The Governance of Islamic Banks: Ethical Challenges and the Implications for Corporate Governance

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Abstract

Corporate governance is one of the most important elements of the corporation as it is meant to ensure and promote principles of fairness, accountability, and transparency in Islamic banking sphere, the governance of this kind of institutions presents specificities that reflect a wider field of a concern than that of "Corporate Governance." Indeed, The Islamic banking vision, unlike the conventional banking approach, is concerned both with performance and shari’ah-compliance. The purpose of this paper is to highlight, on the one hand, the particularity of corporate governance from the Islamic perspective as a system that where an Islamic bank is governed by directors and also by Shariah board. That is what scholars called -double governance-. The study finds that the main issue that arises is related to protecting all stakeholders ‘interests as well as those of shareholders. In fact, Islamic banks have to remedy this situation. Thus, investment account Holders (IAH) are exposed to many of the same risks as shareholders but lack the governance rights like those which the latter fully enjoy. Therefore, this paper is intended on the other hand to view measures proposed by IFSB (Islamic Financial Services Board) to deal with this situation Finally, this paper concludes that the degree required to protect IAH's interests is not yet reached to the detriment of all recommendations and practices implemented.

Keywords: Corporate Governance; Shariah; Shareholders; Stakeholders, investment account holders (IAH)

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Introduction

The issue of corporate governance and the search for an optimal governance structure has received considerable attention in the economic literature and in public-policy debates.

The concept of corporate governance is diverse, and, over a period of time, the definition of the term has oscillated between two extremes—from a narrow concept of a mechanism for safeguarding investors’ interests, to a broad concept advocating the protection of all internal and external stakeholders’ rights.

For institutions which operate in the field of Islamic finance, Corporate Governance have to confront other kinds of considerations. Indeed, many rules that impose ethical restrictions have to be respected. These rules emerge from the Shariah law which constitutes an indispensable framework in this area. Virtually, oversight function, which is basically also a real monitoring function assigned to a specific body, among others, Shariah Supervisory Board (SSB).

In this context, two types of governance arise: corporate governance in the traditional meaning and kind of ethical governance emerging from Shariah requirements. On the whole, this situation refers according to some authors’ review to kind of ‘double governance’. Thus, while corporate governance is mainly intended to protect the shareholders’ interests, the Islamic approach suggest a stakeholder-oriented governance model. It follows from the foregoing a series of issues related in particular to protection of investment account Holders (IAH)’ rights—the depositors—as the most vulnerable party. In fact, this category is exposed to a disproportionate risk within Mudharabah contract which binds this one to an Islamic bank: [We suggest through this paper to focus on the implications that result from restrictions imposed by Muslim law-Shariah- on corporate governance ‘classical approach while having regard mostly to banking structures.]

The one of important issues that we shall debates also is how Islamic finance deal with this type of challenges that directly affects its competitive ability. And whether efforts made in order to dress this matter, are sufficient to deduct a required protection of their rights as well as shareholders’ ones.

\[1\]Shari’ah (also known as “Shari’ah”) is an Islamic religious law that governs not only religious rituals but also aspects of day-to-day life in Islam. Sharia, literally translated, means “the way.” It constitutes a set of rules that emerged mainly from Quran and sunnah. The Qur an (the holy book of Islam) and the sunnah make up the two primary sources of Islamic theology and law. The sunnah is also defined as “a path, a way, a manner of life”; “all the traditions and practices” of the Islamic prophet that “have become models to be followed” by Muslims.

\[2\] It is the most important supervisory body within Islamic financing area. For Islamic banks, each one of them for example has a Shariah Supervisory Board tasked with insuring Shari’ah compliance of all bank transactions.

I - Overview of Corporate Governance

Corporate Governance can be considered as an environment of trust, ethics, moral values and confidence-as a synergic effort of all the constituent parts- that is the stakeholders, including government, the general public etc, professional, service providers, and the corporate sector.

Corporate Governance is a set of promises made by a corporation, and those that make the decisions for a corporation, to the corporation’s stakeholders. It can be viewed as a system of law, contracts, and social norms that govern the structure by which corporation make decision.

It aims at providing institutions with body of rules and principles, with a view to ensuring good practices guide overall management of an institution. It has now come to mean the whole process of managing a company and the incentive structure to address principle-agent issues and ensure that executive management serves the long-term best interests of the shareholders and sustainable value of the company in conformity with the laws and ethics of the country. All of the complex factors that are involved in balancing the power between the chief executive officier (CEO), The Board, and the shareholders are now considered to be a part of the corporate governance framework, including auditing, balance sheet and office balance disclosure, and transparency.

In Corporate Governance sphere, principles for good practices are so important. In fact, Good corporate governance principles stem from practices that have historically served shareholders and the marketplace well. The OECD-the Organisation for Economic Co-operation and Development-is a group of members from 34 different democratic countries that discuss and develop economic and social policy with the aim of supporting free market economies.

In a review of the impact of corporate governance on economic development, Claessens (2003) identifies four areas in which empirical evidence points to the positive effects of good CG on the performance of firms. First, it facilitates access to external finance. Lenders and other investors are more likely to extend financing to a business if they are comfortable with its CG arrangements, including the clarity and enforceability of creditor rights. Second, good CG tends to lower the cost of capital, by conveying a sense of reduced risk that translates into shareholders’ readiness to accept lower returns. Third, good CG is proven to lead to better

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4 David Crowther and Shahla Seifi, “Corporate Governance and International Business, Electronic copy available, Boukboon.com,p.11.
6 Id at 9.
7 Hussein Elasrag, Corporate Governance in Islamic Finance: basic concepts and issues, Electronic copy available at: http://ssrn.com/abstract=2442014
operational performance. Finally, it reduces the risks of contagion from financial distress. In addition to reducing the internal risk through raising investors’ risk perception and willingness to invest, it increases the robustness and resilience of firms to external shocks. The OECD analyzed the workings in these countries and formulated some important principles of good corporate governance. The OECD believed that good corporate principles are primarily based on an ethical code of business conduct. While principles are non-binding, they’re much valued in the corporate world. It’s globally accepted that good governance prevents fraud. These non-binding principles are reviewed in the light of significant changes in circumstances.

1- SHARIAH GOVERNANCE IN ISLAMIC FINANCE

1.1- OVERVIEW OF ISLAMIC FINANCE INSTITUTIONS’ SPECIFICITIES.

Islamic Finance is a relatively new term which denotes engaging in financial and business transactions according to the principles of Islamic Law-Shariah. One of the most important characteristics of Islamic financing is that it is an asset-backed financing. Indeed, the most critical and distinguishing feature of such a system is the prohibition of riba, which includes the payment and receipt of interest as understood in today’s financial markets. Other principles should also be respected: prohibition of gharar, excessive uncertainty; prohibition on financing haram, or prohibited industries (for example sales of alcohol), and quest for justice and an ethical society, which includes paying of zakat.

Succinctly, Islamic banking refers to a system of banking or banking activity which is consistent with Islamic Law [shariah] principles and guided by Islamic economics. In the past century the global Islamic finance industry has grown significantly. It is primarily found in the Middle East, Southeast Asia, and the UK. It aims for investments to provide a return without compromising the prohibition of riba, Islamic investments are structured in a profit-
sharing vehicle whereby the return to the investor is “linked to the profits of an enterprise and derived from the commercial risk assumed by that investor”\textsuperscript{15}. Thus, unlike conventional financial institutions, financing in Islam is always based on illiquid assets which creates real assets and inventories\textsuperscript{16}.

There is many contracts-instruments or options- used in Islamic finance area. These instruments are intended to fulfil various requirements and needs in financing sphere. Among of all Islamic financing options, \textit{Murabaha} is the most commonly used one. Today, 90\% of Islamic banking transactions are done using \textit{Murabaha}.

Other financing instruments as Salam and Istisna’ creates also real assets. The financier in the case of Salam receive real goods and can make profit by selling them in the market. In the case of Istisna’, financing is affected through manufacturing some real assets, as a reward of which the financier earns profit.

In the other hand, sukuk becomes flagship instrument in Islamic financing practice. In fact, Sukuk are financial instruments similar to bonds and also shares that are compliant with Islamic law.

Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) defines Sukuk as being: “Certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activities.”\textsuperscript{17}

There are three requirements for a Sukuk to be considered in compliance with the Sharia law\textsuperscript{18}

It is important to emphasize that leases contracts and Murabaha, are not originally modes of financing. But, in order to meet some needs, they have been reshaped in a manner that they can be used as modes of financing, subject to certain conditions, in those sectors where Musharaka, Mudharabah, Salam or Istisna’ are not workable for some reasons\textsuperscript{19}.

Therefore, while some common finance instruments have developed, for more complex financial transactions, Islamic Financial Institutions (IFIs) seek to develop creative solutions that provide the financing the investors require and comply with the main Islamic principles. However, to reach their purposes, IFIs must deal with a broad range of issues with respect to, amongst others, corporate governance.

\textsuperscript{16} Muhammad Taqi Usmani, op. cit, p. 19.
\textsuperscript{17} The AAOIFI Shariah Standard (17) on investment Sukuk
\textsuperscript{19} For further details see, ibid.
1.2- SHARIAH GOVERNANCE.

According to IFSB standard 10, Shariah Governance System refers to the set of institutional and organizational arrangements through which an IFIs ensures that there is an effective independent oversight of Shariah compliance over issuance of relevant Shariah pronouncements, dissemination of information, an internal and annual Shariah compliance review.\(^\text{20}\)

The definition above illustrates the extensive duties of Shariah Supervisory Board (SSB) to oversight and supervises the Shariah compliance of the Islamic financial institutions, as such, their competence is essential to form a robust Shariah board. It also implies that the Shariah board is crucial to the Shariah governance system as an authoritative body ensuring Shariah compliance.\(^\text{21}\)

Principles 3.1 of the IFSB Guiding Principles on Governance states that an appropriate mechanism must be created to ensure compliance with the Shariah principles. The foundational dimension of Islamic corporate governance is rooted in the fundamental principles of tawhid (the Oneness of Allah), the process of shura (Consultation), property rights and contractual obligations.\(^\text{22}\)

Corporate Governance in Islamic finance entails implementation of a rule-based incentive system that preserves social justice and order among all members of society. This view is commonly referred to as the “stakeholder model” of corporate governance, where “stakeholders” include customers, suppliers, providers of complementary services and products, distributors, and employees. Accordingly, this theory holds that corporations ought to be managed for the benefit of all who have some stake in the firm.\(^\text{23}\)

A widely adopted approach is to have independent bodies certify such compliance. Each Islamic financial institution has in-house religious advisers, collectively known as Shariah Supervisory Board (SSB), as part of the internal governance structure of the institution.\(^\text{24}\) In some countries, authorities have created oversight arrangements, such as Shariah boards or Islamic banking departments within supervisory agencies. These usually operate in conjunction with private independent market agents familiar with Islamic finance.


\(^\text{24}\) They exist in all Islamic countries with the exception of Iran, where compliance of the whole banking system with Shariah is guaranteed and monitored by the central bank.
II- CORPORATE GOVERNANCE: SPECIFIC CHALLENGES TO ISLAMIC FINANCIAL INSTITUTIONS

Corporate governance is not new to Islamic finance. Indeed, Islamic finance embeds the basic tenets of good corporate governance, stressing the three main areas of accountability, transparency and trustworthiness\(^{25}\).

Corporate governance in Islamic finance necessitates Islamic financial institutions abiding by a set of rules called the Islamic law or Shariah. The Shariah governs the bank’s operations and transactions in accordance with Islamic principles derived from the Quran and Hadith.

Exhibit 1.\(^{26}\) below suggests the build-up of a corporate governance framework for IFIs.

**Exhibit 1. Regulatory and corporate governance (CG) framework for IFIs**

<table>
<thead>
<tr>
<th>Regulatory and corporate governance (CG) framework of banks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I National CG framework</strong></td>
</tr>
<tr>
<td>– Banking sector specific laws/codes/guidelines</td>
</tr>
<tr>
<td>– Stock exchanges listing rules and regulations</td>
</tr>
<tr>
<td>– Listed companies regulatory authorities laws, rules and regulations</td>
</tr>
<tr>
<td><strong>II Islamic finance and Shariah specific codes and standards</strong></td>
</tr>
<tr>
<td>– IFSB guiding principles on corporate governance for institutions offering Islamic financial services 2006(^{27})</td>
</tr>
<tr>
<td>– Accounting and auditing organisation for Islamic financial institutions (AAOIFI) accounting, auditing and governance standards (for Islamic financial institutions)(^{28})</td>
</tr>
<tr>
<td>– Islamic Financial Services Board (IFSB) published standards including guidance on key elements in the supervisory review process of institutions offering Islamic financial services (excluding Islamic insurance [takaful] institutions and Islamic mutual funds)</td>
</tr>
<tr>
<td><strong>III International standards and codes</strong></td>
</tr>
<tr>
<td>– The OECD principles of corporate governance(^{29})</td>
</tr>
<tr>
<td>– Guidance by the Basel committee on banking supervision on enhancing corporate governance for banking organisations</td>
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</tbody>
</table>

**Source:** Nasser Saïdi\(^{30}\).

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26 Id.
28 www.aaoifi.com
29 http://www.oecd.org/document/49/0,2340,en_2649_34813_31530865_1_1_1_1,00.html
30 Saidi, corporate governance…, p. 436.
The guidelines[^31] issued by the BIS-Bank for International Settlements-, ‘Enhancing corporate governance for banking organisations,’ builds on a paper originally published by the committee in 1999, as well as the OECD principles for corporate governance. The intent is to help ensure the adoption and implementation of sound corporate governance practices by banking organisations worldwide, whether conventional or Shariah compliant. The guidelines focus on: (a) the roles of boards of directors and the important role of independent directors, and senior management; (b) effective management of conflicts of interest; (c) the roles of internal and external auditors, as well as internal control functions; (d) governing in a transparent manner, especially where a bank operates in jurisdictions, or through structures, that may impede transparency; and (e) the role of bank supervisors in promoting and assessing sound corporate governance practices.

Thus, in order to ensure their development, (IFIs) shall deal with Corporate Governance standards as well as Shariah requirements which materializes in this context by Shariah Governance. It’s a kind of Double Governance[^32] that force IFIs to find adequate solutions to reconcile the various interests involved.

Indeed, according with Siagh approach, the managers have the difficult task to ensure balance between financial performance and Shariah compliance.

Governance process and structures inside and outside the firm are needed to protect the ethical and pecuniary interests of shareholders and stakeholders. A stakeholder-centered model of corporate Governance is the reference model as adopted, according to most experts' analyses[^33]. This model is based on the principles of Islam and suggest that an institution operating within an Islamic system is expected to protect the rights of all stakeholders in the firm as well as in the society[^34].

**III- The issue of protection of all stakeholders’ rights.**

It is generally acknowledged that the main issue that arises frequently in Corporate Governance debate is related to protection of stakeholders ‘rights. In fact, widely publicized mismanagement scandals have focused attention on the relevance of CG for the protection of the rights of shareholders’ as well as of other stakeholders[^35]. The Misconduct in financial services industry was the target of accusations by Eliot Spitzer, New York’s Attorney General, for price fixing, bid-rigging and undisclosed payments, see the economist reprehensible- the insurance industry’ October 23, 2004. in Wafik Grais and Matteo Pellegrini, op.cit. p.10.

[^31]: For further details, see Guidelines Corporate governance principles for banks July 2015, [https://www.bis.org/bcbs/publ/d328.pdf](https://www.bis.org/bcbs/publ/d328.pdf)

[^32]: For further Development, see Lachemi Siagh, L’islam et le monde des affaires, éditions d’organisation, 2003, p. 141 et s.

[^33]: Zamir Iqbal Abbas Mirakhor, op.cit,


[^35]: At the end of 2004, the insurance industry was the target of accusations by Eliot Spitzer, New York’s Attorney General, for price fixing, bis-rigging and undisclosed payments, see the economist reprehensible- the insurance industry’ October 23, 2004. in Wafik Grais and Matteo Pellegrini, op.cit. p.10.
businesses not only creates widespread investment losses, but also shakes investors’ confidence, and raises doubts about the stability of the international financial system. Equally important, they damage the value of all other stakeholders, such as creditors, suppliers, consumers, employees, and pensioners, and of communities at large. They affect the livelihoods of the victims of the businesses’ financial distress.

This issue is particularly acute when we deal with Islamic finance due to the nature of legal ties between IIFs and their stakeholders. Indeed, by the nature of Islamic economy contracts based on the principle of sharing, some stakeholders may be exposed to significant risks without benefiting from the necessary protection that can begin through access to legal participation. This is the case for investment account Holders (IAH)-the depositors. Thus, this issue is so serious at the operational level, as the participation of IAH in the governance structure is nonexistent.

1. IMPLICATIONS ON IAHs’ STATUS AND DOCTRINAL ANALYSIS

1.1- IAHs AS STAKEHOLDERS

In this area, stakeholder theorist argue that all stakeholders have a right to participate in corporate decisions that affect them, managers have a fiduciary duty to serve the interests of all stakeholder’s groups, and the objective of the firm is the promotion of all interests and not just those of shareholders. This view is commonly referred to as the “stakeholder model” of Corporate Governance, where “stakeholders” include customers, suppliers, providers of complementary services and products, distributors, and employees. Therefore, this theory holds that corporations ought to be managed for the benefit of all who have some stake in the firm.

Investment account holders (IAHs) are like quasi-equity holders, but without any participation in the governance of the financial institutions. As a result, IAHs do not have any direct means to protect their rights. Since they do not have any participation in the governance mechanism they are at the mercy of public policymakers, regulators and shariah boards. A transparent and efficient governance arrangement should be devised to include and protect the rights of IAHs.

Therefore, whether the investment mandate is restricted or unrestricted, under a Mudharabah agreement, the IIFS have a fiduciary duty to ensure the protection of IAH’s interests as well as those of shareholders-investors in IIFS’s assets.

The investment- accounts are based on Mudharabah contract. Under the concept of Mudharabah, IAHs as rab al-mal bear the risk of losing their capital invested by the IIFS in its

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36 Id.
37 Various contracts can be used by IISs, in the performance of their duties, among them Mudharabah.
38 For example, Through, among others, voting rights as well as shareholders.
39 Zamir Iqbal Abbas Mirakhor, New issues in Islamic Finanace., p. 64.
capacity as Mudharib. Indeed, some scholars\textsuperscript{41} argue that the status of IAH is similar to that of shareholders. Thus, Pursuant to the Mudharabah contract, the IIFS as Mudharib owes a fiduciary duty to the IAHs which is parallel with their duty to their shareholders. The author\textsuperscript{42} stressed the fact that these fiduciary duties shall be understood as duties of both management and shareholders of IIFS as Mudharib toward the IAH as rab-al-mal.

In case of restricted investment accounts (RIA), the bank acts only as fund manager-agent or non-participating Mudharib- and is not authorized to mix its own funds with those of the investors without their prior permission. It is in the interests of RIAH that they are provided with all relevant information about the returns and risks. In addition, it is the responsibility of the management of IFIs to ensure that investments funded by RIAH are ringfenced from the rest of the investments and there is full transparency in the identification and distribution of profits and losses. Similarly, unrestricted investment accounts, which constitute the majority of deposits, pose specific corporate-governance problems. It is a common practice of IFIs to place shareholders’ and investment funds in common pools, without any mechanism to separate the two. Consequently, there is the concern that shareholder-controlled management and boards may favour and protect shareholders ‘investments at the expense of those of investment-account holders\textsuperscript{43}.

Furthermore, this recognition of the status should enable them-IAH- to exercise all rights which is originally granted only to shareholders.

\textbf{1.2- SCOPE OF RIGHTS}

\textit{Rights of information}

It should enable them to access all relevant information in respect of their investment accounts i.e. transparency is important to the extent that it allows them to make an informed decision in respect of their choice of the investment accounts in which to place their funds. Nevertheless, it is important in this sphere to point out that the restricted investment accounts holders RIAH should have some power of control over the investment of their funds by the Islamic bank and the related risk assessment, since, from the outset, the investments are contractually defined. The holders of unrestricted investment accounts have access to very limited information regarding the allocation of invested funds, investment strategies and the calculation of their share of profits as a result\textsuperscript{44}.

the lack of transparency about the amount of any profits distributed to unrestricted investment account holders is explained by the use of special reserves by the Islamic bank to guarantee a

\textsuperscript{41} Saidi, Corporate Governance in Islamic Finance, p. 438.
\textsuperscript{42} Ibid. p. 439.
\textsuperscript{43} Zamir Iqbal and Abbas Mirakhor, An introduction to Islamic Finance, p. 336.
certain return on *unrestricted investment accounts* while complying with the principles of Shariah.

Among the techniques for smoothing rates of return and paying them a remuneration comparable to that of the market, are two types of special reserves namely:

- Profit Equalisation Reserve. *which is constituted from the gross income* of the Islamic bank before the distribution of profits between the shareholders and the holders of the investment accounts and the calculation of the commission of the bank as Mudharib.

The following schema\(^45\) allows us to better understand the mechanism of operation of the said technique of smoothing income.

This technique has just been the subject of the newly issued standard -FAS 35\(^46\)- which specify in the preface that: safeguarding the long-term interest, as well as, smoothing the profit to investment account holders (IAHs) and other participating stakeholders are primary consideration for maintaining such reserves. This generally done through the profit equalization reserve (PER)\(^47\).

- Investment Risk Reserve\(^48\). which is *levied on the profits attributed only to the holders of the investment accounts* after deduction of the commission of the bank in the capacity of Mudharib.

The use of these special reserves is a source of opacity, particularly in the periodic financial reports intended in principle for the information of investors and shareholders, since there is no clear distinction between the income from the investment of funds of holders of investment accounts -and the calculation of profits that are distributable to them\(^49\).

As a result, the managers enjoy, through these reserves, a wide margin of maneuver that could constitute a means of manipulation likely to negatively impact the financial rights of investment account holders.

\(^45\) [https://islamicbankers.files.wordpress.com/2014/03/per-01.jpg](https://islamicbankers.files.wordpress.com/2014/03/per-01.jpg) (July-2019)


\(^47\) Ibid, p.4.

\(^48\) “A reserve that is created by an Islamic bank by appropriating a specific amount out of the income of investment account holders, after allocating the share of Mudharib as a precaution (buffer) against future losses that might be incurred by investment account holders. The optimal amount of a profit equalization reserve is defined as that considered prudent by the management of the bank taking into account the interest of investment account holders. At the end of a given financial year or period, the amount required to top off the balance of the reserve will be treated as an appropriation of income after the Mudharib receives its share. If the balance exceeds the optimal amount, then the excess amount shall be debited from the reserve balance and simultaneously credited to URIA holders’ ( URIA; unrestricted investment account)share of income relative to the relevant financial period after the Mudharib receives its share”, definition available at: [https://www.investment-and-finance.net/islamic-finance/u/uria.html](https://www.investment-and-finance.net/islamic-finance/u/uria.html) (July 2019)

\(^49\) Rym Loucif, particularism of governance rules, p.95
Financial rights
the rights of investment account holders to special reserves are very limited in comparison with the rights of shareholders over traditional reserves.50

Thus, the investment account holders do not have any voting rights for or against the use of these reserves. In fact, only the shareholders and the board of directors of the bank have voting rights that allow them to decide the fate of these reserves. The investment account holders can only act through the Mudharabah contract by capping the amount of these reserves. In addition, when closing their accounts, investment account holders do not have a right to these reserves which become "orphan" reserves and may be distributed to existing shareholders and investment account holders or charities.51

Control rights
Pursuant to Mudharabah contract, restricted investment account holders should not interfere with the management of the assets in which their funds were invested. thus their situation is similar in this respect to that of the shareholders (who also do not have the right to interfere in the management) but do not have rights comparable to those of the latter within a (conventional) bank such:

- Right to designate or revoke the members of the board of directors;
- Right to participate in the voting of decisions relating to the distribution of dividends;
- Right to appoint an auditor

For restricted investment account holders, they enjoy contractual control rights to the extent that the Islamic bank as a Mudharib must act in accordance with the stipulations of the Mudharaba contract imposing certain limits, for example on the allocation of funds deposited with pre-defined investments.

It therefore appears that the investment owners (in particular unrestricted) are in an ambiguous position that do not recognize for them any of the governance rights as those of the shareholders or creditors of Islamic banks, even though they incur substantially the same risks of loss.

On the other hand, legal support is crucial in local context. If the legal framework is silent of this matter, the supervisory authorities shall help to provide required protection for IAH's rights subject to the principles of Shariah.

Since the contractual relationship between the investment account holders and the Islamic bank is based on the Murabaha contract, it is important to look at contract features before

50 Classic reserves of a company are primarily revolve around legal reserves, statutory reserves and optional reserves.
51 Rym Loucif, particularism of governance rules, p.95.
52 Ibid.
setting out the recommendations issued to overcome the difficulties related to investor protection.

1.3 - MUDHARABA CONTRACT: THE BASIC RULES

The ‘Mudharabah’ is a special kind of partnership where one partner gives money to another for investing it in a first partner who is called “rabb-al-mal”, while the management and work is an exclusive responsibility of the other, who is called “Mudharib”.

-In the Mudharabah, investment is the sole responsibility of rabb-ul-mal.

-The rabb-ul-mal has no right to participate in the management which is carried out by the Mudharib only.

-in Mudharabah, only the rabb-al-mal incurs a loss, because the Mudharib does not invest anything. His loss is restricted to the fact that his labour has gone in vain and his work has not brought any fruit to him.

However, this principle is subject to a condition that the Mudharib has worked with due diligence which is normally required for the business of that type. If he has worked with negligence or has committed dishonesty, he shall be liable for the loss caused by his negligence or misconduct.

-The Liability

The liability of rabb-al-mal is limited to his investment, unless he has permitted the Mudharib to incur debts on his behalf.

-transfer of ownership

all the goods purchased by the Mudharib are solely owned by the rabb-ul-mal, and the Mudharib can earn his share in the profit only in case he sells the goods profitably. Therefore, he is not entitled to claim his share in the assets themselves, even if their value has increased\(^{53}\).

There are two types of Mudharabah, la Mudharabah al-muqqayyadah (restricted Mudharabah) and al Mudharabah al-mutlaqah (unrestricted Mudharabah).

Within the framework of restricted Mudharabah, the rabb-ul-mal may specify a particular business for the Mudharib, in which case he shall invest the money in that particular business only. But if he has left it open for the Mudharib to undertake whatever business he wishes, the

\(^{53}\) However, some jurists have opened that any natural increase in the capital may be taken as a profit distributable between Rabb-ul-mal and Mudharib. For example, if the capital was in the form of sheep, and lambs were born to some of them, these lambs will be taken as profit and will be shared between the parties according to the agreed proportions (see Al-nawawi: Raudha-al-Tabibin v.5, p.125. But this is a minority view. In Muhammad Taqi Usmani, op, cit. p 49.
Mudharib shall be authorized to invest the money in any business he deems fit. This is what is called Unrestricted Mudharabah.

A rab-ul-mal can contract Mudharabah with more than one person through a single transaction. It means that he can offer his money to A and B both, so that each one of them can act for him as Mudharib and the capital of the Mudharabah shall be utilized by both of them jointly, and the share of the Mudharib shall be distributed between them according to the agreed proportion.\textsuperscript{54} in this case both the Mudharib shall run the business as if they were partners inter se.

- Distribution of the profit.

It is necessary for the validity of Mudharabah that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. It has been left to their mutual consent. They can share the profit in equal proportions, and they can also allocate different proportions for the rub-ul-mal and the Mudharib.

- Termination of Mudharabah.

The contract of Mudharabah can be terminated at any time by either of the two parties. The only condition is to give a notice to the other party. If all the assets of the Mudharabah are in cash from at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of the Mudharabah are not in the cash form, the Mudharib shall be given an opportunity to sell and liquidate them, so that the actual profit may be determined\textsuperscript{55}.

2- RECOMMENDATIONS: THE SOLUTIONS TO BE CONSIDERED

Policy makers, professionals, and academics are aware of the corporate governance challenges facing IFIs and are actively seeking solutions. Several organizations operating in this field, such as l’IFSB- and L’AAOIFI-are working to develop standards and provide best practices for IFIs.

In the whole, a ‘guiding principles’\textsuperscript{56} which relates to corporate governance for institutions offering financial services, sets out seven guiding principles (the guiding principles) of prudential requirements in the area of corporate governance for institutions offering only Islamic financial Services (IIFS). The guiding principles are devided into four parts:

- General governance approach of IIFS;

- Rights of investment account holders (IAH);

\textsuperscript{54} See Ibn Qudamah : almoghni v.5.p.145. in Muhammad Taqi Usmani, op, cit. p.

\textsuperscript{55} Al-Kasani: Badai’us-San’i v.6.p.109.

\textsuperscript{56} Guiding principles on conduct of business for institutions offering Islamic financial services, December 2009, viewed on : https://ifsb.org/standard/IFSB-9_Guiding%20Principles%20on%20Conduct%20of%20Business.pdf
- Compliance with Islamic Shari’ah rules and principles; and
- Transparency of financial reporting in respect of investment accounts.

The guiding principles are designed to help IIFS establish and implement effective corporate governance practices. The guiding principles are applicable to commercial banks, investment banks, finance houses and other fund-mobilising institutions that offer only financial services and products complying with Islamic Shariah rules and principles, as determined by the respective supervisory authorities.

Several corporate governance issues are of equal concern to all institutions offering financial services, whether IIFS or others. The IFSB acknowledges that many bodies that are concerned with the promotion of good corporate governance have issued codes of corporate governance best practices, which have been widely accepted as the international standards, and would be relevant and useful for IIFS.

The IFSB in this document—guiding principles places the focus on IAH and protecting their rights. Below seven guiding principles that bear this claimed purpose.

The seven guiding principles of IFSB

| Principle 1.1 | 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. Ensuring the basis for an effective corporate governance framework |
| Principle 2.1 | IIFS shall acknowledge IAHs’ right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised |
| Principle 1.2 | IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognised accounting standards which are in compliance with Shariah rules and principles and are applicable to the Islamic financial services industry as recognised by the supervisory authorities of the country |

Note the special focus in the IFSB principles no 1.2, 2.1, 2.2 and 4 on IAH
| Principle 2.2 | IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns |
| Principle 3.1 | IIFS shall have in place an appropriate mechanism for obtaining rulings from Shariah scholars, applying fatwa and monitoring Shariah compliance in all aspects of their products, operations and activities |
| Principle 3.2 | IIFS shall comply with the Shariah rules and principles as expressed in the rulings of the IIFS’s Shariah scholars. The IIFS shall make these rulings available to the public |
| Principle 4 | IIFS shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage |

**Source:** Nasser Saidi

The AAOIFI has also issued 35 standards on accounting, auditing, governance, ethical and a Shariah governance pronouncement. The AAOIFI explains the role of the audit and governance committee as being responsible for overall monitoring of business covering internal control, compliance with Shariah laws and principles and adherence to code of ethics. In 2008, AAOIFI revised the accounting, auditing and governance standards (for Islamic financial institutions) to take account of changes in international accounting and auditing standards and their impact for IIFs.

The process review is still ongoing. Thus, The new accounting standard on investment accounts- Financial Accounting Standard N.27 (FAS 27) Investment Accounts-updates and replaces two of AAOIFI’S previous accounting standards relating to investment accounts- FAS 5 Disclosure of Bases for Profit Allocation between Owner’s Equity and Investment

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58 Saidi, corporate governance…, p.439.
Account Holders as well as FAS 6 Equity of Investment Account Holders and Their Equivalent. Accordingly, the previous FAS 5 and FAS 6 have been withdrawn.  

Pertinent points that have been incorporated in the new FAS 27 included updated guidance on accounting treatment for an-balance sheet and off-balance sheet investment accounts.  

Meanwhile, the accounting standard on consolidation-FAS 23 has been revised to give additional clarification on the way an Islamic financial institution should determine if financial statements of an investee company, or a subsidiary, should be consolidated with its own.

Conclusion

The Corporate Governance within Islamic finance’ framework face a various type of challenges. Excluding those known within conventional finance, these challenges as explained above emerge mainly from Shariah compliance requirements. It arises from this situation many issues whose complexity depend on the size of Islamic institution involved. But in the whole, the protection of stakeholders ‘rights seems to draw more attention of all the operators inside Islamic financial ‘sphere due, on one hand, to stakeholders ‘approach that governs this kind of institutions accordingly to Islamic economic philosophy and on the other hand, to the vulnerability of IAH status. Nevertheless, although all efforts which are made in this field through standardisation, the degree of required protection is not yet achieved.


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