

THE COMPARISON OF THE CHARACTERISTICS OF THE ANGLO- SAXON GOVERNANCE MODEL AND THE ISLAMIC GOVERNANCE OF IFIS

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Abstract

During the Asian Financial Crisis in 1996-1998 and the recent economic downturn due to sub-prime tribulations in 2008-2009, most corporations that were severely hit are non-Islamic corporations and financial institutions. Although some of the Islamic corporations and banking groups were affected, but the damage done were not as serious as suffered by conventional corporations and financial institutions. We also noticed that almost all financial institution and banking groups around the globe are embarking on Islamic banking products. This paper will examine what are the factors that contribute to the sort of insulation on Islamic corporations and financial institutions from these two economic crises. The discussion will also include the comparison of corporate governance characteristics of the western Anglo-Saxon model and Islamic corporate governance. Unlike the western concept of corporate governance which is based on the western business behaviour that is secular driven, this article suggests that corporate governance in IFIs is founded on the epistemological aspect of Tawhid, Shari'ah and ethics. The initial findings submit that Islam presents unique values and unique characteristics of corporate governance with the aim to uphold and maintain the principle of social morality not only to the shareholders of the firm but to all stakeholders.

Keywords: *Islamic Corporate Governance, Anglo-Saxon governance, shariah board governance*

Introduction

During the Asian Financial Crisis in 1996-1998 and the recent economic downturn due to sub-prime tribulations in 2008-2009, most corporations that were severely hit are non-islamic corporations and financial institutions. There were also some observable patterns that almost all financial institution and banking groups are embarking on Islamic banking products in order for them to sustain and remain in business. As such, are there any significant differences between the corporate governance structures of non-Islamic corporations and financial institutions and their Islamic counterparts? This paper will examine what are the factors if any that contribute to the sort of insulation on Islamic corporations and financial institutions from these two economic crises. The discussion will also include the comparison of corporate governance characteristics of the western Anglo-Saxon model and Islamic corporate governance. Irrefutably, corporate governance is one of the essential elements of any corporation and it is even bigger challenge to Islamic finance system due to its additional risk as compared to the conventional banking system. For instance the depositors would become exposed with various kind of risks when the Islamic banks started moving into the risk-sharing modes i.e. *mudharaba* and *musyaraka* (Chapra, 2007). Therefore, it is very important that any Islamic corporation needs to have a proper corporate governance framework to ensure its growth and success.

Corporate governance in corporations and banking has been analyzed broadly in the context of conventional corporations. By contrast, little is written on corporate governance from Islamic point of view especially the governance structures of Islamic finance sector (Yunis, 2007).

The surveys of Siddiqi (1981) and Haneef (1995), on the contemporary literatures on Islamic economic thought demonstrate that there are lack of references and discussion on the topic of corporate governance from Islamic perspective. Mannan (1984), in his compilation of abstract of researches in Islamic economics also shows the absence of specific research on *Shari'ah* governance of IFIs. Another study was carried out by Chapra and Ahmed (2002) where they produced a book on Islamic corporate governance specifically focusing on the issue of governance framework of Islamic Financial Institutions (IFI). However, both studies however mostly concerns on the issue of auditing, accounting, general framework of corporate governance of Islamic banks rather than providing comparative analysis of Islamic corporate governance with the Western governance concept.

This paper attempts to examine the basic elements of Islamic corporate governance with the western concept of the Anglo-Saxon governance model. In view of scarcity of literature on the subject and the essence of ethics in Islamic finance, this article aims at expanding the faith based moral horizon by advocating ethics as one of the foundational dimensions of corporate governance in Islamic Financial Institutions (IFIs). Unlike the western concept of corporate governance which is based on the western business behaviour that is secular driven, corporate governance in IFIs is founded on the epistemological aspect of Tawhid, *Shari'ah* and ethics. As this paper is theoretical in nature, we use a

straightforward research methodology by reviewing and comparing the existing literatures related with the conceptual and theoretical framework of corporate governance of the Western and Islamic point of view. Brief analysis and commentaries on the literatures available provide comparative overview on their basic elements of corporate governance approach.

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The remainder of this article is structured as follows. The next section reviews conceptual definition of corporate governance based on the Anglo-Saxon perspective and section 3 specifically presents the literature review on the Anglo-Saxon Governance Model and the Islamic corporate governance model. Section 4 attempts to highlight *Tawhid* and *Syura* based and Stakeholders based approach. The last section, Corporate Governance and Ethics in western and Islamic perspectives concludes the discussion

Conceptual Definition of Corporate Governance

The major reason for having corporate governance structures is to reduce agency problems that are caused by the separation of ownership and control (Berle and Means, 1932). This separation provides professional managers, who run corporations, with the opportunity to pursue their own interests, which may not be congruent with the shareholders' objectives. Schleifer and Vishny (1997) suggest that exploitation of shareholders by managers includes building empires, enjoying perks, insider trading, inappropriate investments and management entrenchment.

There is no universally accepted definition of corporate governance because different authors define it in different ways depending on their background and research discipline. Efforts at identifying good governance structures are equally complicated as there are many facets of corporate governance. Nevertheless, the following definition, which was set out in the Principles of Corporate Governance developed by the Organisation for Economic Co-operation and Development (OECD) in 1999, is widely accepted:

1.

“Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structures specifies the distribution of rights and responsibilities among different participants in the corporation and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance”.

(OECD, 1999)

Other definitions of corporate governance include:

2. Shleifer and Vishny (1997),

“The ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”.

These definitions restrict corporate governance to the relationship between shareholders and managers and do not clearly indicate other stakeholders that the firms should take into consideration. However, there are other interested parties and groups of constituents who have a legitimate claim on the firm such as employees, creditors, suppliers, consumers and the government (Hilman, Cannella and Paetzold, 2000). In this respect corporate governance also includes issues of social responsibility such as environmental matters, employment and social education.

Examples of definitions that are expanded to take account of a wider body of stakeholders include:

- 3.

“Corporate governance is holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for states is to strengthen their economics and discourage fraud and mismanagement”.

(Sir Adrian Cadbury, 1992)

A definition by the FCCG (Malaysia) in the Report on Corporate Governance (1999) states that:

- 4.

“Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking into account the interests of other stakeholders”.

(FCCG, 1999)

Literature Review

There has been much talk about corporate governance in East Asia after the 1997/98 Asian Financial Crisis (AFC). The AFC established the importance of having effective corporate governance structures for corporations, particularly PLCs (Kim, 1998). The weak financial structure of many companies; lack of transparency; lack of disclosure and accountability; existence of a complex system of family controlled companies; little or ineffective laws to ensure that controlling shareholders treat minority shareholders fairly

were among the major issues that caused the AFC (Boo, 2003). Despite the harm done to the economy and investors' confidence, the AFC provided the impetus for better awareness and emphasized the importance of corporate governance in Malaysia. The essence of good governance includes safeguarding the interests of shareholders and stakeholders through transparency, accountability, trustworthiness and responsibility (Arif, 1999).

Inevitably, the crisis and criticisms of the poor corporate governance standards in Malaysia led to the formation of the high level "Finance Committee on Corporate Governance" (FCCG) in March 1998. The Committee's main task was to comprehensively review the current corporate governance environment and develop a new corporate governance code and standards for Malaysian companies. The FCCG specified broad principles of good corporate governance and proposed a detailed code of best practice for companies; this culminated in the Malaysian Code on Corporate Governance (MCCG). Although the code was voluntary in nature, it has been seen as pivotal in improving the corporate governance practices of PLCs in the post-AFC period (Abdul Samad, 2002). Since the inception of the FCCG in 1998, corporate governance has become an investment criterion in Malaysia. Both foreign and domestic investors tend to shift from stocks and markets with poor corporate governance to stocks and markets with better governance (Arif, 1999).

A decade later, beginning August 2007, financial markets and financial institutions all over the world have been hit by catastrophic developments with problems in the performance of subprime mortgages in the United States. Financial institutions have written off losses worth many billions of dollars and Stock markets have plunged. Central banks have provided support on the order of hundreds of billions, intervening not only to support the markets but also to prevent the breakdown of individual institutions. At last, governments in the United States and Europe are stepping in to support financial institutions on a gigantic scale. Because of their losses, many financial institutions have been forced to recapitalize.

By September 2007, total reported write-offs of financial institutions are said to have reached 760 billion dollars; global banks alone have written off 580 billion dollars. As of April 2008, the International Monetary Fund (IMF) was predicting aggregate losses of 945 billion dollars, By October 2008, the IMF had raised its loss prediction to 1.4 trillion dollars overall, 750 billion dollars in US residential real-estate lending, and 650 billion dollars from repercussions of the crisis on other securities (Hellwig, 2009).

The Anglo-Saxon Governance Model in the Banking Industry

The Anglo-Saxon model of corporate governance is the most dominant theory championed by the United States and the United Kingdom. This is evidenced, by the practice of many corporations in other countries which uphold the shareholders' system such as Australia, New Zealand, Canada, South Africa and majority of South East Asia Countries. The model is characterized by arm's length relationship between corporations and investors who are said to be concerned primarily about short-term returns (Frank and Mayer, 2004). The Anglo-Saxon model is based on the corporate concept of fiduciary relationship between the shareholders and the managers motivated by profit-oriented behavior. One

of the most distinctive aspects of the Anglo-Saxon system is the structure of corporate ownership where the share ownership is widely dispersed and shareholders influence on management is weak. Apparently, the central preoccupation of corporate governance in the Anglo-Saxon system is to protect the interest and rights of the shareholders. However, control over management behavior is exerted through bank and other forms of debt. The incentives of debt-holders to influence corporate behavior depend to a large extent on their rights in case of distress. As such, bankruptcy laws are a key component of Anglo-Saxon corporate governance system.

Apparently, shareholders, creditors, regulators, and academics are examining the decision-making process in corporations and other organizations and are proposing changes in governance structures to enhance accountability and efficiency. However, they generally draw upon a large body of studies on the governance of firms in unregulated, non-financial industries. Financial institutions, however, are very different from firms in unregulated industries, such as manufacturing firms. As a result, the board of directors of a banking firm is placed in a crucial role in its governance structure. Although they are assigned the same legal responsibilities as other boards, regulators have placed additional expectations on bank. These usually take the form of laws, regulations, or guidance, and they generally reflect interest in safe and sound financial institutions. But during the Asian Financial Crisis in 1996-1998 and the recent economic downturn due to sub-prime tribulations in 2008-2009, most corporations that were hit severely are non-Islamic corporations and financial institutions. Although some of the Islamic corporations and banking groups were affected, but the damage done were not as serious as suffered by conventional corporations and financial institutions. As such, there seem to be some factors that contribute to the sort of insulation on Islamic corporations and financial institutions from these two economic crises.

Islamic Corporate Governance Model

In the context of Islamic corporate governance, there are a few studies that have been carried out particularly IFIs to come up with alternative models of corporate governance. The studies seem to suggest that Islamic corporation may adopt a totally different model of corporate governance or a modified version of the Anglo-Saxon model as an alternative for its corporate governance framework. The former refers to the corporate governance model based on the principle of consultation where all stakeholders share the same goal of *Tawhid* or the oneness of Allah (Choudury and Hoque, 2004) and the latter concerns on adopting the stakeholders' value system with some modifications (Iqbal and Mirakhor, 2004). Although corporate governance is a universal subject, it is not easy to compare how Anglo-Saxon governance and Islamic corporate governance operate. Generally, it is observed that the main objective of the corporation including the Islamic corporation is to maximize the shareholder's value of wealth. Thus, it can be seen that the corporate governance in Islam and Western plays very essential roles in order to meet the specific goals and objectives of the corporation.

Nevertheless, a concept of corporate governance from Islamic perspective does not differ much with the conventional definitions as discussed above. This implies that in actual practice, many Islamic corporations adopt the Anglo-Saxon model of corporate governance (Lim, 2007). In Islamic point of view, corporate governance refers to a system by which companies are directed and controlled with a purpose to meet the corporation's objective by protecting all the stakeholders' interest and right. But uniquely, it presents distinct characteristics and features in comparison with the conventional system as it refers to a broader decision-making theory that uses the premise of Islamic socio-scientific epistemology which is premised on the divine oneness of God (Choudury and Hoque, 2004). Specifically, the objective functions of corporate governance in Islam are to define and attain an objective of understanding the relations between critical variables supported by policies, programs and strategic coalition.

Tawhid and Shura Based Approach

As the foundation of Islamic faith is *Tawhid* (Al-Faruqi, 1982), the basis for the corporate governance framework also emanates from this concept. Allah says in *Al-Quran* "*Men who celebrate the praises of Allah standing, sitting, and lying down on their sides, and contemplate the wonders of creation in the heavens and the earth, (with the thought): "Our Lord! Not for naught Hast thou created all this! Glory to Thee! Give us Salvation from the penalty of the Fire"* (3: 191). This verse provides fundamental principle of governance where everything created by Allah has a purpose and human being is created to be the world's vicegerent. By putting a trust to mankind as a vicegerent, Allah plays actively roles to monitor and involve in every affairs of human being and *He* is aware and knowing everything all the times (Chapra, 2007). As Allah knows everything and all mankind is answerable to Him, the principle of *Tawhid* shall be the foundation of the corporate governance model in Islam as the parties involved in the corporation are answerable and accountable to Allah.

According to Choudhury, an Islamic corporation is "*a legal entity where the principle and proportionate of the firm's shares owned by the shareholders based on equity participation and profit sharing ratios and deals with legal and organizational structures that control the internal governance of a firm*" (Choudury and Hoque, 2004). There are four principles and instruments governing Islamic governance i.e. extension of *Tawhid* unity of knowledge via interactive, integrative and evolutionary process to the interacting envioning factors, the principle of justice, the principle of productive engagement of resources in social and the principle of economic activities and recursive intention amongst the above stages. All of these principles are the main grounds of the Islamic corporate governance where the *Shari'ah* rules embedded in *Al-Quran* and *Al-Sunnah* make the Islamic corporation market driven and at the same time uphold the principle of social justice (Choudury and Hoque, 2004). The principle of *Tawhid* derives important concept of vicegerency (*khilafah*), trust (*amanah*) and justice or equilibrium (*aladl wal Ihsan*). The stakeholders as vicegerent of Allah have fiduciary duty to uphold the principle of distributive justice via the *Shuratic* process. Chapra, (1992) mentions that the practice of *Shura* is not an option but it is rather an obligation.

In IFIs, there are two main institution involved in the above process of corporate governance namely the *Shari'ah* board and the constituent of *Shura's* groups of participants i.e. all the stakeholders. In determining the scope of *Shari'ah*, the institution of *Shari'ah* board comes into picture and plays crucial role to ensure that all corporation activities are in line with the *Shari'ah* principles. The other stakeholders including community should also play their roles to provide mutual cooperation to protect the interest as a whole and to stimulate the social wellbeing function for social welfare. All of these processes are centered on toward fulfilling the ultimate objective of Islamic corporate governance of complementing the private and social goals via upholding the principle distributive justice (Choudury and Hoque, 2004). Thus the *Tawhid* and *Shura* based approach provides the epistemological foundation of Islamic corporate governance in IFIs.

Stakeholders Based Approach

Based on stakeholders approach, Chapra and Ahmed, (2002) in their research on corporate governance of IFIs emphasize on the notion of equitably protecting the rights of all stakeholders irrespective of whether they hold equity or not. This seems to support the model proposed by Iqbal and Mirakhor, where they view that the corporate governance model in Islamic economic system is a stakeholder-centered model in which the governance style and structures protect the interest and rights of all stakeholders rather than just the shareholders (Iqbal and Mirakhor, 2004). Their main arguments are based on two fundamental concepts of Islamic law namely principle of property rights and commitment to explicit and implicit contractual agreements that govern the economic and social behavior of individuals, society and state. These two principles provide strong justification for the notion of classifying Islamic corporate governance as a stakeholder-oriented model. In addition, Nienhaus (2003) states that Islamic corporate governance should be based on value oriented and promote the principle of fairness and justice with respect to all stakeholders.

The principle of property rights in Islam clearly provides a comprehensive framework to identify, recognize, respect and protects interest and rights of every individual, community, the state and corporation. In fact, rights of ownership, acquisition, usage and disposition of the property itself are considered as property (*al-mal*) which has beneficial use and value. In term of the rights of ownership, Islam declares that Allah is the sole owner of property and human being is just a trustee and custodian in which it implies the recognition to use and manage the properties in accordance with the *Shari'ah* rules (Iqbal and Mirakhor, (2004). There are various verses of al-Quran mentioned the principle of property rights and one of them is in surah 57:7 Allah says: "*Believe in Allah and His Messenger and spend of that whereof He made you trustee*". The implied meaning of this verse lays down the principle of property's ownership where the mankind is only regarded as a trustee of God. Beside, Islam recognizes private and society or state ownership. This implies the recognition of individual ownership in corporation as shareholders and at the same time *Shari'ah* rules provide guidelines to the individual, corporation and the state on how to deal with the property ownership.

In short, the concept of property rights in Islam is based on these fundamental principles i.e. the rights on the property is subjected to *Shari'ah*, the enjoyment of rights to property is balanced with the rights of society and the state, every individual, society and the state is stakeholders and the recognition of rights of stakeholders by Islamic law (Iqbal and Mirakhor, 2004: 54). Contractual framework is also very unique in Islam. In *al-Quran surah 5:1* Allah clearly reminds the Muslims on the principle of fulfilling each of their contractual obligations where He says: “*O you who believe, fulfill contracts*”. This verse presents a basic foundation the notion of contract that every individual, society, corporation and the state are bound by their contracts which defines the rights and obligations of the parties. In relation with the issue on corporate governance, each stakeholder has duty to perform his contractual obligations in accordance with the term stipulated in the contract directly or indirectly. For example, the shareholders has duty to provide business capital, the management to manage and run the business, the employees to perform their respective duties and the state to ensure enforceability of the contracts in case of violation by any party.

All of these duties arise through contractual framework and they are subjected to the rules of *Shari'ah*. In short, the principle of contract in Islam establishes guideline to identify and qualify who is a rightful stakeholder. The Islamic corporate governance based on stakeholders-oriented model is preoccupied by two fundamental concepts of *Shari'ah* principles of property rights and contractual frameworks. The *Shari'ah* board plays a role to advise and supervise the operation of the corporation so as to ensure that it complies with the *Shari'ah* principles. The board of directors acting on behalf of the shareholders has duty to monitor and oversee overall business activities and the managers have fiduciary duty to manage the firm as a trust for all the stakeholders and not for the shareholders alone. The other stakeholders such as employees, depositors, customers have duty to perform all of their contractual obligations. In addition, the state as a stakeholder will be the external institution to provide regulatory framework and its enforcement.

Having analyzed the stakeholder based model approach, it is important to highlight a few issues on the arguments put forward by Iqbal and Mirakhor (2004). Chapra, in his critical review on the Iqbal's arguments comments that while most of the arguments are positively supported the stakeholder model and acknowledged the stakeholders rights, they do not demonstrate as to how to ensure that these rights are protected. The argument that the observance of rules of behavior guarantees internalization of stakeholder rights seems difficult to be materialized. Chapra argues that Islamic norms had become internalized in the Muslim society in classical period of Islamic society and it does not work in today's society (Chapra, 2007). In this aspect, he views that there are other factors need for the internalization of stakeholder rights such as wellfunctioning competitive markets and proper legal framework for the protection of stakeholders. Another debatable argument refers to the task of designing a corporate governance system to be solely the prerogative of Islamic government. It is the duty of Islamic government to regulate the rules and legislation to specify the appropriate corporate governance structure. This argument raises a few issues such as a proper definition of Islamic government and as to how to design the corporate governance structure of Islamic corporation in the countries where the Muslims are minorities.

Conclusion

The design of corporate governance model in Islam has its own unique features and presents distinctive characteristics in comparison with the western concept of the Anglo-Saxon model. The study summarizes the diversities of these models and classifies them into four aspects namely the episteme, the corporate objective, the nature of management, the management board and the capital-related ownership structure. The findings of this paper are that there are several differences between the corporate governance structures and principles of non-Islamic corporations and financial institutions and their Islamic counterparts. All of these principles are the main premises of the Islamic corporate governance where the *Shari'ah* rules embedded in *al-Quran* and *al-Sunnah* make the Islamic corporation market driven and at the same time uphold the principle of social justice. The rights of ownership, acquisition, usage and disposition of the property itself are considered as property (*al-mal*) which has beneficial use and value. In term of the rights of ownership, Islam declares that Allah is the sole owner of property and human being is just a trustee and custodian in which it implies the recognition to use and manage the properties in accordance with the *Shari'ah* rules. The Islamic corporate governance approach is premised on the *Tawhid* epistemological model whereby the functional roles of corporation are working via the *Shari'ah* rules. The principle of *Tawhid* derives important concept of vicegerency (*khilafah*), trust (*amanah*) and justice or equilibrium (*aladl wal Ihsan*). Based on these principles, although some of the Islamic corporations and banking group were affected during the two crises, the damage done were insignificant. Thus the factors that contribute to the sort of insulation on Islamic corporations and financial institutions from these two economic crises were clearly observable.

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