

Islamic Banking

Challenges & Corporate Governance

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Current Situation

- Since the early creation of Islamic banking, the absence of a central religious authority has been a nagging problem
- Lack of uniform religious principles applied in Islamic countries
- Islamic banks had to form their religious boards who act as Sharia advisors before introducing new instruments
- Differences in the interpretation of Islamic principles would suggest that identical financial instruments are accepted by one board but rejected by another.



Today's Financial Marketplace & Its Challenges

- Regulatory
 - Existing banking regulations in most Islamic countries are based on the Western banking model.
- Accounting, Transparency & Surveillance
 - Any Islamic financial system needs sound accounting procedures and standards
 - Western accounting procedures are inadequate because of the different nature and treatment of financial instruments.
 - Well-defined procedures and standards are crucial for information disclosure, building investors' confidence, and surveillance.



How are Islamic Financial Institutions Responding to the Challenges?

- As a result, Islamic Financial Institutions had to police themselves
- The absence of Islamic Money Market Instruments has forced Islamic Banks to hold on average 40% more liquidity than their conventional counterparts
- Islamic Financial Institutions operating in non-Islamic countries face difficulties owing to the absence of a regulatory body that operates in accordance with Islamic principles and suffers loopholes in corporate governance and transparency.



Transparency and Accountability

- In the Western model, several fiascoes:
 - Savings & Loans crisis (\$240 b in '89)
 - Metallgesellschaft (\$1b loss in '93)
 - Procter & Gamble (\$160m in '94)
 - Orange County (\$1.7b in '95)
 - Long Term Capital Management (\$4b in '98)
 - Enron (\$billions in '00)
- Recently, the Enron scandal has sparked numerous debates on issues relating to transparency, accountability and disclosure
- For the US — a strong proponent of transparency and good corporate governance — a scandal like Enron is certainly an embarrassment.



Enron Background

- Last October, the energy giant surprised the market by announcing that it was forced to recognize losses of US\$1.01 billion.
- These losses were related to the unwinding of partnerships controlled by Enron's CFO.
- As a result the company would eliminate more than US\$1 billion in shareholder equity.



The Enron Debacle

- This led to a securities class action lawsuit on behalf of all persons who acquired Enron's stock during 2000-01. The lawsuit alleges that Enron's management:
 - misled investors by failing to disclose material information about the company's risk position.
 - issued false and misleading information to potential investors.
 - disposed of over US\$73 million of their stock to unsuspecting investors.
- What transpired next was a corporate soap-opera: bankruptcy, suicide, political patronage, cronyism, more allegations and even more denials.



Corporate Governance: *what does it mean?*

- In the practical sense, corporate governance involves the nuts and bolts of how corporations should fulfil their responsibilities to their shareholders and other stakeholders.
- Transparency, accountability and disclosure are three essential ingredients in corporate governance.



Islam & Corporate Governance

- The concept of corporate governance was put forward as a result of increasing awareness on the importance of the need to protect the rights of all stakeholders, including minority shareholders.
- While the term corporate governance is relatively new, the concept is actually not alien to Islam.



Corporate Governance in The Quran

- The Quran for instance, in a lengthy explanation in verses 282 and 283 of Surah al-Baqarah, states a detailed, step-by-step process for transacting:
 - **O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you. You should not become weary to write your contract down, whether large or small, for its fixed term, that is more just with Allah, more solid as evidence, and more convenient to prevent doubts among yourselves... Take witnesses whenever you enter into a commercial contract** **S. 2, V. 282**
 - **And if you are traveling and cannot find a scribe, then let there be a mortgage taken And do not conceal any evidence for he whoever hides it, surely his heart is sinful, and Allah is all Knower of what you do.** **S. 2 V. 283**



Corporate Governance in The Quran

- The verses highlight the importance of proper record-keeping so no party involved suffers injustice.
- The message behind this verse is the need for transparency and disclosure in business dealings.
- These in essence are two of the important underlying principles of “contemporary” corporate governance.



Corporate Governance in Hadith

- Another important ingredient of corporate governance is accountability. On this matter, one hadith by Prophet Mohammed (PBUH) suggests:

“Each one of you is a guardian, and each guardian is accountable to everything under his care”

- If this tradition is translated into modern business dealings, all persons involved in business transactions are indeed accountable for all their actions.



Corporate Governance in Other Civilizations

- In Asian and Far-Eastern cultures, we find a similar concept.
- In South East Asia, during the financial crisis in 1997, Hong Kong, Thailand, Malaysia, and Korea were lectured by Western scholars, fund managers and international banks on the need to improve standards of corporate governance.
- Unless this was done, it was prophesized that none of these countries, known as the Asian Economic Tigers, could get out from the economic doldrums.
- In Japan, when a bank fails, there is no bail out from a government agency like the FDIC
- Other banks join hands to buy out the troubled institution. Together they share responsibility



Laws vs. Self Regulation

- The concept of corporate governance in actuality is a code of conduct of best practices.
- It is worthless if this code remains only as ink on paper.
- However, what is important to realize is that, even with these laws, rules and regulations, good corporate governance could not be instilled within corporations if the persons regulated by these laws are not aware of their responsibilities.
- A comprehensive code together with state-of-the-art legislation cannot enhance standards unless and until company directors, shareholders, senior management and auditors are aware of their roles and responsibilities.



Conclusion

- From the perspective of Islam, deeds are more important than mere words, slogans, rhetoric or lectures, as highlighted in one verse of the Quran:

"Why do you say that which you do not do?"

- Corporate governance should be practiced in the form of deeds and actions.
- Only when actions speak louder than words, can a good corporate culture emerge and protect the welfare of all stakeholders in today's corporate world.

