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Corporate Governance and the Islamic Moral Hazard

Ibrahim Warde[1]

Corporate governance, defined as "the whole system of rights, processes and controls established internally and externally over the management of a business entity with the objective of protecting the interests of all stakeholders,"[2] has taken center stage in the past few years. The initial impetus came in the wake of the 1997 Asian financial crisis, when "bad governance" was designated as the primary culprit in the sudden collapse of economies that appeared healthy on the surface. The interest in the subject has not abated, as a steady stream of corporate scandals in the United States and Europe—involving companies such as Enron, World Com, Global Crossing, and Parmalat—has kept the preoccupation with corporate governance in the limelight.[3]

The Islamic world has in that regard been the subject of special scrutiny. Since the attacks of September 11, 2001, there is a wide consensus about the need for democratic reform and institution-building in the "greater Middle East."[4] Financial institutions, and especially the Islamic ones, have for a variety of reasons (such as their importance within national and regional economies, their inscrutability to outsiders, their rapid growth, the lack of universally accepted norms, etc.) been urged to take the issue of corporate governance particularly seriously.[5]

This paper focuses on the need to integrate moral hazard in the debate on the governance of Islamic institutions. The abundant literature on corporate governance has an ethnocentric character. It assumes U.S. style practices and norms, and places heavy emphasis on checks and balances and the creation of committees to monitor compensation, conflicts of interest,

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[1] Reseach Affiliate, Center for International Studies, Massachusetts Institute of Technology (Cambridge, Massachusetts).
[2] Lannoo 1995: 5.
[3] See Warde 1998 and 2002.
[4] The "Greater Middle East" initiative was, for example, at the center of the June 2004 meting of the G8 meeting in Sea Island, Georgia.
[5] See the issues raised in Taylor 2004.

and the like. As in all one-size-fits-all approaches, it ignores the different institutional frameworks and regulatory cultures within which Islamic institutions operate. More specifically, being essentially secular, the corporate governance canon pays no attention to the religious element, which of course is at the core of Islamic finance.

At the same time, the Islamic finance literature resolves by assumption the issues raised by the corporate governance and moral hazard debates. A pioneer in the field explains what is expected of employees: "The staff in an Islamic bank should, throughout their lives, be conducting in the Islamic way, whether at work or at leisure."[6] By the same token, clients are expected to be people of impeccable character. Overall, "Islamic banks have a major responsibility to shoulder. . . . [A]ll the staff of such banks and customers dealing with them must be reformed Islamically and act within the framework of an Islamic formula, so that any person approaching an Islamic bank should be given the impression that he is entering a sacred place to perform a religious ritual, that is the use and employment of capital for what is acceptable and satisfactory to God."[7]

In addition, good governance happens to represent one of the ideals of Islamic finance, which is all about fairness, transparency, accountability, and social responsibility. Thus the Islamic concept of "trust" *(amana)*, which requires financial institutions to manage the funds entrusted to them in an effective, efficient, and responsible manner, corresponds almost exactly to that of corporate governance.

From the early days of Islamic finance in the 1970s, the ideal was not easy to put in practice. Problems of moral hazard, and by extension of corporate governance, proved endemic. Over time, Islamic institutions dealt with them in a number of ways—from devising contractual safeguards to avoiding certain transactions altogether—which resulted in diluting their Islamic character. The Islamic moral hazard has nonetheless seldom if ever been analyzed in any systematic way. However, as this paper will show, eliminating it or at least reducing it would be an essential step toward good governance. The paper consists of three parts: the first discusses the moral hazard issue, the second explains how it has been addressed by Islamic institutions, and the third attempts to identify the roots of the Islamic moral hazard.

MORAL HAZARD

Moral hazard refers to a range of perverse incentives and unintended consequences. It exists whenever a contract changes the risk-taking

[6] Janahi 1995: 28.
[7] Janahi 1995: 42.

behavior of one party to the detriment of the other, or whenever a party can gain from acting contrary to the principles implied by the agreement. In the financial world, perverse incentives and unintended consequences include excessive risk taking, unwise investments, reneging on commitments undertaken, and outright fraud.[8]

For example, an insurance policyholder may have a financial incentive to wreck his car or burn down his house. This is why insurance companies devise ways (for example, by imposing costs on the policyholders, such as deductibles) to minimize such occurrences. Similarly, in the financial industry, loose credit, lax controls, and implicit or explicit guarantees of bailout can create moral hazard. The collapse of U.S. savings and loans in the 1980s has generally been attributed to the moral hazard created by the combination of sudden deregulation and generous deposit insurance. Indeed, just as savings and loan companies, whose activities were once confined to the financing of single-family homes, were allowed almost overnight to invest in virtually anything, the ceiling on deposit insurance was raised from $40,000 to $100,000. In a freewheeling environment, unscrupulous entrepreneurs gambled on risky construction projects or junk bonds with the assurance that the government would bail them out. From their standpoint such gambling was always rewarded, since they would keep whatever profits they made while the deposit insurance would cover their losses.[9] Profits were thus privatized and losses socialized, at an eventual cost to American taxpayers of over $300 billion.[10] Throughout the 1990s, a succession of bail-outs of countries (Mexico, Russia, etc.) and companies (such as Long Term Capital Management), have perpetuated the moral hazard problem by rewarding reckless lending.

THE EARLY EXPERIENCE OF ISLAMIC BANKS

Though seldom addressed as such, the moral hazard problem was evident from the early years of Islamic finance. Since it was assumed that participants in Islamic finance were righteous, questions of governance and moral hazard were by definition resolved. As noted by Hamid Algabid: "At the beginning, confidence was the rule. The good faith of the participants could not be questioned since it was identified with religious faith. Since spiritual and temporal matters could not be dissociated, a pious man could only act in good faith. Experience has since shown that banking operations

[8] See Allen 2001: 13, and Temple 2001: 73.
[9] Another thing made possible by deregulation was that investment bankers could group deposits into insurable $100,000 bundles and place them in savings and loans offering high returns.
[10] Vickers 1997: 98.

could not be established on that assumption, and particularly that guarantees could not be limited to the affirmation of one's Islamic faith."[11]

After a few years, Islamic institutions discovered that perverse incentives were at play, and dealt with those incentives in a variety of ways. This section considers the cases of late fees, *murabaha*, profit-and-loss sharing, and investment accounts.

Late Fees

For most religious scholars, late fees are analogous to *riba*, and thus forbidden. In the early years of Islamic finance, late fees were seldom charged. This had an impact on the behavior of debtors who "know that they can pay Islamic banks last since doing so involves no cost."[12] Over time, Islamic institutions realized that such behavior had a real impact on their management, and often a real cost. Although there are differences across institutions, most consider that late fees are necessary as a "disciplining mechanism," forcing borrowers to pay on time. At the same time, because of theological considerations, late fees are typically treated differently: after deducting actual costs, income derived from late fees goes to charity.

Murabaha

Mark-up transactions are by far the most common Islamic financial products.[13] The best-known is the *murabaha*, a cost-plus contract in which a client wishing to purchase equipment or goods requests the financial provider to purchase the items on his behalf and sell them to him at cost plus a declared profit. It is thus a financing-cum-sale transaction: the bank purchases the required goods directly and sells them on the basis of a fixed mark-up profit, agreeing to defer the receipt of the value of the goods.

Two of the main theological sticking points concern the actual "ownership" of the goods by the financial institutions, and the implications of the "promise" to purchase. In theory, the deal involves two sales transactions (one involving buying the goods from the manufacturer, the other involving selling them to the "borrower"). There is thus a period during which the financial institution owns the goods. During that time the bank bears the risk that the goods will be damaged or destroyed, or that the client may go bankrupt, or otherwise reject the goods as unsatisfactory.

[11] Algabid 1990: 182.
[12] Vogel and Hayes 1998: 139.
[13] al-Harran 1995: xi and 135.

Shari'a scholars in the early days of Islamic finance were keen, in the name of the risk-sharing logic of Islamic finance, to place a significant burden on the financial institutions. There were also intense debates among *shari'a* scholars as to what the promise *(wa'd)* entailed, or whether a promise was binding or not.[14]

A few institutions introduced *murabaha* contracts that were in effect revocable, insofar as they resulted in the actual, though of course temporary, ownership of the goods by the bank and did not consider the promise to purchase binding. In effect, such contracts allowed the buyer under many circumstances to renege on the deal. Not surprisingly, quite a few clients abused the privilege—leaving the financial institution with an unanticipated headache. Put differently, there was a clash between the risk-sharing logic of Islamic finance and the prudential rules of bank management. It did not take long for financial institutions to discover that it was neither their role nor part of their expertise to act as potential merchants for whatever products their clients had ordered.

Thus the practice of *murabaha* changed over time. Today, in most cases, the period of ownership by the financial institutions will be more symbolic than real. The duration could theoretically be of just one second. Hence the notion of "synthetic *murabaha*." Frank Vogel wrote about the commonly-used trade financing deals: "many doubt the banks truly assume possession, even constructively, of inventory, a key condition of a religiously acceptable *murabaha*. Without possession, these arrangements are condemned as nothing more than short-term conventional loans with a predetermined interest rate incorporated in the price at which the borrower repurchases the inventory."[15] In sum the moral hazard problem was resolved, albeit at the expense of the principle of correspondence of risk and reward. Indeed, the risk incurred by the bank is minimal, whereas the profit margin is determined in advance and usually pegged on interest-based benchmarks such as Libor. As a result of criticisms by Islamic scholars, many financial institutions have vowed to start phasing out certain types of *murabaha* transactions—though in practice this remains to be seen.[16]

Islamic Profit-and-Loss Sharing

The basic principle of profit-and-loss sharing is that instead of lending money at a fixed rate of return, the banker forms a partnership with the "borrower," sharing in a venture's profits and losses. The partnership can be of one or two types: *mudaraba* (finance trusteeship) and *musharaka*

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[14] Vogel and Hayes 1998: 125-128.
[15] Vogel and Hayes 1998: 9.
[16] Vogel and Hayes 1998: 143.

(longer-term equity-like arrangements). In both cases, the financial institution receives a contractual share of the profits generated by business ventures.

In the early days of Islamic finance, a lot of enthusiasm was generated by the prospect of implementing the ideal of profit-and-loss-sharing finance. It was at once the most "authentic" form of Islamic finance since it replicated transactions that were common in the early days of Islam,[17] the one that was most consistent with the value system and the moral economy of Islam, and the most "modern" one. Indeed, venture capital and merchant banking—both among the fastest growing segments of contemporary finance—were the conventional equivalents of profit-and-loss sharing arrangements.

One of the criticisms of collateral-based lending at a fixed, predetermined interest was that it is inherently conservative. It favored well-established businesses and was only marginally concerned with the success of the ventures it financed. In contrast, under profit-and-loss sharing, Islamic institutions as well as their depositors linked their own fate to the success of the projects they were financing. The system allowed a capital-poor but promising entrepreneur to obtain financing. The bank, being an investor in the venture, had a stake in its long-term success. The entrepreneur, rather than being concerned with debt-servicing, could concentrate on matters of business growth, which in turn would provide economic and social benefits to the community.

Under *mudaraba*, one party, the *rabb al-mal* (beneficial owner or the sleeping partner), entrusts money to the other party called the *mudarib* (managing trustee) who is to utilize it in an agreed manner. After the operation is concluded, the *rabb al-mal* receives the principal and the pre-agreed share of the profit. The *mudarib* keeps for himself the remaining profits. The *rabb al-mal* also shares in the losses, and may be in a position of losing his entire investment. There are a few other basic principles: The division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump-sum or guaranteed return; the *rabb al-mal* is not liable for losses beyond the capital he has contributed; the *mudarib* does not share in the losses except for the loss of his time and efforts. Such a financing system was common in medieval Arabia where wealthy merchants financed the caravan trade. They would share in the profits of a successful operation, but could also lose all or part of their investment if, for example, the merchandise was stolen, lost, or sold for less than its cost. *Mudaraba* contracts were codified by medieval jurists and could take on extreme complexity.

Musharaka is similar in its principle to *mudaraba*, except for the fact that the financier takes an equity stake in the venture. It is in effect a joint-venture agreement whereby the bank enters into a partnership with a client

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[17] Udovitch 1970: 170-248.

in which both share the equity capital, and sometimes the management, of a project or deal. Participation in a *musharaka* can either be in a new project, or in an existing one. Profits are divided on a pre-determined basis, and any losses shared in proportion to the capital contribution.

Islamic profit-and-loss sharing has been a major disappointment. Today it only accounts for barely 5 percent of Islamic banking assets. The moral hazard problem between the entrepreneurs and their lenders is one of the many reasons for the failure. Under profit-and-loss sharing, although the financier shares in the risk, he does not share in the management, and this creates the potential for conflicts of interest, as well as managerial and regulatory complications that have yet to be fully mastered. For instance, the *mudarib* can ask for more money than he needs, or he can engage in high-risk endeavors, knowing that he will not be committing his own money. The bank can also take advantage of a *mudarib* who is pressed for cash, or of holders of investment accounts who know little about the deal. More generally, there is the possibility of structuring the transaction in such a way as to transfer the risk onto the other participants.[18]

Moral hazard issues are at the core of the failure of profit-and-loss sharing. In explaining why his bank was no longer involved in profit-and-loss sharing, Hassan Kamel, chief executive of the (now-defunct) London branch of Al-Baraka, (PLS) operations addressed the issue: “The depositors wanted an Islamic deal without risk. They liked, at least, to guarantee their capital. The problem with PLS is that (the Islamic economists) assume the scenario of the entrepreneur being a good Muslim.”[19] After suffering losses, many banks left profit-and-loss sharing activities altogether. Others have tried, not always successfully, to devise appropriate safeguards. But decisions to exert due diligence thorough checks on *mudarib*s and striving for transparency and the avoidance of negligence, mismanagement, or fraud were not easy to put in practice.[20]

Investment Accounts

The distinctive feature of Islamic institutions on the liability side of their balance sheet is their reliance on investment accounts, which allow the customers to share in the profits of the bank. Because of the ban on interest *(riba)*, an Islamic bank is not supposed to commit to any fixed return in advance. Unlike a conventional bank which is basically a borrower and lender of funds, an Islamic bank theoretically operates on the basis of “double *mudaraba*”—one with its “depositors,” the other with “borrowers”

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[18] See for example Ziaul Haque, *Riba: The moral economy of usury, interest, and profit* (Lahore: Vanguard 1985), 190-214.
[19] al-Omar and Abdel-Haq 1996: 43.
[20] Parigi 1989: 137.

in need of financing. Investment accounts come in a variety of forms: "depositors" can share in the profits of certain instruments only (for example "special investment accounts" dealing with, say, a specific real estate fund, or a broader class of investments) or of the bank as a whole.

Many of the observations made in the previous section in connection with the latter form of *mudaraba* also hold true in connection with the former, where the bank is the *mudarib* and the depositor acts through his investment account as the *rabb al-mal*. Such partnership entails fundamentally different relations with the financial institution than under conventional banking. The distribution is done according to a certain ratio. For example 80 percent of the net profits may be distributed to the depositors, and 20 percent to the shareholders. Empirical surveys have shown that banks often arbitrarily change distribution ratios. When profits decline, depositors often still expect a competitive rate of return, or else they may take their savings to another Islamic institution, or to a conventional bank. Thus in Egypt, from the mid to the late 1980s, the International Investment Bank for Investment and Development (IIBID) distributed all its profits to investment account depositors, while the shareholders received nothing. In 1988, the bank even had to distribute to its depositors an amount exceeding its total net profit. The difference appeared in the bank's account as "loss carried forward."[21] Clearly such practices fly in the face of sound banking management practices, and cannot be sustained for long, yet the competitive logic of financial markets makes such behavior likely in the absence of strict regulatory controls.

ISLAMIC FINANCE AND THE MORAL HAZARD ISSUE

Many of the well-publicized cases of fraud or abuse could be traced to the righteousness assumption. Following the collapse of the Bank of Credit and Commerce International (BCCI) in 1991, it appeared that at least a couple of Islamic banks had failed to exercise proper scrutiny and due diligence. Although not itself an Islamic bank, BCCI had set up in 1984 an Islamic Banking Unit in London, which at its peak had $1.4 billion in deposits, and had generally made heavy use of Islamic rhetoric and symbolism. The Price Waterhouse report commissioned in the wake of the bank's closure revealed that of BCCI's $589 million in "unrecorded deposits" (which allowed the bank to manipulate its accounts) the major part—$245 million—belonged to the Faisal Islamic Bank of Egypt (FIBE). This amount was supposed to be used for commodity investments, though there was no evidence that such investments were ever made.[22] Similarly, the Dubai Islamic Bank (DIB) had

[21] Kazarian 1993: 179.
[22] Potts et al. 1992: 77-78.

placed $86 million with the bank. Although neither FIBE nor DIB was suspected of wrongdoing, the scandal highlighted the problems of control and due diligence. In 1998 two major swindles, one involving bank employees, the other involving a client, occurred at Dubai Islamic Bank, causing runs on deposits and necessitating the Dubai Central Bank and the United Arab Emirates' authorities to ride to the rescue.[23]

While it is undeniable that religious fervor was for many people a reason to work for an Islamic bank, or conduct business with it, it was soon discovered that religion could be a double-edged sword. The religious character of certain institutions could turn certain institutions into a magnet for dubious characters. And indeed, a number of bank executives have acknowledged that they had trusted people who did not deserve their trust.[24] Since time immemorial, con artists have used the cover of religion as a means of rapid enrichment. Countless financial scandals have involved religious figures.[25] Even when the overwhelming majority of people are honest, all it takes is a few bad apples—a few dishonest customers or employees—for banks to incur serious difficulties. Indeed, one big swindle can bring a financial institution down.

A broader issue is that of the ambiguity of norms. Unlike secular systems, the legal system of Islam incorporates both an economic and a religious logic. In the words of Noel Coulson: "Commercial law . . . in the West is orientated towards the intrinsic needs of sound economics, such as stability of obligation and certitude of promised performance. In the religious law of Islam, on the other hand, equitable considerations of the individual conscience in matters of profit and loss override the technicalities of commercial dealings. It is the harmonization of these two very different approaches which poses the real challenge for developing Islamic law today."[26]

This dual logic can account for a variety of dysfunctions. Religion can make certain institutions immune to scrutiny or criticism. In Iran, for example, a whole sector of the economy has been able to operate outside of any regulatory framework, allowing financial abuses to persist and go unsanctioned.[27] Then there is the question of forbearance. Like other religions, Islam recommends forbearance and even loan forgiveness to borrowers in difficulty.[28] Unlike secular bankers, who can use a whole array of tools to protect their interests as lenders (and at times take advantage of borrowers who have fallen on hard times), Islamic institutions are expected

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[23] Warde 2000: 84.
[24] Algabid 1990: 182.
[25] DiFonzo 1983.
[26] Saleh 1986: preface.
[27] Zubeida 1997: 113.
[28] "If the debtor is in difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew." (Qur'an: 2:280)

to take into account the borrower's circumstances. Those who are unable to pay for reasons beyond their control are treated differently from those who are able but unwilling to fulfill their financial obligations.

The dilemma of Islamic financial institutions is that although they are profit-making enterprises, as opposed to charities, they are bound by religious precepts. Moral hazard issues appear whenever customers take advantage of dilatory legal and religious devices to renege on their obligations. Invoking religious principles, forum-shopping, or otherwise taking advantage of dual or multi-layered systems that are common in the Islamic world has been a problem for Islamic banks. In Pakistan, where the banking system was (in theory though not really in practice) Islamicized in 1979, and where a complex legal system includes special banking tribunals and *shari'a* courts, this happened quite frequently.[29] Many businessmen who had borrowed large amounts of money over long periods of time seized the opportunity of Islamicization to claim that the accumulated interest on their debt was now voided, leaving them liable only for the principal owed—usually only a small part of the total amount due.[30]

Saudi Arabian banks commonly encounter comparable problems. Peter Wilson observed that "Saudi Arabia's bad loan problem is as old as the country's banking system, given the doctrinal dilemma of having an interest-based financial system in a country that officially prohibits interest."[31] More specifically: "The Kingdom's law courts reflect the uneasy balance in the country. There are Islamic or *shari'a* courts that fall under the jurisdiction of the cleric-dominated Ministry of Justice and special commercial committees under the sway of the more progressive finance and commerce ministries. Enforcement, however, remains the domain of the Interior Ministry and each province's governor. The result is a legal quagmire, as the country's economic development has overwhelmed the abilities of the existing courts."[32]

CONCLUSION

The preoccupation with the corporate governance of Islamic institutions has largely left out moral hazard issues that, as argued in this paper, should be an important preoccupation of both students and practitioners of Islamic finance. Those issues, which stem from the hybrid nature of the Islamic finance industry—its being subjected to both secular and religious norms—have been addressed piecemeal.

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[29] Warde 2000: 112-117.
[30] al-Omar and Abdel-Haq 1996: 101.
[31] Wilson 1991: 109.
[32] Wilson 1991: 8.

This paper has looked at the early experience of Islamic finance in connection with late fees, *murabaha*, profit-and-loss sharing, and investment accounts. In dealing with these issues, many Islamic institutions have either created theologically dubious solutions (as was the case with the "synthetic *murabaha*") or abandoned altogether distinctive instruments such as *mudaraba*. In both cases, it confirmed the view of critics of Islamic finance who say that it replicates, albeit under different names, the main conventional instruments.

This paper suggests that by systematically and thoroughly addressing the question of moral hazard, more creative solutions can be found. It is useful to recall that Islamic financial institutions only came into existence in the mid-1970s, and are still experiencing growing pains. At a time of rapid growth, and as a number of organizations (among them the Accounting and Auditing Organization for Islamic Financial Institutions [AAOIFI] and the Islamic Financial Services Board [IFSB]) are attempting to create transnational industry norms, thinking about adequate solutions to the moral hazard problem holds the promise of revitalizing original Islamic instruments.