke, 2004; Letza et al., 2004; Letza & Sun, 2002; Mallin,

2013; Nordberg, 2010) associate the concept of corporate governance with three main theories: agency theory, stakeholder theory and stewardship theory. Nonetheless, theories that are deliberated in the literature go well beyond the three and include many other theories such as class hegemony, managerial hegemony, transaction cost theory, institutional theory and prospect theory (Mallin, 2013; Cuevas-Rodriguez, Gomez-Mejia & Wiseman, 2012). The three theories discussed above are the most commonly referred to when considering corporate governance of both Islamic and conventional banks (Obid & Naysary, 2014).

### *Shareholding versus Stakeholding*

One of the major dilemmas in corporate governance is identifying the purpose behind corporations and whose benefit it should be serving. The debate in the corporate governance literature is polarised into shareholding and stakeholding models (Letza et al., 2004).

Friedman (2007) claimed that all of the business's activities and managers' decisions should focus on generating maximum profits and maximising shareholders' value. Furthermore, Davis et al. (1997) argues that as both agents and principles aim to maximise their own utility based on the assumption of the 'homo-economics' model of man, where directors as opportunistic and self-serving. The main objective of the agency theory is to reduce the agency cost arising from the divergence in principal-agent interests. Therefore, agency theorists provide several governance mechanisms which could be applied to achieve that goal including financial incentive schemes aimed at aligning principal and agent interests or a governance structure aimed at controlling the agent.

Freeman (2010) argued that maximising owner's wealth could only be achieved by taking into consideration all stakeholders' interests. Furthermore, Jensen (2001, p. 13) moves to an enlightened standpoint by claiming that as "firms should pay attention to all their constituencies, the theory is unassailable. Taken this far stakeholder theory is completely consistent with value maximization or value-seeking behaviour, which implies that managers must pay attention to all constituencies that can affect the value of the firm."

Jensen (2001) introduced the enlightened value maximisation which adopt the classic stakeholder theory principle as long as it participates in creating long-term value maximisation and not only short-term profits. On the other hand, Mallin (2013) describes the stakeholder theory as the 'juxtapositions' to the agency theory that focuses on a wider range of people that are affected in the decision making process including employees, suppliers, customers, lenders and governments. Furthermore, corporate governance mechanisms including monitoring processes and board construction might differ based on the country of operation. For instance, the so-called Anglo-Saxon model of corporate governance emphasis on maximising the shareholders wealth where in other

models such as the German and Japanese models tend to take a long-term strategic view and embrace a broader prospective.

Many scholars in Islamic finance claim that Islamic banks should adopt a “societal model” which acknowledges the rights and needs of substantial stakeholders including depositors, investment account holders and employees (Graiss & Pellegrini, 2006; Archer & Abdel Karim, 2007; Iqbal & Mirakhor, 2007).

### *Agency theory versus Stewardship theory*

Corporations are the spine of all advanced economies in the world. Most of these corporations evolved from small trading entities enabling their stockholders to trade in regional markets, and in some cases multibillion dollar corporations trading in global financial markets. As these corporations grow, for most the entrepreneurial founders transfer the running of the business onto professionals giving rise to separation between ownership and management. Governing firms requires a professional level of monitoring of all fundamental components including strategy, human forces, marketing, financial accounting and structure also assuring their stakeholders that all mechanisms are in harmony (Nordberg, 2010).

Agency theory is a key factor in shaping corporate structure and business policies. Agency theory was founded on the assumption that directors (Agents) and owners (Principals) are both attempting to maximise their own utility, often referred to as ‘slack’. In its original form, agency theory adopted a simplistic approach of two actors, namely, agent and principal (Jensen & Meckling, 1976; Davis et al., 1997). Davis et al. argue that there is a perceived need for a new theory which is able to explain the complex nature of organisational behaviour. Additionally, this theory should aim to explore the affairs in corporations taking into consideration non-economic factors.

Stewardship theory was introduced as a revolutionary concept able to explain relationships based on other noneconomic behavioural assumptions (Donaldson & Davis, 1991; Davis et al., 1997). Rather than management being seen as utility maximisers as proposed in agency theory, stewardship theory views management as stewards unlike agency theory which requires either incentives or a monitoring mechanism to ensure harmony. Stewardship theory is capable of introducing an element of trust in the agent to deliver harmony. Davis et al., (1997) states that stewardship theory and agency theory are complementing each other, and there is no one-best-way of thinking and therefore, there is no perfect theory. However, reconciliation is required to differentiate between both theories and be able to determine which one suits best the organisation’s circumstances to achieve the best outcome for major stakeholders.

The agency problem was recognized in the literature of Islamic finance by many scholars such as Safieddine (2009), Obid and Naysary (2014). Moreover, Safieddine (2009) argued that Islamic banks suffer from a more complex agency problem accrued from the separation of not only management and ownership

but also from the separation between cash flow and control. Therefore, any attempt to develop a corporate governance model of Islamic banks should take into consideration the additional complexities of agency. On the other hand, some scholars, including Bhatti and Bhatti (2009), Obid and Naysary (2014), argued that corporate governance in Islamic banks should be based on the stewardship theory since all the parties of the bank are viewed as stewards and perform their duties in the 'spirit of partnership in line with Islamic beliefs'. Finally, Obid and Naysary (2014) present what they call a 'development of an integrated theoretical framework of Sharia governance'. This theoretical framework represents the relationships between the three main theories deliberated in Islamic banking. Obid and Naysary go on to discuss these relationships from a theoretical stand and suggests how it might lead to a better governance performance. However, Obid and Naysary's ideas are not linked to practice nor do they discuss the internal mechanisms of Islamic banks. Nonetheless, this framework enhances the idea of 'one-size does not fit all' from a theoretical prospective and supports the adaption of the three main theories as discussed above.

### **1.3. The significance of corporate governance in banks**

Financial institutions in general and banks in particular have caught the attention of scholars and governments over the last three decades due to their major influence on an economies' progression (John, De Masi & Paci, 2016). Corporate governance of banks has also caught the attention of policy makers and academics due to banks significant role in society (Macey & O'Hara, 2003; Levine, 2004; Walker, 2009; Dermine, 2013; de Haan & Vlahu, 2016; John et al., 2016).

Archer and Abdel Karim (2007) argued that corporate governance in all banks, irrespective of any specific nuance such as Islamic or Western, should be the subject of particular attention and requires a unique governance structure due to three main factors. Firstly, banks are more "opaque" than other corporations, which causes more complex agency problems. Secondly, the heavy regulation facing the banking sector provides much greater externally imposed control than most sectors. Thirdly, significant government ownership of many banks resulting in concentrated shareholding and consequently the conventional understanding of the principal/agent theory based on dispersed shareholding is of lesser significance.

Extending the work of Archer and Abdel Karim (2007) John et al. (2016) claim that banks suffer from a more complex agency problem than non-financial firms due the significance of debtholders and divergence between shareholders' interests and debtholders' interests. John et al. (2016) stated that banks are unique and therefore it should be treated with a higher level of attention. The uniqueness of the banks could be attributed to many elements. Firstly, for most banks the leverage ratio, measured as the ratio of debt to equity, is very



high, often 90 percent, while in the non-financial sector the leverage ratio rarely exceeds 30 percent. Secondly, the conflict between shareholder-debtholders mentioned earlier. Thirdly, banks are key players in society and potentially could have a larger impact on a wider range of stakeholders than non-financial firms, the 2007/8 banking crisis is an example of this wider impact. Finally, as discussed above, banks have a complex and an opaque asset structure which might necessitate a more complex governance mechanism.

#### 1.4. The case of Islamic banks

Warde (2000) argues that the definition of an Islamic bank is much deeper than the popular view of “interest-free” banks. It includes a wider variety of products and services that are compliant with fundamental Islamic principles. Warde (2000) and Iqbal and Mirakhor (2007) highlight two main features in Islamic banking. First, Islamic banking is based on the risk-sharing model i.e. lenders and borrowers must participate not only in profits but also in losses. Second, Islamic banking pays major attention to economic development and seeks to develop social well-being through specific investments and utilizing alms-giving known in Islam as “Zakat”. Zakat was defined as “the compulsory giving of a set proportion of one’s wealth to charity” (*Religions*, 2009), this applies to both individual and institutions. Despite the rapid growth of Islamic banks there is a gap in the literature on corporate governance in Islamic banking (Abu-Tapanjeh, 2009; Abdullah Saif Alnasser & Muhammed, 2012; Muneza & Hassan, 2014; Mollah & Zaman, 2015).

The governance structures in Islamic banks differ from similar counterparts in the west. This divergence is largely attributed to the unique business model of IBs since these institutions include unique items in their balance sheets such as alms-giving. Additionally, IBs require a secondary board known as a Sharia supervisory board (SSB), the objective of the SSB is to assure all stakeholders that the banks’ activities and investments are in line with Sharia law (Abdullah Saif Alnasser & Muhammed, 2012). Consequently, IBs require a unique comprehensive governance structure enabling all additional elements unique to Islamic finance to be captured.

Archer and Abdel Karim (2007) and Abdullah Saif Alnasser and Muhammed (2012) argued that a good governance structure requires aligning the interest of the banks’ management with its wide range of stakeholders not only the bank’s shareholders. Additionally, there is a substantial need for a proper incentive scheme that allows a more effective supervisory mechanism to motivate managers to be more efficient in allocating banks’ resources. Finally, complying with Sharia rules and principles is essential to establish a relevant governance structure in order to avoid any reputational damage.

IBs consist of two boards: the traditional Board of Directors (BODs) and a Shariah Board (SB) as with the traditional role of non-executive directors,

the role of the SB fluctuate from advisory to supervisory depending on the regulations and codes of the countries in which they are operate and provide an audit of the banks' activities to make sure that they are compliance with Sharia principles. Furthermore, the divergence in the governance structure is not limited between IBs and its counterparts in the conventional markets but also between IBs in different Muslim regions such as the study by Grassa and Matoussi (2014) which found that board structure is affected by cultural, social and economic factors in GCC and Southeast Asia.

Moreover, Grassa and Matoussi (2014) claimed that corporate governance in IBs is required to be different from its conventional counterparts in three substantial areas; Firstly, All IBs must comply with the Shariah law consequently any non-compliance risk might lead to reputational damage and financial losses. Secondly, the role of the investment accounts holders (IAHs) and their unique role in IBs. Thirdly, the argument by (Claessens, 2006, cited in Grassa & Matoussi, 2014) that IBs generally operate in less transparent systems and weaker regulated and monitored markets.

All the above underpin the importance of having a unique governance structure for Islamic banks. As Chapra (1992, p. 19) citing the famous Islamic philosopher Al-Ghazali (died 1111) states "The very objective of the Shari ah is to promote the welfare of the people. Which lies in safeguarding their faith, their life, their intellect, their posterity and their wealth. Whatever ensures the safeguarding of these five serves public interest and is desirable." From the above quote we can see that Sharia emphasis is on society and the need to ensure a stewardship of the assets under management.

Drawing upon the Ideas of leadership highlighted in the Islamic principles, Stewardship theory is more applicable in Islamic banks rather than forming a governance structure based solely on the assumption that managers are self-serving and should be treated as agents. Moreover Abdullah Saif Alnasser and Muhammed (2012) suggest any governance structure for IBs should utilize the stakeholder theory to insure they fulfil their purpose and achieve long-term success. Additionally, Grais and Pellegrini (2006) claimed that the moral codes of Islam might enhance the ethical behaviour of managers in banks. Despite the strong moral principles there is the ever-present danger of the agency costs, particularly in the case of Islamic banking when you have a more complex agency problem caused by the existence of investment account holders which suffer from a lack of representation under the traditional governance structure (Safieddine, 2009).

This paper adopts a theoretical stance aligned with the ideas presented by Davis et al. (1997); Obid and Naysary (2014) that there is no one-best fit theory for all organisations and applicable under all circumstances. This paper embraces the idea of reconciling the different theories to recognize which one is leading to a better governance structure serving the best interest of major stakeholders. Nonetheless, this paper emphasises that corporate governance in

Islamic banks is affected not only by local cultures and regulations mentioned earlier by Solomon (2013) but also by the ideas of leadership highlighted in the Islamic rules and philosophy. Therefore, the focus of Stewardship in this paper which embraces the core dogma of Islam without neglecting the importance of Stakeholder and Agency theories.

### **1.5. Enhanced shareholder activism**

The debate on active shareholders, such as institutional shareholders and their effect on companies' governance, is not a new phenomenon. The debate has been ongoing for decades and can be traced back to the early 90s (Cadbury committee, 1992, cited by Banaga et al., 1995; Goranova & Ryan, 2014; McNulty & Nordberg, 2016; Armitage, Haig & Hodgkinson, 2017).

Archer and Abdel Karim (2007) argue that corporate governance adopted by western banks is not inconsistent with the requirement of Islamic principles. However, a number of additional features should be implemented over and above conventional models and theories of corporate governance to be compliant with Islamic principles. Therefore, it would be only rational to build upon the existing models and research of contemporary corporate governance and implement the required features to suit the mechanisms and products of Islamic finance.

Goranova and Ryan (2014, p. 1232) defined shareholder activism as "actions taken by shareholders with the explicit intention of influencing corporations' policies and practices, rather than as latent intentions implicit in ownership stakes or trading behavior." As an example the UK Stewardship Code (2012) argues that the investors' role must exceed beyond just simply voting to include activities such as engaging, managing, strategies and corporate governance. McNulty and Nordberg draw a useful distinction between the episodic and change-orientated activism identified by Goranova and Ryan and stewardship/engagement aimed at mutual understanding.

On the other hand, the Islamic Financial Services Act 2013 (IFSA), as cited by the Central Bank of Malaysia (2014, p. 1), "distinguishes investment account from Islamic deposit". These investments could be divided to three main types 'Mudarabah' contracts which is an equity-like instrument based on the partnership principle including profit and loss sharing, where one party is providing capital and the other party managing the asset (Minhat & Dzolkarnaini, 2016). 'Musharakah' which is equity partnership combining the act of investment and management (Iqbal & Mirakhor, 2007). Finally, 'Wakalah' which is a contractual relationship between two parties one is acting as an agent to perform specific tasks to the other party either voluntarily or with associated fees (Central Bank of Malaysia, 2014).

Drawing upon the above, it is concluded that IAHs could be treated as equity investors since they provide capital and participate in profits and losses.

Moreover, IAHs should act alongside shareholders actively and responsibly seeking to enhance the stewardship practice in their bank which consequently will be able to achieve long-term success and sustainable performance.

## **2. Proposed conceptual model of corporate governance in Islamic banks**

This research aims to incorporate the three main theories underpinning corporate governance and corporate governance in IBs specifically into an over-arching model. Firstly, Principal/Agent theory is a key theory in corporate governance and is seen as fundamental in corporate governance in Islamic banks. The focus is on reducing agency costs (Jensen & Meckling, 1976; Cuevas-Rodriguez et al., 2012). Secondly, this model employs a governance structure taking primary stakeholders into consideration since most of the Islamic literature on Islamic finance argues that any Islamic corporations should be serving the public good and expand its purpose beyond the financial needs of its shareholders in an attempt to fulfil the non-financial needs of its primary stakeholders based on moral and Islamic values (Chapra & Ahmed, 2002; Grais & Pellegrini, 2006; Abdullah Saif Alnasser & Muhammed, 2012). Finally, stewardship theory acts as the pre-eminent element in this model guiding directors in Islamic banks to both monitor and trust their managers encouraging them to act as stewards and work for the best interest of their banks (Donaldson & Davis, 1991; Davis et al., 1997; Cuevas-Rodriguez et al., 2012).

In addition to the three theories identified above, the proposed conceptual model (Figure 2) draws on three main codes of practice. Firstly, the UK stewardship code published by the Financial Reporting Council (FRC 2012) which is considered as one of the most substantial moves to engage shareholders as active owners (McNulty & Nordberg, 2010; Nordberg, 2017). Secondly, "Guiding principles on corporate governance for institutions offering only Islamic financial services" published by the Islamic financial services board (IFSB 2006) and deliberated by the literature of many scholars such as (Archer & Abdel Karim 2007). Thirdly, the "Investment Account" policy published by the Central Bank of Malaysia (2014) being a leading country in Islamic finance. Moreover, this "Investment Account" policy aims to set the guiding principles on the treatment of investment account holders. This policy document was set to ensure four main areas for IAHs: firstly, ensure compliance with the Sharia principles. Secondly, to establish a sound risk management structure to manage the assets of IAHs in order to safeguard the stakeholders' interests including the IAHs. Thirdly, to set a minimum disclosure requirement enabling IAHs to make informed decisions this will boost the performance of the IFIs. Fourthly, this policy is set to ensure the sustainability of the Islamic financial system by supporting a robust risk management structure.

The policy divides into two types of structuring: Standard that must be complied with 'S' or advisory guidance 'G'. Figure 1 is a representation of *The UK Stewardship Code, 2012* (Financial Report Council, 2012). In this representative model the stewardship responsibility is shared between the board of directors and the institutional investors. Boards hold primary responsible for the stewardship practice by monitoring/trust managers' activities, while institutional investors are responsible for holding the board accountable for its stewardship responsibilities through the asset managers employed by the institutional investors. Consequently, the UK code of corporate governance (Financial Report Council, 1992/2016) acts to enhance the effectiveness and efficiency of corporate governance. Moreover, this model is mainly concerned with institutional investors such as pension funds, insurance companies, investment trusts and collective investment vehicles that provide the capital to the asset managers who manage the assets on behalf of the institutional investors. Consequently, these investment owners "set the tone of stewardship" and may influence a behaviour change and improve the corporate culture.

Banaga et al. (1995) claimed that while there has been an ongoing discussion on the role of institutional investors for over two decades the reality remains a strategy of 'exist' i.e. the sale of shares in response to poor financial performance rather than active engagement in the governance of companies by institutional investors.

Figure 2 provides a representation of the proposed conceptual model for corporate governance in Islamic banks. This model extends figure (1), the Stewardship model, by incorporating IAHs as unique to IBs and considered one of the most substantial stakeholders (Archer & Karim, 2007). Their investment is crucial to Islamic banks and should be well protected. Moreover, Archer and Abdel Karim (2007) argue that IAHs are like 'quasi-equity holders' with the former having no power on how this institution is governed. Thus, IAHs have no protection and rely on the sympathy of policy makers and the Sharia board. Therefore, this conceptual model presents IAHs as a form of active shareholder/Institutional investors with an entitlement to engage in a stewardship role in the Islamic bank.

Under the proposed model both the board and the IAHs engage in stewardship of the bank. However, due to the unique structure of Islamic banks the board of directors share the responsibility with the sharia supervisory board which advise the board on all Sharia principles. Moreover, the Governance Committee suggested by the (IFSB 2006) shown in (Figure 2) represents a parallel to the UK code. Furthermore, IFSB (2006) suggests that the Governance Committee could consist of:

The governance committee oversees and monitors the application of the governance framework in addition to providing the Islamic banks' board with reports and recommendation designed to enhance the accountability and the effectiveness of the board. Therefore, this Governance Committee is considered

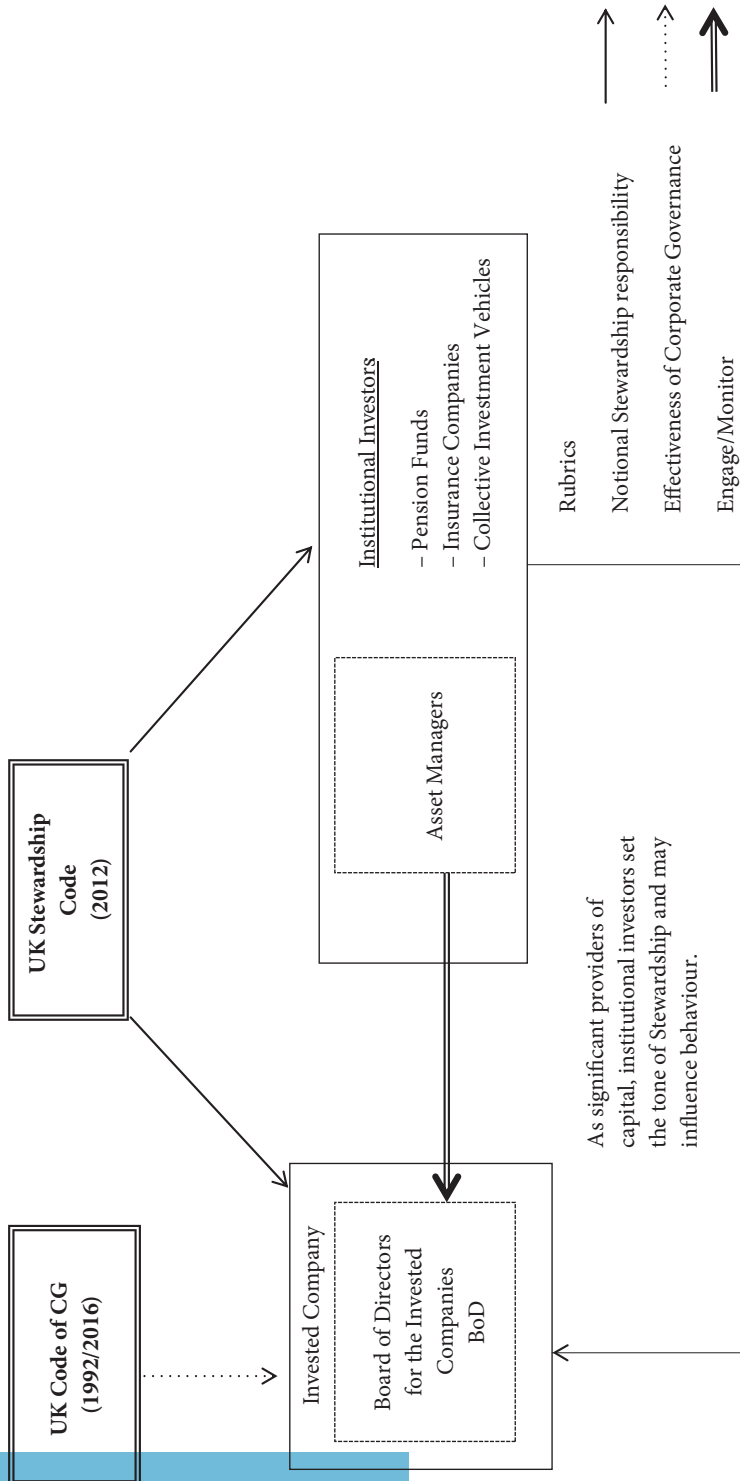


Figure 1. Diagram of the UK Stewardship Code 2012

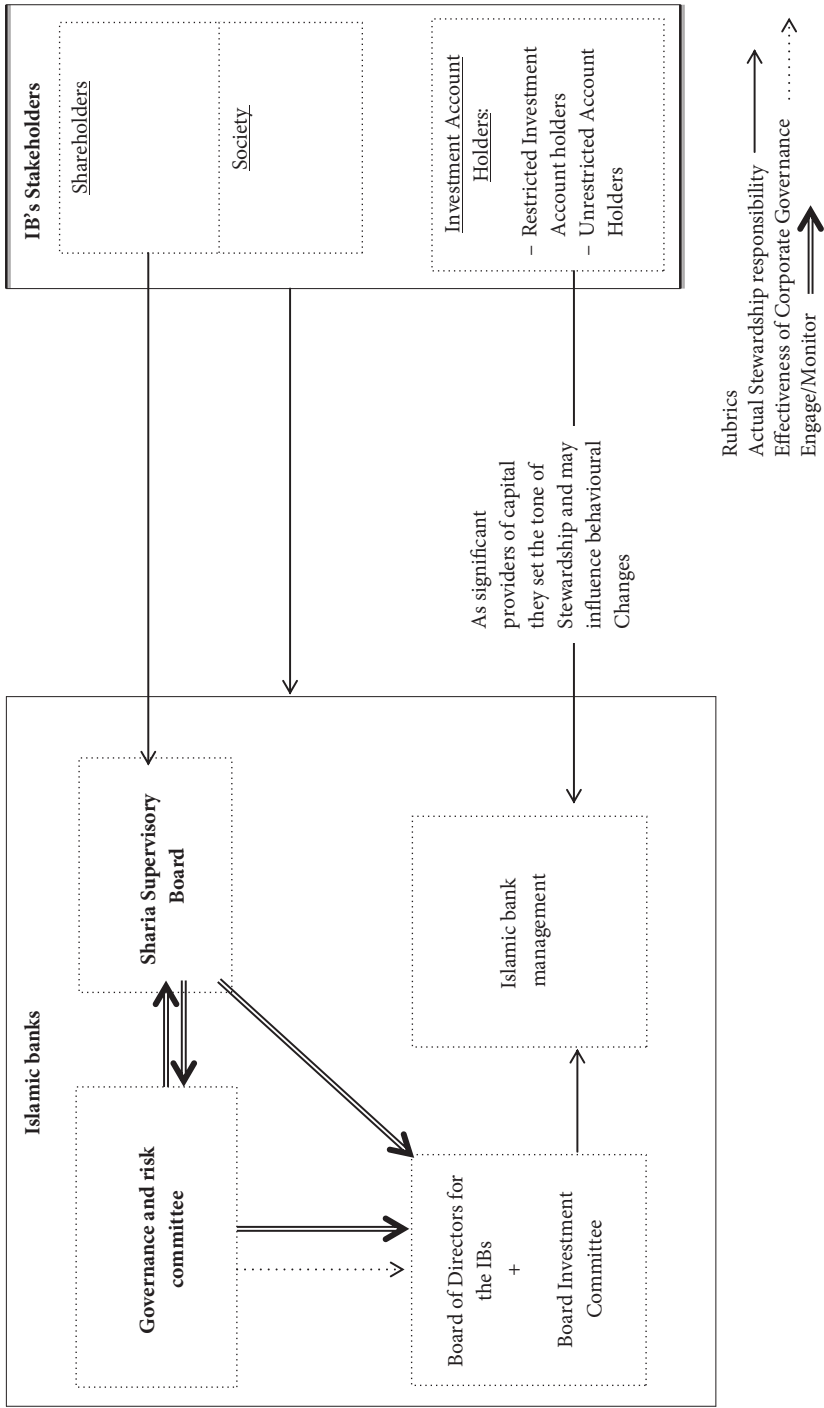


Figure 2. Conceptual model of IBs corporate governance

a key player in reducing agency costs. The Central Bank of Malaysia (2014) goes further by suggesting the formation of a risk management committee designed specifically to provide a more robust risk management for the IAHs. This paper suggests the amalgamation of both committees to form the governance and risk committee as shown in (Figure 2) which is responsible for providing a robust risk structure for IAHs. Finally, the model adopts the recommendation of the Central Bank of Malaysia (2014) that a board investment committee should be formed when the investment account constitutes a significant proportion of the total assets in the bank. Nonetheless, it is the boards' responsibility to determine the significant of this investment.

## Conclusions

This paper highlights the unique position of corporate governance in Islamic banks and proposes a model for further development combining the fundamental philosophical principles of Islam with the theories and practical structures, codes and systems developed in the West. The Investment Account Holders are identified as significant stakeholders and are given a pivotal role in the proposed conceptual model. The model proposes to combine the recommendations of both the Central Bank of Malaysia (2014) and the Islamic Financial Supervisory Board (2006) through the formation of a governance and risk management committee designed to enhance the efficiency and the accountability of the Board of Directors. These inclusions together with integration of a Sharia supervisory board are designed to improve the corporate governance in Islamic banks and provide assurance to all primary stakeholders that all the investments and activities are compliant with the Islamic principles.

On a final note and in the light of the recent banking crisis it may be of interest to Western governments and bank regulators to reflect on the founding principles of Islamic banks where the focus is on real assets, sustainability, wide stakeholder engagement with specific attention to society and the public good—attributes that have widespread appeal to global society whether of Western or Eastern persuasion.

## References

- Abdullah Saif Alnasser, S. & Muhammed, J. (2012). Introduction to corporate governance from Islamic perspective. *Humanomics*, 28(3), 220-231. doi:10.1108/08288661211258110
- Abu-Tapanjeh, A. M. (2009). Corporate governance from the Islamic perspective: A comparative analysis with OECD principles. *Critical Perspectives on Accounting*, 20(5), 556-567.



- Archer, S. & Abdel Karim, R. A. (2007). *Islamic finance: The regulatory challenge*. Chichester: John Wiley.
- Armitage, S., Haig, A. & Hodgkinson, L. (2017). Is an investing institution one shareholder or a collection of separate funds?. *Corporate Governance: An International Review*, 25(1), 20-40. doi:10.1111/corg.12159
- Banaga, A., Ray, G. & Tomkins, C. (1995). A conceptual framework for corporate governance and effective management. *Corporate Governance: An International Review*, 3(3), 128-137. doi:10.1111/j.1467-8683.1995.tb00108.x
- Bhatti, M. & Bhatti, I. (2009). Development in legal issues of corporate governance in Islamic finance. *Journal of Economic and Administrative Sciences*, 25(1), 67-91.
- Cadbury, A. (1992). The financial aspects of corporate governance. Retrieved from GB: Cadbury, A. (2002). *Corporate governance and chairmanship: A personal view*. Oxford: Oxford University Press.
- Central Bank of Malaysia. (2014). *Investment Account*. Malaysia: Bank Negara Malaysia. Retrieved from [http://www.bnm.gov.my/guidelines/01\\_banking/04\\_prudential\\_stds/investment\\_account.pdf](http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/investment_account.pdf)
- Chapra, M. U. (1992). *Islam and the economic challenge*. Leicestershire: The Islamic Foundation.
- Chapra, M. U. & Ahmed, H. (2002). Corporate governance in Islamic financial institutions. *Occasional Paper*, 6.
- Clarke, T. (2004). *Theories of corporate governance: The philosophical foundations of corporate governance*. London: Routledge.
- Cuevas-Rodríguez, G., Gomez-Mejia, L. R. & Wiseman, R. M. (2012). Has agency theory run its course?: Making the theory more flexible to inform the management of reward systems. *Corporate Governance: An International Review*, 20(6), 526-546. doi:10.1111/corg.12004
- Davis, J. H., Schoorman, F. D. & Donaldson, L. (1997). Toward a Stewardship theory of management. *The Academy of Management Review*, 22(1), 20-47. doi:10.2307/259223
- de Haan, J. & Vlahu, R. (2016). Corporate governance of banks: A survey. *Journal of Economic Surveys*, 30(2), 228-277. doi:10.1111/joes.12101
- Dermine, J. (2013). Bank corporate governance: Beyond the global banking crisis. *Financial Markets, Institutions & Instruments*, 259-281.
- Donaldson, L., & Davis, J. H. (1991). Stewardship theory or agency theory: CEO governance and shareholder returns. *Australian Journal of Management*, 16(1), 49-64.
- Financial Report Council. (1992/2016). *The UK corporate governance code 2016*. Retrieved from <https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code>
- Financial Report Council. (2012). *The UK Stewardship Code 2012*. Retrieved from: [https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-\(September-2012\).pdf](https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf)
- Ernst & Young. (2015). *World Islamic Banking Competitiveness Report*.
- Ernst & Young. (2016). *World Islamic Banking Competitiveness Report*.
- Freeman, R. E. (2010). *Strategic management: A stakeholder approach*. Cambridge: Cambridge University Press.

- Friedman, M. (2007). The social responsibility of business is to increase its profits. In W. C. Zimmerli, M. Holzinger & K. Richter (Eds.), *Corporate ethics and corporate governance* (pp. 173-178). Berlin, Heidelberg: Springer.
- Goranova, M. & Ryan, L. V. (2014). Shareholder activism. *Journal of Management*, 40(5), 1230-1268. doi:10.1177/0149206313515519
- Grais, W. & Pellegrini, M. (2006). *Corporate governance in institutions offering Islamic financial services issues and options*. (Working Papers S4054). World Bank Policy Research.
- Grassa, R. & Matoussi, H. (2014). Corporate governance of Islamic banks. *International Journal of Islamic and Middle Eastern Finance and Management*, 7(3), 346-362. doi:10.1108/imefm-01-2013-0001
- IFSB (Islamic Financial Supervisory Board). (2006). Guiding principles on corporate governance for institutions offering only Islamic financial services (excluding Islamic insurance (takaful) institutions and Islamic mutual funds). Retrieved from <http://www.ifsb.org/standard/ifsb3.pdf>
- Iqbal, Z. & Mirakhor, A. (2007). *An introduction to Islamic finance: theory and practice*. Singapore: John Wiley.
- Irfan, H. (2013). Could Islamic finance save capitalism?. Retrieved from <https://www.theguardian.com/sustainable-business/2014/dec/04/could-islamic-finance-solution-capitalism>
- Jensen, M. C. (2001). value maximization, stakeholder theory, and the corporate objective function. *Journal of Applied Corporate Finance*, 14(3), 8-21. doi:10.1111/j.1745-6622.2001.tb00434.x
- Jensen, M. C. & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), 305-360. doi:[http://dx.doi.org/10.1016/0304-405X\(76\)90026-X](http://dx.doi.org/10.1016/0304-405X(76)90026-X)
- John, K., De Masi, S. & Paci, A. (2016). Corporate governance in banks. *Corporate Governance: An International Review*, 24(3), 303-321.
- Khan, M. S. & Mirakhor, A. (1989). The Financial System and Monetary Policy in an Islamic Economy. *Journal of King Abdulaziz University: Islamic Economics*, 1(1), 85-93.
- Letza, S. & Sun, X. (2002). Corporate governance: paradigms, dilemmas and beyond. *Poznan Economic Review*, 2(1), 43-59.
- Letza, S. & Sun, X. (2004). Philosophical and paradoxical issues in corporate governance. *International Journal of Business Governance and Ethics*, 1(1), 27-44.
- Letza, S., Sun, X. & Kirkbride, J. (2004). Shareholding versus stakeholding: A critical review of corporate governance. *Corporate Governance: An International Review*, 12(3), 242-262.
- Letza, S., Kirkbride, J., Sun, X. & Smallman, C. (2008). Corporate governance theorising: limits, critics and alternatives. *International Journal of Law and Management*, 50(1), 17-32. doi:10.1108/03090550810852086
- Letza, S. (2017). Corporate governance and the African business context: The case of Nigeria. *Economics and Business Review*, 3(1), 184-204.
- Levine, R. (2004). *The corporate governance of banks: A concise discussion of concepts and evidence*. World Bank Open Knowledge Repository.

- Macey, J. R. & O'Hara, M. (2003). The corporate governance of banks. *Economic Policy Review*, 9(1).
- Mallin, C. (2013). *Corporate governance*. Oxford: Oxford University Press.
- McNulty, T. & Nordberg, D. (2016). Ownership, activism and engagement: Institutional investors as active owners. *Corporate Governance: An International Review*, 24(3), 346-358. doi:10.1111/corg.12143
- Minhat, M. & Dzolkarnaini, N. (2016). Islamic corporate financing: Does it promote profit and loss sharing (1467-8608)?. Retrieved from <http://dx.doi.org/10.1111/beer.12120>.
- Mollah, S. & Zaman, M. (2015). Shari'ah supervision, corporate governance and performance: Conventional vs. Islamic banks. *Journal of Banking and Finance*, 58, 418-435. doi:10.1016/j.jbankfin.2015.04.030
- Muneeza, A., & Hassan, R. (2014). Shari'ah corporate governance: the need for a special governance code. *Corporate Governance: The International Journal of Effective Board Performance*, 14(1), 120-129. doi:10.1108/CG-02-2011-0015
- Nordberg, D. (2010). *Corporate governance: principles and issues*. London: Sage.
- Nordberg, D. (2017). Board ethos and institutional work: Developing a corporate governance identity through developing the UK code. *Economics and Business Review*, 3(1), 73-96.
- Obid, S. N. S. & Naysary, B. (2014). Toward a comprehensive theoretical framework for Shariah governance in Islamic financial institutions. *Journal of Financial Services Marketing*, 19(4), 304.
- Religions. (2009). Retrieved from <http://www.bbc.co.uk/religion/religions/islam/practices/zakat.shtml>
- Safieddine, A. (2009). Islamic financial institutions and corporate governance: New insights for agency theory. *Corporate Governance: An International Review*, 17(2), 142-158. doi:10.1111/j.1467-8683.2009.00729.x
- Solomon, J. (2013). *Corporate governance and accountability*. John Wiley.
- Walker, D. (2009). A review of corporate governance in UK banks and other financial industry entities – Final recommendations. Retrieved from [http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker\\_review\\_261109.pdf](http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf)
- Warde, I. (2000). *Islamic finance in the global economy*. Edinburgh: Edinburgh University Press.
- World Islamic Banking Competitiveness Report 2014-15*. (2015). Retrieved from [https://www.ey.com/Publication/vwLUAssets/EY-world-islamic-banking-competitiveness-report-2014-15/\\$FILE/EY-world-islamic-banking-competitiveness-report-2014-15.pdf](https://www.ey.com/Publication/vwLUAssets/EY-world-islamic-banking-competitiveness-report-2014-15/$FILE/EY-world-islamic-banking-competitiveness-report-2014-15.pdf)
- World Islamic Banking Competitiveness Report 2016 New realities New opportunities*. (2016). Retrieved from [https://www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report-2016/\\$FILE/ey-world-islamic-banking-competitiveness-report-2016.pdf](https://www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report-2016/$FILE/ey-world-islamic-banking-competitiveness-report-2016.pdf)

Reproduced with permission of copyright owner. Further reproduction prohibited without permission.