



Corporate governance of Islamic banks: a sustainable model to protect the participatory depositor?

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Abstract

The religious principles that characterize the Islamic bank have direct consequences on the models of Corporate Governance which, at the same time, must be in accordance with national and international regulations and best practices. The aim of this paper is to analyze the role of the participatory depositor in the Corporate Governance Models of the Islamic Bank, a special category of stakeholder that entrusts their savings to the Islamic Bank on the basis of the Profit and Loss Sharing principle. In the present study the models of Corporate Governance of the Islamic Bank, with regard to the protection of the interests of the participatory depositor, are analyzed through a comparative analysis of the regulations of the following Countries, Malaysia and Morocco. The objective is to highlight the strengths and weaknesses of the protection of the interests of affected stakeholders in order to verify the presence of a sustainable model of Corporate Governance, namely if the participatory depositor needs more guarantees than other categories of stakeholders.

Keywords Participatory depositor · Profit and loss sharing principle · Corporate governance · Islamic banks · Investment accounts holders · International comparison

Introduction

The Islamic Bank is characterized by the presence of a series of specificities due to its nature of being an economic model based on the religious principles of Islam. This determines the validity of the contracts as well as the economic and financial activities undertaken as long as operating [29, 42] in accordance with the Sharia, i.e., the Qur'an and the Sunnah.

There are five principles that oversee the religious validity (sharia compliance) and regulation of any Islamic economic and financial activity, as follows: the principle of profit and loss sharing (*Profit and Loss Sharing—PLS*); ban on speculating (*maysir*) and introducing elements of uncertainty in contracts (*ghàrar*); ban on *ribà* (charging of interest); ban on the use of trade and investment in prohibited assets or activities (*haram*) and the obligation to have *real assets*

underlying all financial transactions and (Archer and Karim [32]; [11, 24], Alam et al. [3]; [6, 10, 14, 25, 35]).

The Islamic religious principles that influence the models of Corporate Governance of Islamic Banks, according to several scholars [8, 28], Archer and Karim [4]; [2, 23] are mainly two: the *tawhid* and the *shura*.

The first is based on the Islamic belief, i.e., the belief in the existence of a single God "Allah", and is placed in the "*ethical-religious sphere*" of the "faithful Muslim", that is in the possession of values (honesty, respect, reciprocity and transparency) that guide the conduct of his work. The second *shura* is based on the ability to consult others and is placed in the "*managerial sphere*", that is the management of activities in relation to social policies, business and good corporate governance.

Based on principles, various definitions of Corporate Governance have been developed [8, 23, 28]. One of the most cited is the one by Chapra and Ahmed [8], which highlights a convergence of principles (in terms of prudence, transparency and responsibility toward stakeholders) that characterize the corporate governance of companies: "*a set of organizational arrangements whereby the actions of the management of a corporation are aligned as far as possible with the interests of its stakeholder*".

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The issue of corporate governance has attracted increasing attention following the numerous scandals involving large conventional international companies (Enron, WorldCom, HIH Insurance, Global Crossing, Lehman Brothers). Albeit to a lesser extent, Islamic financial institutions were involved with the 2001 bankruptcy of the Ihlas Finance House (IFH) in Turkey. A failure caused by weak corporate governance [12], an ineffective auditing system and excessive exposure to risk by management [18, 19].

This highlights the importance of an effective corporate governance system based on corporate values [15] inspired by the principles of social responsibility, regardless of the different approaches and regulatory orientations. A corporate governance system characterized by the presence of responsible bodies and individuals who, in addition to being competent and professional, must be able to transfer ethical values into the company's strategic and operational decisions.

The religious principles, the resulting Islamic financial instruments, as well as the roles of the parties involved, determine a model of Corporate Governance of the Islamic Bank characterized by specificity that differs from that envisaged in the models of Corporate Governance of conventional banks [20, 22, 30, 33, 37, 40]).

Specificity linked to the presence of Shariah supervisory system and categories of stakeholders that deposit and entrust their money according to the principle of sharing profits and losses [5, 8, 21, 34]. A category of stakeholders that assumes the risk of the loss of its financial resources, but which is often not involved in the management and monitoring of the financed investments [31, 38]. An aspect that is accentuated, if we consider the aspect of uncertainty "Gharar" (D'Alvia [10]) and its repercussions in terms of the risk indirectly assumed not only at an economic level, but also at the level of its admissibility by the Shariah.

The study focuses on the role that participatory depositors have in the Islamic Bank's Corporate Governance in relation to the risks supported by applying the principle of *profit and loss sharing*. A category of stakeholders that is characterized by the blending of typical attributes of the depositor-saver and shareholder-investor, but with the variant of not being able to benefit from all the powers granted to the shareholder [1, 8, 13, 16, 21, 36, 37], for example, the right to vote in the Shareholders' Meeting [8].

The study aims to highlight the specific regulations of Corporate Governance as well as the level of involvement of the participatory depositor in the bank's investment choices in the two countries under analysis, Malaysia and Morocco, in order to create a comparative analysis of the aforementioned cases and the consequent considerations.

The present work follows the literature on the principles that underlie Islamic finance, with specific regard to the principle *Profit and Loss Sharing*. A principle that implies

risk above all for those categories of savers whose resources are managed by the Islamic bank. More specifically, the present work contributes to highlighting the protection of participatory depositors' interests in the corporate governance of the Islamic bank through the analysis of the guidelines and regulations in force (Sect. "[Literature review: the protection of participatory depositors.](#)"). We apply the study to two countries Malaysia and Morocco using the case study methodology (Sect. "[Methodology: analysis of two case studies.](#)"). In particular, Sect. "[Results](#)" presents the results of the comparative analysis which highlights corporate governance regulations and guidelines and their implementation on protection of the interests of participatory depositors in each country.

Finally, Sect. "[Discussion: a comparative analysis of Malaysian and Moroccan cases](#)" includes a discussion and draws some conclusions about the current state and how this special category of stakeholders could be better protected in their respective legal systems of corporate governance.

Literature review: the protection of participatory depositors

The application of the principle of Profit and Loss Sharing (PLS) as a basic principle and the total absence of interests in Islamic financial institutions implies changes in the roles of depositors, regulators and the way deposits are managed. The depositor entrusts savings to the bank, while the officially appointed regulator is assigned the task of protecting the interests of these stakeholders.

The choice of the participatory depositors to put their capital at risk and have no right to vote or scrutiny, entails the need to prepare regulations and guidelines to guarantee and protect this category of stakeholders. The public regulator should act as representative of the participatory depositor and, through a system of regulations, ensure adequate control and supervision of the banking activities [39].

This circumstance occurs mainly in Islamic participatory financial contracts, namely the *mudarabah* and the *musharakah* and the related *investment accounts*, in which depositors could suffer economic losses arising from projects mainly managed by the bank or its representatives.

The stakeholders' protection of the Islamic Bank is a topic of significant and recent interest in Corporate Governance studies [8, 13, 16, 21, 37].

The international Supervisory authorities of Islamic finance have devoted ample space providing specific guidelines. In particular, the Islamic Financial Services Boards (IFSB) document on Corporate Governance of 2006 is mentioned "[Guiding principles on Corporate Governance for institutions offering only Islamic financial services \(excluding Islamic insurance \(takaful\) institutions and Islamic](#)



mutual funds)”, which dedicates a section to *investments account holders*. The standards of the IFSB recommend to the Islamic Bank, with the help of the *Governance Committee*, to control and guarantee that the administrative procedures, the *disclosure* policies and the internal control system are carried out in respect of the interests not represented in Company’s governing bodies, with attention to the owner’s of participatory deposits [27].

Scholars have analyzed various scenarios and possible ways to represent and guarantee the interests of participatory depositors in Islamic Financial Institutions. According to some, the protection of participatory depositors could be accomplished by using suitable insurance instruments [8], but it would be a solution that contrasts with the religious belief of risk-sharing. Others, on the other hand, have identified the need to provide a representation of participatory depositors in the Governance Committees, as independent non-executive Directors [16].

The study focuses on the comparative analysis of the Corporate Governance of the Islamic Bank, respectively, in Malaysia and Morocco, with the aim of investigating whether the participatory depositor, in view of the risk to which he is exposed, is protected by the regulation of each Country and whether a representation is envisaged in the Corporate Governance bodies of the Islamic Bank.

Methodology: analysis of two case studies

The research methodology adopted is the *Case Study* [41], a qualitative method based on the analysis of information derived from documents collected during the research, from conducting semi-structured interviews and, in general, from qualitative techniques. The current work is characterized by the study of two cases. This methodology has made it possible to carry out an in-depth analysis of the two different selected cases and to support the verification whether the participatory depositor, in view of the risk to which he is exposed with the stipulation of participatory Islamic financial contracts, needs greater protection than other stakeholders and, if so, how could this protection be implemented.

In particular, the aim of this paper is to highlight the specific corporate governance regulations of Malaysia and Morocco countries with respect to the development of Islamic finance, as well as the factors that have favored (or could favor) the flourishing of this financial model, with a view to conducting an objective comparison between analyzed cases. Two countries that have opted for a central regulation of the Islamic Finance sector: Malaysia is in an advanced state of this topic and Morocco is still in an adjustment of its own position in the international Islamic finance market and integration with its own conventional financial system.

The first is Malaysia, a country characterized by a consolidated existence of Islamic finance and strict regulatory standards of the Islamic financial sector. To date, Malaysia recognizes itself as an international *hub* of Islamic finance in continuous growth, thanks to its commitment to the promotion and development of this sector by offering a variety of competitive and innovative financial products both in its local and international markets. The data reported in the latest annual report on financial stability and payment systems for 2017, “*Financial stability and payment systems report 2017*”, published in March 2018 by the Malaysian central bank, *Bank Negara Malaysia* (BNM), confirm this continuous growth of Islamic finance equal to 9.4% (34.9% of the total of the Malaysian banking system).

The second, Morocco, a country that despite being Muslim is at an early stage and launching its first Islamic Banks. In 2014 the Moroccan Parliament established, with the banking law n. 103.12 “*Etablissements de credit et organismes assimilés*”, the institution of Islamic Banks. The legislator introduced the model of Islamic Banks with the name of “*participatory banks*”. The expression “*participatory*” underlines the legislator’s desire to strengthen the use of Islamic participatory financial instruments (the *musharakah* and the *mudarabah*) based on the principle of *Profit and Loss Sharing*.

Results

The study of Country-cases was addressed through the documentary analysis [9] of the regulations and guidelines on the Corporate Governance of Islamic Banks, with particular regard to the protection of the interests of a particular category of stakeholder, the participatory depositor of each Country involved.

The objective is to highlight the regulatory specificities of corporate governance as well as the level of involvement of the participatory depositor in the bank’s investment choices in the two countries under analysis, Malaysia and Morocco. We will make a comparative analysis of the cases highlighting the consequent synthesis reflections.

The Malaysian case study

The Malaysian Corporate Governance guidelines provide the possibility of setting up two other Committees to support the activity of the *Board of Directors*, with reference to the management and supervision of the activity concerning *investment accounts*, that is the *Senior Management* and the *Board Investment Committee*.

Specifically, the Malaysian *Islamic Financial Services Act* (IFSA) of 2013 discerns investment accounts from non-participatory Islamic deposits, since *investment accounts*



are not guaranteed and are subject to risk loss related to the results of the financed projects.

At the same time, the IFSA reinforces the investment management activity, providing procedures and processes aimed at protecting the interests of *investment account holders* (IAH), defined as “customer with an investment account maintained at an IFI”.

In March 2014, IAH guidelines were published “*BNM/RH/STD 029–4. Investment account. Islamic Banking and Takaful Department*”, from the Malaysian Central Bank with the aim of outlining the regulatory requirements on the conduct of investment accounts.

These guidelines provide the possibility of setting up a separate *board*, the *Board Investment Committee* (BIC), if the *investments accounts* constitute a significant portion of the total banking activity, with the main role of supporting the *Board of Directors* in processing surveillance functions, in providing recommendations regarding investment strategies and the management of investment account assets.

This body must be composed solely of non-executive directors (at least three members) chaired by an independent director. The management of investment accounts involves the provision and involvement of other committees such as the *Sharia Committee*, appointed to ensure compliance with the principles of sharia in the activities financed by investment accounts and the *Risk Management Committee* (BRMC) which has the task to implement risk management policies and procedures.

Another important body identified by the Malaysian Corporate Governance Guidelines is *Senior Management*, responsible for the development and implementation of policies for the management of investment accounts.

Finally, the guidelines, specifically the “*BNM/RH/GL/007–9. Guidelines on Musharakah and Mudharabah Contracts for Islamic Banking Institutions*”, make available to the Islamic Bank, as a partner, the possibility of appointing representatives to protect their interests in the projects financed and managed directly by its customers (entrepreneurs), according to the *musharakah* and *mudharabah* contracts, through the identification of a *Representative Board*.

The *Representative Board* has the main mandate to safeguard the interests of the Islamic Bank by providing a continuous activity of surveillance and monitoring of information concerning the financed economic activity and therefore prevent and protect its own interests and investments.

With regard to the appointment of the *Representative Board*, Islamic Banks have the obligation to establish internal policies, in compliance with the designated guidelines, aimed to define the procedures and conditions to be used to nominate this body, then submitted for approval of its own board.

In addition to *Representative Boards*, with reference to *investment account holders*, the regulator provides for

the Islamic banking institutions the possibility of adopting a mechanism to monitor the progress of funded projects, through the identification of a bank representative for each specific project.

The document *Guidelines on Musharakah and Mudharabah Contracts for Islamic Banking Institutions*, BNM/RH/GL/007–9, ends with the statement of final provisions on prudence, transparency, financial reporting and management of conflicts of interest between the members of the *Board Representative* and the Company (*invested entities*) with which the bank has executed participatory contracts.

From this prevision related to various management and control committees, it may be deduced that the management of participated deposits in Malaysia is mainly based on the preparation of support guidelines dictated by legislative provisions and focused on the identification of a series of bodies and committees responsible for managing these deposits according to prescribed procedures and mechanisms, applicable to all Islamic financial institutions, aimed at protecting both the interests of the bank and its stakeholders.

The Moroccan case study

By means of the banking law nr. 103.02, the Moroccan Legislator has assigned some products and services offered by the participative banks in Morocco to the Superior Council of *oulémas*, that is the only competent authority empowered to issue the notice for the Islamic religious compliance to the activities.

In accordance with article 55 of law 103.02, the participative banks are authorized to receive investment deposits from the public which remuneration is connected to the results of the investment products, as agreed with the clients. Article 56 then explains what investment deposits are, namely funds raised from the participative banks, with a view to their collocation in investment projects as for the manners agreed by the parties.

The article continues referring to the circulars issued by the governor of the Moroccan central bank (after having gathered the opinions of the credit institutions’ committee and of the Superior Council of the *oulémas*) for determining the conditions and manner of the gathering of these deposits. As for the protection of depositors throughout art 67 of law 103.02 provides the establishment of a “Guarantee Fund for the deposits of the participative banks” with the aim of indemnifying the depositors of the participative banks in case of unavailability of their deposits and of all the reimbursable funds. Article 68, then, specifies that the guarantee fund defined at article 67 shall cover all the deposits and reimbursable funds gathered by the participative banks, excluding the investment deposits envisaged at the above-mentioned article 55.



The Official Journal nr. 6548 has issued the Circular of the Moroccan central bank nr. 2/W/17 the March 2, 2007, related to the investment deposits' reception conditions and manners. Based on the indications regarding the investment deposits, they are clustered in investment portfolios with underlying real activities, which remuneration relies on the profits generated and characterized by any loss sharing. The loss risks upon the depositing investors have been limited by the Circular, through recourse to other mechanisms which may be compatible with the participative banks' basic principles, or the depositors' protection through the use of provisions that are created from profit deriving from its customers' portfolio.

These provisions represent a minimum legislative protection, as from the economic point of view and also for the depositor investors, or a way of implicitly compensating monetarily any loss-risk, which may be determined by the projects' underlying the investment portfolio alleviating the impact of application of the profit and loss sharing principle that characterizes the Islamic banks.

As resulting from the considerations above, the Moroccan participative banks pay great attention to the protection of the participative depositors' interests, by means of the institution of reserves and do not provide participation mechanisms within the management and the monitoring for the participatory depositors in the context of financed projects.

Discussion: a comparative analysis of Malaysian and Moroccan cases

The comparative analysis is based on the regimentation study and on the guidelines of corporate governance of two countries-cases, which were object of inquiry.

In order to be compatible with the sharia law and to be a sharia compliant company, the Islamic bank must be subject to a shariatic supervision process in order to verify compliance with the principles on which the Islamic economic system is based. The supervision activity is carried out by the sharia supervisory board (SSB) which can be internal or external to the bank based on the regulatory context of the country in which the bank operates.

From the analysis of the legislation and corporate governance guidelines of each country, we highlight the need to provide mechanisms aimed at protecting stakeholders other than shareholders, including participatory depositor. A category of stakeholder who needs to be better protected and who has an active role in the management of the bank's investments.

Table 1 points out the presence in both case studies of a national sharia compliant authority, deputed to the shariatic supervision, "the national shari'ah advisory council" in Malesia e "le conseil supérieur des oulémas"

Table 1 Comparative analysis

	Malaysia	Morocco
Shariah compliance authority	×	×
Shariah committee / Shariah supervisory board	×	×
Self-regulation code/best practices	×	×
Senior management	×	
Nominating committee	×	×
Remuneration committee	×	×
Risk management committee	×	×
Audit committee	×	×
Governance committee		×
Board representative	×	
Board investment committee	×	

in Morocco. This choice of centralizing the activities of shariatic conformity control resolves the difficulties of the various interpretations and legal opinions (*fatawa*) which may be issued by the *scholars* regarding a specific operation and thus avoiding the so-called *sharia risk* [7, 17, 19].

In both the cases studied there is a self-governance code that recommends a series of good corporate governance and the institution of several committees (*nominating committee, remuneration committee, audit committee, risk management committee*) responsible to the management support, controlling activities and the protection for those holding an interest in the company.

There is, however, a discrepancy between the four corporate governance entities: *board representative, board investment committee, senior management, governance committee*. These are bodies directly connected to the stakeholders' protection within the Islamic bank, specifically the participatory depositors.

The *board investment committee* and the *board representative* and are envisaged in the Malaysian guidelines related to the financial participative contracts of the *musharakah* and of the *mudarabah*. The first has the main task of supporting the *board of directors* of the Islamic bank through the management of investment accounts. The second's main objective is to safeguard the Islamic bank's interest and its investments at the funded company. Another body identified is *Senior Management*, responsible for the management of investment accounts.

In the Moroccan case, instead, it shall be pointed out that the presence of the *governance committee* that is recommended by the Self-Regulatory Code and responsible for ensuring the good-practices of the governance entities. This entity has been provided also by the guidelines on corporate governance of IFSB in 2006, for the safeguard of stakeholders other than the shareholders.



Conclusion

The research has focused on the corporate governance regulation and the safeguard of a special category of stakeholder, namely the participatory depositors.

Malaysia, compared to Morocco, tables more attention to the safeguard of the participatory depositors through a strict regulation based on the identification of various entities and committees with managing and monitoring responsibilities over the participative investments.

In both cases, there is a general lack of meaningful involvement of the participatory depositors in the corporate governance of the Islamic bank and thus the opportunity of being an insider in the corporate governance of the bank. In case of participation or representation of the participatory depositors within the project management and/or the funded companies shall encourage lasting relationships that go toward a transparent and careful management, accomplishing both an economic responsibility and a social one, as well.

It is important to stress that the Malaysian Islamic banks have the possibility of identifying their own institutional representative *board* (*board representative*), appointed by its *board of directors*, at the entity which is financed for the purpose of a protection of the interests of the parties involved in the stipulated participative contracts.

This possibility may be extended to its participatory depositors with the aim of protecting all the parties involved by means of an active and direct participation in the investments' management, to which even they have contributed by depositing their savings. This perspective may be realized also in Morocco, where the legislation provides that the participatory deposits of the Islamic bank are organized in investment portfolios. External advisors may be nominated from these portfolios, as representatives of the depositing investors (participatory) of the participative bank at the entities funded by the investment portfolio funds, of which they are partners [16].

Anyways, both Countries safeguard the participatory depositor; on the one hand, Malaysia with its regulator of the public authority that protects the stakeholders' interests from the Islamic financial institutions and, on the other hand, Morocco, that by establishing reserves is able to grant a preventive economic coverage.

Moreover, even the recommendations and the guidelines outlined by IFSB, the adoption of which allows to create those conditions for sustainable government models, intended to guarantee the development in an international economic environment and to answer the stakeholder's expectations.

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Declarations

Conflict of interest On behalf of all authors, the corresponding author states that there is no conflict of interest.

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