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Basel II and Corporate Governance in Islamic Banks

M. Kabir Hassan,[1] Mehmet F. Dicle[2]

> *Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the Fire: They will abide therein (for ever).*[3]
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> *The Apostle of Allah (peace be upon him) cursed the one who accepted usury, the one who paid it, the witness to it, and the one who recorded it. (Narrated by Abdullah ibn Mas'ud.)*[4]

Stakeholder theory for Islamic banking defines the related parties and their rights within Islamic banks. The concept of the stakeholder is well defined in Islamic schools of thought and in *fiqh*. For this reason, compliance with *shari'a* will ensure effective corporate governance. Jameel Ahmad defines corporate governance as "the system by which business corporations are directed and controlled by structuring rights and responsibilities of different participants in the corporation, such as, the board, managers, shareholders and stakeholders."[5] According to Shleifer and Vishny's definition, corporate governance "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their

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[3] Qur'an 2:275 (Translation of Yusuf Ali).
[4] *Sunan Abu Dawud*, Book 22, Number 3327.
[5] Jameel Ahmad, "Handbook of Corporate Governance," State Bank of Pakistan (2003), http://www.sbp.org.pk/about/corp_gov/index.htm.

investment."[6] The unique structure of banks and their ability to collect deposits differentiates corporate governance of banks from that of any other entity.

In their summary of the stakeholder's model of corporate governance, Iqbal and Mirakhor state that stakeholders may include "customers, suppliers, providers of complementary services and products, distributors, and employees," and that corporations "ought to be managed for the benefit of all who have some stake in the firm."[7] Stakeholders for banks include shareholders, board members, management, employees, regulators, account holders, and credit customers. The main difference with Islamic banks lies in the types of accounts and credit instruments that are used in daily transactions. Islamic banks comply with the rules of *shari'a*. Such rules apply to corporate structures as well as relationships between stakeholders.

The first section of this paper explains Islamic banking products with reference to the stakeholder model, in order to discuss the unique characteristics of corporate governance for Islamic banks. The second section explores each stakeholder within an Islamic banking system. Specifically, terms of corporate governance in Islamic banking are discussed. The corporate governance of Islamic banks under Basel II is discussed in the third section. Compliance issues related to Basel II and possible problems with compliance are presented in the final two sections.

ISLAMIC BANKING PRODUCTS

The main distinguishing feature between Islamic banks and conventional banks is the exclusion of interest (*riba*) and excessive risk taking (*gharar*) in Islamic banks. Where Islamic banks coexist with conventional banks, they must comply with regulations designed for conventional banking products as well as with *shari'a*.

With the exception of Iran, Sudan, and Pakistan, Islamic banks operate alongside conventional banks[8] and hold less than 15 percent of the market that contains all the deposit-accepting banks. Such a limited share

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[6] Andrei Shleifer and Robert Vishny, "A Survey of Corporate Governance," *Journal of Finance* 52, no. 2 (June 1997): 737.

[7] Z. Iqbal and A. Mirakhor, "Stakeholders Model of Governance in Islamic Economic System," Paper presented at the International Islamic Banking and Finance Conference in Bahrain, October 2003; (hereafter cited as Iqbal and Mirakhor (2003).

[8] M. K. Hassan, "Cost, Profit and X-Efficiency of Islamic Banks in Pakistan, Iran and Sudan," Paper presented at the International Seminar on Islamic Banking: Risk Management, Regulation, and Supervision, Jakarta, September, 2003.

of the market forces Islamic banks to operate with products that are more acceptable to the financial environment in which they operate.

Figure 1: Selected financial figures for Islamic banks and for conventional banks for the 19 countries where Islamic banks operate[9]

	Year	Total Banks	Islamic Banks	Conventional Banks	Islamic % of Market	Conventional % of Market
Number of Banks; % of Market		411	64	347	15.57%	84.43%
Loans	2002	505,383,319	58,564,690	446,818,629	11.59%	88.41%
Loans	2001	497,606,526	69,300,868	428,305,658	13.93%	86.07%
Loans	2000	495,145,769	116,638,461	378,507,308	23.56%	76.44%
Loans	1999	449,567,899	96,120,001	353,447,898	21.38%	78.62%
Fixed Assets	2002	19,715,333	2,773,090	16,942,243	14.07%	85.93%
Fixed Assets	2001	19,720,726	3,510,021	16,210,705	17.80%	82.20%
Fixed Assets	2000	17,847,920	6,758,194	11,089,726	37.87%	62.13%
Fixed Assets	1999	16,939,848	5,861,634	11,078,214	34.60%	65.40%
Total Assets	2002	1,126,695,543	132,135,866	994,559,677	11.73%	88.27%
Total Assets	2001	1,114,631,294	149,229,165	965,402,129	13.39%	86.61%
Total Assets	2000	1,095,932,093	223,272,903	872,659,190	20.37%	79.63%
Total Assets	1999	993,367,109	177,700,412	815,666,697	17.89%	82.11%
CSTF*	2002	934,003,534	113,246,918	820,756,616	12.12%	87.88%
CSTF	2001	921,927,397	124,025,964	797,901,433	13.45%	86.55%
CSTF	2000	873,399,971	167,403,328	705,996,643	19.17%	80.83%
CSTF	1999	802,595,458	125,042,571	677,552,887	15.58%	84.42%
Equity	2002	106,358,733	11,194,457	95,164,276	10.53%	89.47%
Equity	2001	97,029,410	10,664,704	86,364,706	10.99%	89.01%
Equity	2000	88,103,263	13,286,790	74,816,473	15.08%	84.92%
Equity	1999	70,147,503	9,027,731	61,119,772	12.87%	87.13%
Net Income	2002	15,558,691	2,300,606	13,258,085	14.79%	85.21%
Net Income	2001	4,075,413	1,542,070	2,533,343	37.84%	62.16%
Net Income	2000	11,589,934	2,209,955	9,379,979	19.07%	80.93%
Net Income	1999	–1,051,917	1,078,110	–2,130,027		

*Customer & Short Term Funding

[9] Source: BankScope Database, Bureau van Dijk, release 165.2, update April 2004. Amounts indicate thousands of U.S. dollars.

Credit Instruments: Trade Related

Murabaha transactions are Islamic banking products that are the most similar to conventional banking credit utilization in terms of customer financing. Due to such similarity, Islamic banks use the *murabaha* transaction extensively. This preference may be due to regulatory compliance, lower associated risks compared to other Islamic credit instruments, or ease of use. With the *salam* transaction, Islamic banks may purchase goods that will be delivered at a future date with full payment in advance. With *salam* contracts, Islamic banks are able to provide pre-harvest financing for farmers. *Istisna'* transactions are very similar in nature. However, *istisna'* transactions do not require a payment in advance and involve production of the underlying goods. The main intention is to provide financing for manufacturers, much like pre-export credits or contract-based credits. The parties involved in *murabaha, salam,* and *istisna'* transactions include the Islamic bank, a seller, and a buyer.

Ijara transactions are more like operational leasing transactions than financial leases. Regulations of leasing transactions for conventional banks make them very easy for Islamic banks to follow. With *ijara* transactions, Islamic banks are the owners of the subject goods and are simply renting them. Therefore, the renter is directly involved with the Islamic bank as long as the *ijara* transaction is valid.

Credit Instruments: Equity Related

The important aspect of *mudaraba* partnerships is the long-term relationship that exists between the investing and the managing partners. In terms of corporate governance, the managing partners become stakeholders at the Islamic bank, even though they have no claims against the Islamic bank after the investment has been completed. Well-defined terms of the relationship between the Islamic bank and the managing partners are required for successful implementation of *mudaraba* transactions. Therefore, the importance of corporate governance within an Islamic bank will be reflected in any *mudaraba* partnership that it enters.

Corporate governance becomes a major issue for *musharaka* partnerships, considering the fact that Islamic banks actively participate in the operations. Therefore, any business partner within a *musharaka* partnership naturally becomes a stakeholder. The corporate governance of the *musharaka* partnership, as well as that of Islamic banks, should be well designed to allow for the successful operation of *musharaka* partnerships. Any control facilities and operational responsibilities should be described well in advance.

Deposit Instruments

Islamic banks collect deposits into current accounts for the purpose of safekeeping, and in some cases, these accounts form more than 75 percent of total funds under management.[10] Considering the magnitude of these accounts and their usage, special attention should be given to current accounts. Although the purpose of current account holders is safekeeping, in practice they face much of the same risks as investment account holders. Funds from current accounts may be utilized to generate profits, yet these profits are not shared with them. Iqbal and Mirakhor state that in Islam, “a stakeholder is the one whose property rights are at stake or at risk due to voluntary or involuntary actions of the firm.”[11] Based on this definition, current account holders should be considered as stakeholders.

Depositors of investment accounts, or profit and loss sharing (PLS) accounts, assign the Islamic bank to act as their agent to conduct credit transactions and generate profit. Thus they assume the risk involved with credit instruments and are directly influenced by the performance of the bank. Since there is no deposit insurance coverage for any loss on these accounts, their stakeholder status is imperative. Investment deposit holders are exposed to risk as much as shareholders. The question is whether to allow investment account holders to participate in the management of the Islamic bank to the same degree as shareholders. With commercial banks, deposit insurance would represent the time deposit holders as a whole.

STAKEHOLDERS FOR ISLAMIC BANKS

Iqbal and Mirakhor (2003) summarize property rights in Islam.[12] Their justification for stakeholder participation in the decision-making process is based on four principles. The first is collectivity, where each individual has sharing rights of the properties acquired. The second is the principle that exercising a property right should not cause damage to others or to the property of others. Third, the rights of others and their property are subject to rules regarding property rights. Fourth, according to *shari‘a*, a property leading to denial of a right is not recognized as a property and is considered unlawful. Iqbal and Mirakhor conclude, “It is not necessary for each stakeholder to be a participant in the decision-making as long as their rights are protected through sound institutional arrangements.”

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[10] T. Khan and H. Ahmed, “Risk Management: An Analysis of Issues in Islamic Financial Industry,” Islamic Research and Training Institute, 2001, http://www.irti.org/publications/publications_english6.htm.
[11] Iqbal and Mirakhor (2003).
[12] Ibid.

In his comment about Islamic economics, Lewis quotes Khaliffa: "The distinctive characteristics of Islamic economics are that it is Godly, ethical, humane, and moderate and balanced."[13] Lewis further states that Islamic businesses conducted by Muslims should reflect the characteristics of Islamic economics. It is expected that Islamic banks comply with *shari'a*, and that insiders of Islamic banks comply with the Islamic way of life. This view is contrasted with the fact that some Islamic banks are owned by international financial corporations and some interest-bearing banks operate Islamic banking windows. However, this is an issue for *fiqh*. Our discussion is purely from a financial and economic perspective.

Shareholders select the board of directors, and in turn, the management. Thus, they are in a position to control the activities of the Islamic bank, including *shari'a* compliance. The regulatory responsibility of shareholders also requires them to control Islamic banks against any excessive risk. This is especially true for countries where deposit insurance exists. A failure would affect the whole Islamic banking system and might result in the loss of public confidence.

The board of directors is at the primary level of authority in an Islamic bank. They are the key decision makers in implementing policies and bylaws within the bank. Their responsibilities include profitability, safety, and compliance with laws. Compliance with *shari'a* is also a key concern. The board of directors may establish subcommittees, such as committees for risk management, credit, internal audit, and compensation, in order to delegate authority and share responsibility with the management. The Islamic Financial Services Board suggested in 2005 that a governance committee be established for corporate governance along with an audit committee for oversight of the accounting process.[14]

The importance of the *shari'a* board has been emphasized by Suleiman who states, "those who deal with an Islamic bank require assurance that it is transacting [in compliance] with Islamic law."[15] Hassan and Chowdhury explain the role of the *shari'a* board as follows: "The *shari'a* board plays a very significant and multi-dimensional role related to the relation between the bank and its clients, the bank and its depositors,

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[13] Mervyn Lewis, "Islamic Corporate Governance," *Review of Islamic Economics* 9, no. 1 (2005): 5-29; Azaddin Salem Kaliffah, "The Multidimensional Nature and Purpose of Business in Islam," *Accounting, Commerce & Finance: The Islamic Perspective Journal* 7, no. 1&2 (2003): 1-26.

[14] Islamic Financial Services Board, "Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services," Exposure Draft No. 3, December, 2005; hereafter cited as IFSB (2005).

[15] Nasser M. Suleiman, "Corporate Governance in Islamic Banks," *Arab Gateway* (December 2000), http:// www.al-bab.com/arab/econ/nsbanks.htm.

the bank and shareholders, and even the role of bank management."[16] IFSB (2005) suggests that Islamic banks should be persistent with their *shari'a* boards, and discourages "*fatawa* shopping."[17] Hassan and Chowdhury suggest that instead of having a separate *shari'a* board for every Islamic bank, a centralized board within each central bank should be established.[18] Chapra and Ahmed emphasize the costs of each Islamic bank having its own *shari'a* board, as well as the uncertainty generated by conflicting opinions.[19] Consequently, they suggest the creation of a centralized *shari'a* board. Iqbal and Mirakhor (2003) conclude: "A *shari'a* board for every firm, which is seen in present architecture of Islamic banking, is not efficient whereas only one set of rules is needed for appropriate corporate governance."[20] The standardization of Islamic banking operations can be established through centralized efforts such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).[21]

Managers are the key personnel in terms of the decision-making process. Iqbal and Mirakhor (2003) state that "managers have a fiduciary duty to serve the interests of all stakeholder groups."[22] The balance between stakeholders may require tradeoffs. For instance, products such as *mudaraba* and *musharaka* may be suggested more in terms of *shari'a* compliance than *murabaha*. However, associated risk, complications with the credit evaluation process, and liquidity concerns make them less preferred by the management. According to Hassan, Wolfe, and Maroney, when the risk is high enough, "management may not invest in projects that are worthwhile to shareholders."[23] The illiquid nature of Islamic banking products, the lack of Islamic money markets, and the lack of a lender of last resort leave management with a problem of liquidity. There may also be tradeoffs for the decision of profit stabilizing techniques. Changes in an

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[16] M. K. Hassan and M. A. M. Chowdhury, "Islamic Banking Regulations in Light of Basel II," Paper Presented at the 2004 Harvard University Islamic Finance Forum Conference, Boston, April 12, 2004; hereinafter cited as Hassan and Chowdhury (2004).
[17] IFSB (2005).
[18] Hassan and Chowdhury (2004).
[19] M. Umer Chapra and H. Ahmed, "Corporate Governance in Islamic Financial Institutions," Islamic Research and Training Institute, Occasional Paper No. 5, 2002, http://www.irti.org/publications/ publication_english1.htm; hereinafter cited as Chapra and Ahmed (2002).
[20] Iqbal and Mirakhor (2003).
[21] See www.aaoifi.com and www.ifsb.org.
[22] Iqbal and Mirakhor (2003).
[23] M. Kabir Hassan, David R. Wolfe, and Neal C. Maroney, "Corporate Control and Governance in Banking," *Corporate Ownership & Control* 1, no. 4 (Summer 2004): 94-107.

Islamic bank's share ratio in profits is a tradeoff between investment account holders and shareholders. Therefore, effective corporate governance is crucial for management to find the optimum balance among each stakeholder.

Employees of Islamic banks invest their efforts and careers in the Islamic banks they work for. They are compensated through their salaries. Their place within the corporate governance as a stakeholder is certain. They are the applicators of all the rules, regulations, and procedures that are defined to them. However, their rights may require more attention since they are the actual field workers.

Current accounts holders provide Islamic banks with funds that expect no return. Therefore, any profit on investments done with current accounts will not be claimed and will be left to the Islamic bank. However, these accounts bear the indirect risk of loss through usage of these funds in investment activities. Thus, current account holders should either be compensated for the risk they are facing, or else usage of such funds should be restricted. One survey conducted in 2002 revealed that 50 percent of Islamic banks surveyed had extended deposit insurance to them.[24] Therefore, in case of no deposit insurance, current account holders are not properly represented within current stakeholder scheme.

Investment accounts, unlike current accounts, face the risk of loss even if the Islamic bank does not entirely fail. Facing credit risk directly may entitle investment account holders to a place in the decision-making process. In fact, the level of credit risks faced by the shareholders is similar to that faced by investment deposit holders. However, representation of investment account holders within the board of directors may become cumbersome, considering the large number of investment account holders. Extended transparency may prove to be very useful to protect the rights of investment deposit holders and protect them against any risks that they do not want to take.

Partners through *mudaraba* and *musharaka* transactions should be given special attention within the corporate governance structure, considering the fact that these partnerships have long term commitments and involve heavy consequences for dissolution. The auditing process should be structured to evaluate and control the relationship between the Islamic bank and the partnership. The situation gets more complicated for *musharaka* partnerships where Islamic banks participate with management.

Regulators should be able to monitor the activities of Islamic banks. The potential of systematic risk is the same for commercial banks as well as Islamic banks. Al-Jarhi summarizes such monitoring activity to include three kinds of supervision: *shari'a* supervision, financial supervision, and

[24] Chapra and Ahmed (2002).

operational supervision.[25] It is recommended that regulators design frameworks for unique Islamic banking products. It is often Islamic banks that have to alter their products to local regulations. Such alterations could pose unforeseen risks. In order to maintain proper transactions and compliance with *shari'a*, regulators should establish ground-rules for Islamic banks.

External auditors provide objective evaluation of financial and operational situations. *Shari'a* compliance should also be included in an external audit, and external auditors should be familiar with Islamic banking products.

Chapra and Ahmed (2002) also include the overall economic, financial, legal, and accounting systems, as well as banking associations as being the key players along with the ones explained above. They explain that successful corporate governance requires an efficient legal system and the enforceability of contracts and laws facilitating Islamic banking operations. In addition, accounting and auditing standards are required to establish transparency and comparability.

BASEL II AND CORPORATE GOVERNANCE OF ISLAMIC BANKS

The Basel committee on banking supervision defines corporate governance as the manner in which the business and affairs of individual institutions are governed by their board of directors and senior management.[26] It should set corporate objectives and descriptions of day to day operational procedures, consider the interests of stakeholders, align corporate activities, and protect the interests of depositors. Such definitions should also include special stakeholders that are included within the Islamic banking framework. As explained in the previous section, credit customers and deposit holders have a special place within the stakeholder model and have very different rights and responsibilities compared with deposit holders of conventional banks.

Basel II suggests establishing strategic objectives and a set of corporate values. These apply to Islamic banks as well, which are mostly operational in developing countries. Due to a lack of developed and effective equity markets in these countries, the growth of the economy is primarily facilitated by banks. Therefore, banking institutions in these

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[25] M. Al-Jarhi, "Issues of Corporate Governance in Islamic Financial Institutions," Corporate Governance and Risk Management in Islamic Financial Institutions Conference, Beirut, March 21–22, 2000.

[26] Basel Committee on Banking Supervision, "Enhancing Corporate Governance for Banking Organizations," Basel, September, 1999.

countries have particularly important roles within the economy. However, their operations are impaired by limited potential for deposits, and sometimes less than perfect legal environments. This is why banking institutions in developing countries need to integrate with international financial markets, even more than banks in developed countries need to integrate.

While international integration is a crucial issue for Islamic banks in developing countries, we must also keep in mind that the Islamic banking concept is a relatively new one, and competition is fierce. It is the aim of the standardization of banking procedures to provide comparability to facilitate international integration even for institutions established under differing principles, such as those of Islamic banks. Basel II, in this regard, provides guidelines for standardization as well as minimum financial stability requirements. Compliance with Basel II will enable Islamic banks and banks in developing countries to establish themselves as international banks. In this respect, Basel II provides the minimum requirements for Islamic banks to meet. The unique nature of Islamic banking products requires Islamic banks to extend Basel II for financial stability as well as for international integration.

IFSB's "Guiding Principles on Corporate Governance" (2005) provides several guidelines for Islamic banks to extend the already established guidelines for conventional banks. The principles provided are tailor-made for Islamic banks and are derived from Islamic banking experience. IFSB (2005) emphasizes the importance of international integration. One of the issues raised by the IFSB is the rating of Islamic banks. Transparency is emphasized along with following international reporting standards:

> IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with *shari'a* rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.[27]

Standardization will also benefit Islamic banks in terms of international benchmarking financially as well as operationally. It will enable Islamic banks to compare themselves to conventional banks and to each other. The comparability is the crucial issue for corporate governance. The advances in effective corporate governance will be achieved by following other effective practices and adopting principles that are proven successful. Considering the small size of the Islamic banking industry, the

[27] IFSB (2005).

collective development of issues will benefit individual Islamic banks as well as the Islamic banking industry.

Following the already proven corporate governance structure, Islamic banks will define and enforce the rights and responsibilities of each stakeholder. All procedures and interrelations should be defined for proper day to day activities. A total quality control mechanism that is in line with the guidelines of the International Standard Organization (ISO) may be suggested.[28] Although the system may need alterations, Islamic banks may adopt ISO standards to define all procedures and levels of hierarchy. The board of directors and management should work toward the establishment of a total quality system and its enforcement. Such systems will leave enough room for detecting process flow errors and points of weaknesses. After the implementation of such systems, internal auditors should check for compliance and any feedback from staff for system improvement. The total quality book for each Islamic bank should be made public for the purpose of developing standardized Islamic banking procedures and corporate governance structures throughout the Islamic banking community. External auditors, regulators, shareholders, deposit holders, and credit customers would benefit from a transparent total quality book. Those who interact with Islamic banks would gain more knowledge about the system. Inclusion of procedures, job flow charts, job descriptions, and product definitions would provide Islamic banking customers with information that may not be otherwise easily available to them. This would also assist in promoting and teaching Islamic banking to the public. Some of the Islamic banks are already certified through ISO 9000/1, but it is not possible for an outsider to obtain their quality books. The document may have privileged information that provides a competitive advantage to the Islamic bank. However, it may be possible to separate sensitive parts of the total quality book.

Standardization will ensure comparability and eventually international integration. The accountability in international financial markets is just as important as accountability within the domestic market and with different stakeholders. The accountability issue is also emphasized by the IFSB (2005), which states: "IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS's accountabilities to various stakeholders."[29]

The accountability issue is also important in terms of compliance with *shari'a*. Because *shari'a* compliance is the main difference between Islamic banks and others, it is the main issue for effective corporate

[28] For detailed description of ISO standards, see www.iso.org.
[29] IFSB (2005).

governance structures that are tailor-made for Islamic banks. It is also imperative for Islamic banks to appoint board members and senior managers who are qualified and experienced in Islamic banking. Although an Islamic bank is still a bank, most of the transactions are unique. In particular, risks faced by Islamic banks are very different from those faced by conventional banks. The board of directors and senior management may have banking, supervision, or auditing background, but this expertise may not be relevant to Islamic banking. They should be aware of the importance of corporate governance and its influence on practice. Any internal or external audit performed should be closely watched and paid attention to in order to solicit suggestions for improvement.

Internal control systems also play an important role within the corporate governance structure of Islamic banks. Their duties include checking for compliance with internal procedures as well as regulations. Boards of directors and senior management enforce their policies, along with corporate governance, through internal audits. Any feedback from staff for the system should be directed to internal auditors. External auditors provide the same services with outside eyes, providing independence and objectivity. The auditing process also forces Islamic banks to comply with international standards, such as international accounting standards, even though such compliance is not required by their domestic regulators.

Hassan, et al. (2004) conclude that for developing countries where Islamic banks are mostly operative, "information asymmetries are more severe, market participants less experienced, and regulations, even if they exist, are not enforced effectively and impartially because of political corruption and the general weakness of judicial systems." They also conclude that "the adverse effects of ineffective corporate governance can be more serious in the case of financial institutions because the number of their stakeholders is much larger and the systemic risks are much greater."

Islamic banks face many complications for their operations. Although there are many financial entities that conduct businesses with products similar to Islamic banking products, Islamic banks contain them all. Mutual funds, venture capital, equity participation, leasing, foreign exchange, and international trade financing are just some of these common lines of businesses. The extent and variety of transactions involve many different stakeholders. Therefore, Islamic banks should pay adequate attention to each stakeholder group and incorporate them into their corporate governance structure. Basel II provides suggestions for corporate governance of conventional banks, but does not include Islamic banks. The definitions of each stakeholder, associated rights, and their responsibilities toward each other should establish the foundation for extending corporate governance to include every one of them.

With the development of Islamic finance and the considerable increase in Islamic funds, many banks are considering Islamic banking as an alternative instrument to their commercial banking activities. The latest trend is to include this alternative within the product portfolio. Islamic banking departments, windows, and subsidiaries have received considerable attention. Although many institutions have been offering Islamic banking products to their customers for years, the trend has received much attention within the last decade. These banks that offer Islamic products along with their usual commercial banking products comply with Basel II rules and suggestions without any alterations.

COMPLIANCE OF ISLAMIC BANKS WITH BASEL II

Systemic Risk

As participants in the financial system, Islamic banks pose risks to economic systems as well as to all stakeholders. Shakil provides several critiques to the Basel accord.[30] Some of the critiques are based in the very nature of Islamic banks. The characteristics of the economies in which Islamic banks operate also draw criticism.

The systemic risks that Islamic banks pose are similar to conventional banks. The profit and loss accounts, by nature, provide flexibility to Islamic banks to distribute losses. Holders of profit and loss accounts are aware of the illiquid nature of these accounts. Therefore, it is expected that Islamic banks would be immune to system-wide liquidity crises and bank runs. Lack of a lender of last resort, lack of deposit insurance, and inability to access short term money market instruments (and markets) affect Islamic banks negatively in terms of systemic risk. However, as long as Islamic banks do not make investments from current accounts and keep the adequate liquidity measures, profit and loss account holders cannot cause Islamic banks to fail. In practice, there are problems associated with liquidity of investment accounts. There have been failures of Islamic financial institutions, and hence, the extent of immunization is limited.

Ideally, Islamic banks should match every deposit to each investment and provide appropriate transparency to both sides about the details of the transaction. Any *mudaraba* and/or *musharaka* transaction is a partnership between the investment account holder and the credit-utilizing company. The Islamic bank is just an intermediary. Thus, all parties to the transaction

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[30] M. Shakil, "The Impact of Basel II on the Future of Islamic Banking," *Islamic Finance: Current Legal and Regulatory Issues* (Cambridge, MA: Harvard Law School, 2005).

have a right to transparency. However, heavy usage of *murabaha* transactions increases the number of transactions and decreases the likelihood of matching customers with projects. Thus, instead of one-to-one investments, a pooling method is utilized. This is also because of the fact that deposit customers are always relatively short-term oriented and credit customers are relatively long-term oriented. As a result of the pooling method, Islamic banks cannot match the maturities of deposits and credits. If there is a system-wide bank run, short-term depositors would have to wait longer than investment deposit holders to receive their funds. The difference of maturities between deposits and credits would need to be financed.

The conditions of immunization for Islamic banks against any system-wide risk are the following: current accounts will not be used in investments, required liquidity will be kept in cash, and investment deposits' maturities will match maturities of investments made from these accounts. The last condition is very hard to accomplish. Thus, Islamic banks are exposed to system-wide risks with a lack of a lender of last resort and money market instruments. In order to compensate for the additional risk, the maturity mismatch should be measured in terms of length and magnitude. Islamic banks should be required to report this data publicly. Islamic banks should also be required to report the measures they have taken to account for this difference in case of a run.

Financial Status

Islamic banks are financial intermediaries between lenders and borrowers of funds. In this respect, they are similar to interest-bearing banks. Shakil explains that the Islamic banks collect deposits, intermediate payments, and possibly cause systematic risks.[31] Therefore, the functions of Islamic banks, which are similar to interest-bearing banks, require us to treat them as banks.

The main question is: can we treat Islamic banks as pure trading companies instead of banks? Companies involved in trade act very much like Islamic banks. Islamic banks are intermediaries of actual trade. Trade companies operate for their own account and with their own funds. Therefore, if Islamic banks did not collect deposits and worked only with shareholder funds, they would be titled "Islamic trading companies." In cases where shareholder funds are inadequate, trade companies issue debt and Islamic banks collect deposits. The association of debt to a specific project can be achieved through debt covenants. While an Islamic bank

[31] Ibid.

may have to pool its funds and deal with a maturity mismatch problem, a corporation that issues project financing debt has no such risk. Thus, if Islamic banks are acting as agents of investment deposit holders, they are only representative bodies who evaluate and invest.

Even though it is easier to collect deposits by calling these entities Islamic banks, it is actually a representative agency. Organized exchange providers have many regulations and requirements for companies to be listed on their exchanges. This is to protect the rights of their investors and provide a platform in which investors can benefit from fair trade. In terms of investment accounts, Islamic banks are similar to exchange providers by making funds available for investment without making any profit or interest promise. In addition, Islamic banks act as investors' agents to actually make the investments.

PROBLEMS OF CORPORATE GOVERNANCE AT ISLAMIC BANKS

IFSB (2005) guidelines for corporate governance of Islamic banks are derived from the literature about corporate governance and experience at Islamic banks. The fact that the Islamic banking industry is a new and growing industry creates many complications. In most cases, countries do not have uniquely designed laws for Islamic banks. The same applies to lack of specialized accounting procedures for Islamic operations. For instance, lack of *shari'a* auditing by the supervisory authorities is a major obstacle. Centralization of *shari'a* boards is another issue. The IFSB (2005) suggests that "*fatawa* shopping" should be avoided. While leaving room for interpretation and consideration of rulings of different schools of thought, the underlying effort is to keep Islamic banks *shari'a* compliant. It is generally agreed that the reputation of each Islamic bank is of utmost importance for the entire Islamic banking industry.

Islamic banking is a new concept. Even though it has been around for decades now, the world financial markets are only recently noticing its importance. Islamic banking within the whole economic system needs further recognition. It is true that Islamic banking need not prove to anyone its necessity and sustainability. However, Islamic banks need to prove their uniqueness and novelty to both Muslims and non-Muslims.

The competitive advantage for Islamic banking is the religious aspect. Rational expectations theory shows that a rational investor will choose a higher yield for the same risk. Currently, Islamic banks are more risky and provide a higher rate of returns to their investors. Although religiosity provides them comparative advantage over conventional banks, they still need to improve efficiency. Otherwise, their survival will be at stake in the

world financial markets. One estimate shows that average cost of efficiency for Islamic banks is 74 percent while average profit efficiency is 84 percent.[32] Islamic banks are less cost-efficient but are more profit-efficient, leading to the conclusion that they are taking advantage of the religiosity of the Islamic banking customer, who is paying a premium for Islamic banking products due to a desire to adhere to an Islamic way of managing financial matters.[33] However, Islamic banks need to be inclusive rather than exclusive to better fit into the world financial market structure. However, under no circumstances should Islamic banks compromise their *shari'a* basis. It is expected that Islamic banks will be "*shari'a*-compliant" in the technical sense first, and then be "*shari'a*-based" in the broader sense. This is to say that the operations of Islamic banks need to strictly comply with *shari'a* as a prerequisite. However, it is also expected that Islamic banks are *shari'a*-based in their overall presence within the community. Islamic banks need to pay *zakat* and be ethical community members.

The question of whether adherence to *shari'a* will result in good governance still remains. We believe that *shari'a* is a necessary but not sufficient condition for good governance. *Shari'a* compliance needs to be complemented and supplemented by market discipline and regulatory supervision. It is not easy to comply with all aspects of *shari'a* in countries where the economic environment is not *shari'a* compliant. Islamic banks have to make a trade-off between completely *shari'a* -based products and market conditions. An external *shari'a* audit could improve the governance structure by increasing consistency of interpretation and application of *shari'a* across the Islamic financial services industry. One *shari'a* board per institution needs to be complemented by a *shari'a*-based rule for all institutions. A comprehensive system-based *shari'a* board consisting of scholars from different disciplines on a national and international level will bring a more level playing-field into this industry, and help it integrate with the world financial market.

[32] M. Kabir Hassan, "The X-Efficiency of Islamic Banks," *Islamic Economic Studies* 13 (February 2006): 49-77.
[33] Ibid.

Financial Engineering

The products that are in use today by Islamic banks have received much attention. Most of them have been discussed in this paper. These financial instruments are sometimes criticized for their application and usage. The legal systems that Islamic banks operate under may require them to alter the way they handle some of their products. However, the intent and the end results are acceptable. It is generally accepted that some of the procedures must be criticized in order to achieve the economic acceptance that Islamic banking needs.

In the early years of Islamic banking, the view was toward leniency. The system was new and needed to achieve sustainability. The idea was completely foreign to governments and legal systems, as well as to most customers. It was nearly impossible to divert customers from familiar interest-bearing commercial banking to Islamic banking. Therefore, it was acceptable to adopt familiar Islamic banking products such as *murabaha*. This is not to say that *murabaha* is a dubious product; it is only to acknowledge that it is similar to some of the popular banking products.

However, today the Islamic banking industry must recognize the need for international economic recognition. For that purpose, the criteria for *shari'a* compliance should be made more stringent. Standardization needs to be established, not only in accounting and other procedures, but also in *fatawa*. In this respect, some Islamic banking products need to be re-evaluated. The aim of such criticism should be to establish Islamic banking as an alternative within global financial markets. The level of compliance with stricter rules and regulations, pertaining to religion, will make the difference between Islamic banking and interest-bearing banking much more visible.

The main criticism of Islamic banking products is their similarity to interest-bearing commercial banking products. Islamic banks should refrain from engineering products similar to those used in the interest-bearing system. For instance, the most popular instrument of Islamic banks, *murabaha*, has several distinct characteristics. For instance, Islamic banks cannot sell what they do not posses. Islamic banks may appoint powers of attorney (*wakala*) to comply with the *shari'a*. However, if Islamic banks engineer a credit card using *murabaha* for each transaction and appoint the seller as the power of attorney, then the whole procedure will work very much like an interest-bearing credit card. The intent may be to engineer a product to compete with interest-bearing commercial banks. However, the economic system categorizes the new product as a credit card with a convenient label.

The IFSB (2005) refers to two distinct procedures that would smooth profits paid to investment account holders: "Investment Risk Reserve

(IRR)" and "Profit Equalization Reserve (PER)."[34] The idea is a simple and logical one. Islamic banks collect funds into investment accounts and invest in projects. The profits or losses realized from these projects are distributed to investment account holders. The IFSB (2005) explains the importance of handling these procedures correctly. This is because Islamic banks invest in projects with funds from equity and funds from investment accounts. Thus, if there is any collection into IRR and/or PER, it should be from profits distributed both to equity owners and investment account holders. The payments should also be made to both funds' owners. Apart from these consequences, IRR and PER involve other major issues. Even though the funds are invested in real projects through Islamic banking products, this is neither visible to account holders nor to economic observers. Unless Islamic banks adopt a strategy to be transparent about the individual investments and profit calculation/distribution procedures, outside observers only see an investment account with different maturities (similar to interest-bearing banks) and smoothed profits (no losses or fluctuations). Such extensive transparency is rarely achieved. The Islamic bank may also be tempted to smooth profits with reference to market interest rates in order to retain account holders. It can be argued that as long as the product conforms to *shari'a*, the smoothing technique may be employed. It can also be debated whether or not these products actually conform to *shari'a*. The IFSB (2005) provides some points of attention for IRR and PER that may need emphasis, such as the point that reserve funds may be collected from account holders who may never receive any smoothing payments. However, the main emphasis should be on the intent and the end result. The intent is the competition and desire to have continuous similar level profit payments for the account holders. While IRR and PER do not constitute a promise similar to interest, it may have an implied meaning for the account holder. The end result is a competitive product that is similar to an interest-paying account.

In terms of financial engineering, Islamic banks have two concerns: *shari'a* compliance and international economic recognition. Islamic banks are obligated to either make themselves as transparent as possible in many aspects, or be concerned about how the financial products look to outside observers. Otherwise, it is just the Islamic bank's and/or the *shari'a* board's word. This obligation is toward the Islamic banking industry and to all related stakeholders. Ideal corporate governance should ensure that above all operational concerns, Islamic banking is achieved.

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[34] IFSB (2005).

Stakeholder Rights

As mentioned by IFSB (2005), the stakeholders of Islamic banks have a vote by hand or by feet. Shareholders can elect board members and, indirectly, executives. Account holders can influence the bank by simply withdrawing their funds and walking away. However, some stakeholders do not have a voting right, neither by hand nor by feet. Although the main instrument of Islamic banks is *murabaha* and customer structure is completely different for *mudaraba* and *musharaka*, it is necessary to define the rights of project partners of Islamic banks. A *musharaka* can have a maturity as long as five years, sometimes even more. During this period, *musharaka* partners may not walk away from the Islamic banks as easily as account holders. The same hardship applies to *mudaraba* partners. Their livelihood and capital may be tied up in the project, and they may be bound by an obligatory contract. Even though Islamic banks actively audit and interfere with their project partners, these partners have no right to do the same. This is of course the same for venture capital and other similar partnership schemes.

The lack of a mechanism to protect the rights of project partners within the Islamic bank leads to hesitation on the customer's side regarding entry into such partnerships. The same lack of mechanisms to protect the rights of investment account holders has captured much attention in the literature. It is contended that representation of investment account holders is not feasible. Therefore, two of the most important stakeholders are not represented within the Islamic bank management. They do not have voting rights and may not have the option to walk away. Basically, there are only three parties represented within an Islamic bank: shareholders, *shari'a* scholars, and the supervisory authority through regulations. It is assumed that the regulatory authority represents all unrepresented stakeholders.

An Islamic bank also is a stakeholder at another Islamic bank due to systemic financial and reputational risk. As long as the bank is labeled Islamic, any wrong-doing will affect all. Thus, if an Islamic bank declares bankruptcy, it is generally agreed that all other Islamic banks within the same country, or perhaps around the world, will be affected. The same principle applies to *shari'a* compliance. If an Islamic bank diverges from compliance, it will have an effect on the entire system. Representation of such groups is ensured by the existence of *shari'a* boards.

The representation of all stakeholders does not necessarily mean managerial power or voting rights. It may only mean adequate transparency. Through transparency, Islamic banks would declare their procedures and finances to allow stakeholders to make their own judgments. Through transparency, the differences between Islamic banks

and interest-bearing banks would be made clear. The transparency needed is not about the customer database or trade secrets. It is about procedures, financial structure, and *shari'a* compliance.