

**Islamic Banking and Finance Conference**  
**Lessons From International Corporate Governance Scandals**

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International financial integration

The issue of how corporations manage their affairs is very important everywhere, but may be particularly so in the Middle East and North Africa region. Why? Perceived political instability and small national markets have left this region behind in the global capital allocation process: in 2002, it was the smallest regional recipient of FDI (it received \$3 billion out of \$143 billion), behind Sub-Saharan Africa with \$7 billion and South Asia with \$6 billion. It is the only region which has not placed equity securities on the international markets in 2001 and 2002. In 2003, it is expected to be the only region to suffer negative portfolio equity flows in an amount of \$1 billion, reversing the cumulative inflows of the last five years.

Given some of its structural handicaps, I am posing that corporate governance could be a competitive lever to differentiate the region in the international market place. This is what transpires from a 2002 AT Kearney FDI Confidence Index review, which places corporate governance at the top of business environment factors most likely to affect corporate strategy (with a 78% rating). And strong corporate and bank governance are essential ingredients for the development of a vibrant and sound Islamic finance industry.

Corporate governance in the development context

Before coming here, I read with considerable interest the first Arab Human Development Report prepared by a group of distinguished Arab intellectuals and sponsored by the UNDP in 2002. It focused on a central concern for the region which is the weak and volatile growth rate (actually negative on a per capita basis in the last decade). Caused by low factor productivity, it creates a persistently high unemployment rate that constrains the development of human capabilities. The report states: "*Growth and equity considerations make promoting dynamic private sector development a critical priority of economic governance in Arab countries*". And the issue of governance of development is put in these terms: "*Governance can be seen as the exercise of economic, political and administrative authority to manage a country's affairs at all levels. Good governance is, among other things, participatory, transparent and accountable. It encompasses state institutions and their operations but also include those of the private sector and civil society organizations.*"

Corporate governance arrangements under scrutiny worldwide

Since Enron's demise in December 2001, barely more than a year ago, the business community and the authorities worldwide have started dissecting the way corporations are run – from many angles: the issue of board composition and effectiveness, the issue of executive compensation, the role of the investment banking community, stock exchange listing requirements, the role of the accounting and auditors professions, the voting patterns of institutional investors. A range of very technical issues. But what are the main principles underpinning these discussions and proposals?

They aim at a single factor, identified in the early 1930s by a US economist Bearle, which is how best to translate ownership into profitable entrepreneurial opportunities, that is the issue of the interface between ownership (i.e., the investors, or the “principal”) and control (i.e., management, or the “agent”). These are central issues in Islamic finance as well.

### Financial democracy, but with weak institutions

In the last decade, the world has experienced an astounding democratization of economic opportunities. Owners of companies do not rely any longer on internally generated funds or on bank borrowing to pursue growth opportunities – i.e. funds provided by a very limited number of subjects, mostly connected to the owner by long-standing relationships. Instead, they rely on financing provided by a large range of investors, the largest majority of them being unknown to them. Conversely, savings products have been multiplied, from the traditional bank account to a range of bond and equity investments available not only from domestic issuers, but worldwide. It is this extreme fragmentation of the debtor-creditor relationship that lies at the heart of the corporate governance problem.

Financial markets, outside banking, intermediate a stock of personal savings that is well in excess of GDP in industrialized countries. In the Euro-area, for example, households have financial assets that are exposed to market risk in an amount equal to 145% of GDP, compared to financial assets intermediated by the banking sector that are equal to 65% of GDP. These data exclude data from the UK where an even greater proportion of household financial assets is exposed to market risk.

Please allow me now a short digression to try and frame this issue in terms that may help us achieve a good level of strategic understanding of what is at stake here. The essence of corporate governance can be understood looking through the lenses of political representation. Traditional European constitutional models (going back to the city of Athens 3,000 years ago) called for a separation of functions and a separation of institutions for an effective translation of citizens’ will into government executive actions. Citizens vest the legislative power (i.e., the expression of their willingness) in a parliament through elections. The parliament (or sometimes the citizens directly) votes in the executive branch, with the latter being accountable to the former for the execution of the citizens’ goals. There is a third power, the judiciary, which controls the activity of the other two powers being independent from each of them.

In the corporate world, the investor (i.e. the citizen) votes for the appointment of the members of the board of directors which constitute themselves in the legislative function of the corporate activities. The board, in turn, appoints the CEO as the head of the executive branch who then appoints its management team, which is his cabinet. Internal and external auditors, stock exchange authorities, bank credit officers, investment bank analysts, credit rating agencies, securities regulators and, in some extreme cases, the judiciary authorities exercise an oversight over the activities of the corporation that is equivalent to the judiciary power in a democracy. There is, thus, a striking similarity in functions and interfaces between the constituent elements of a financial democracy and those of a political democracy.

The recent corporate scandals teach us that, as the world economy moved from a “financial oligarchy” (owners and bankers) to “democratic rule” in the 1990s, it did not place sufficient importance in adopting strong institutions that would protect the right of the citizens, i.e. of the investors, vis-à-vis potential abuses of the executive branch, i.e. management.

Management did not make itself accountable to investors. Board of directors often lack effectiveness. And the oversight functions that I have just outlined have failed to rein in management abuses. We all know of auditors not having upheld the highest professional standards in front of aggressive management teams, of research analysts willingly abusing investor confidence in pursuit of personal financial gain, of credit rating officers slow in changing their notation etc. And we know of how strong a resistance have major US mutual fund investors put forward when the SEC was deciding to make it compulsory to disclose how they exercised the voting rights on behalf of their investors. It is widely known that many of these institutions side with management because they receive profitable ancillary business such as corporate pension fund management.

So, financial democracy does not work properly yet in the world. How to strengthen it?

#### How to strengthen financial democracy?

The feature of a regime that is not democratic is the concentration of powers in a single or a few pairs of hands. The fundamental rule of democracy is, conversely, division of power and absence of conflicts of interest. Where to start from?

**First, to strengthen the link between the electorate and the legislative.** It is essential that investors keep the board accountable to them. This happens typically in the context of the annual general meeting. But the electorate, which speaks largely through institutional investors, often fails to exercise its rights and duties. A democracy with feeble electoral turnout or without the possibility of voting out the incumbent legislators is not a democracy. Yet, institutional investors (who hold four times as many financial assets as retail investors in the UK and more than 60% of the equity market in the US) tend to rally behind management. No wonder, then, as I said earlier, that they vehemently resist the idea of disclosing their voting decisions to their fiduciary clients. The Myners Report on institutional investors, which appeared in the UK in 2001, touched also on the issue of shareholder activism. It said: *“The most powerful argument for intervention in a company is financial self-interest, adding value for clients through improved corporate performance leading to improved investment performance”*. Faced with institutional investor reluctance to take on an activist role, the report concludes that *“voting is one of the central means by which shareholders can influence the companies in which they have holdings”*, and recommends that the principle of the US Department of Labor be incorporated in due course into UK law. The US Department of Labor principles are as follows: 1) the fiduciary act of managing pension plan assets include the voting of proxies on issues that may affect the value of the plan’s investments; 2) active monitoring would concern issues such as assuring that the board has sufficient information to carry out its responsibility to monitor management. Indeed the weak oversight provided by owners on corporations is a major fault line in the structure of financial democracy.

**Second, to strengthen the functions of the legislative relative to the executive.** The Board’s role needs to be enhanced from a court-like role of rubberstamping the decisions of the all-mighty CEO (as happened in the Enron case) to becoming the main engine of the future of the company, in accordance with the fiduciary mandate entrusted by investors.

In this respect, the first action is that the CEO must not combine the position of Chairman of the Board, as a prime minister cannot be the speaker of the parliament at the same time. As The Economist said, *“Everybody needs to have a boss.”* This principle is well understood in corporate Europe – not only in dual-board countries, but also in single-board countries such as the UK. The Higgs report, published last January in the UK, emphasizes this element.

Also in the US, this principle is slowly taking hold, although bosses do not like to share power.

The second action is that the Board needs to take the leadership of the company. As the Higgs report stated, “*[The board] is collectively responsible for promoting the success of the company by directing and supervising the company’s affairs*”. Related to this enhanced role, the board needs to have an effectiveness orientation. This introduces the issue of its composition. Directors have to be appointed for their expected contributions to the long-term success of the company (as any other advisor or staff) – no sweet favors to old friends. And they must be able to operate with independence from management. I refer here to the independent non-executive directors that, when equipped with suitable professional qualifications, are the mainstays of effective boards.

**Third, the legislative needs to facilitate the external oversight of the executive.** The board needs to take active ownership of the relationship with the external auditors – typically through a well-structured audit committee. In order to ensure the accuracy of financial reporting (that is so central to keeping the public trust), it is critical that this function be placed under the direct oversight of the board so as to be as much at arms’ length from management as possible. Accuracy of financial reporting is the basis for transparency and disclosure, a pre-requisite for investors and creditors to hold the company accountable.

**Fourth, together with investors, other members of the “judiciary” should fulfill their oversight role of the executive:** creditors and market participants should monitor corporations actively. Market-based discipline has gained prominence in the thinking of financial supervisors as an essential component of financial stability. It is one of three pillars of the new Basel Capital Accord presently in an advanced stage of discussion. But for market discipline to be effective it has to be free of conflicts of interests, so that market participants can be free to take a position against management, if this is justified on business grounds. The \$1.4 billion Spitzer settlement on Wall Street last December, involving ten of the world’s largest investment banks, is a testimony to how deep the breach of trust of investors in the industry has become. Present inquiries on the linkage between extending loans and bidding for investment banking mandates is another facet of a breakdown of roles and functions that has occurred where conflicts of interest twist the exercise of natural incentives.

#### A strong financial democracy contributes to economic stability

The benefit of a clear division of powers in the corporate world, away from the present dominance of the executive branch, would be very significant. It would allow a more disciplined pursuit of the shareholders’ goal to generate value, leading to a better allocation of savings and a more efficient functioning of the entry and exit selection process of companies. Greater discipline would attract more investors, domestic and international. And companies would be able to access a larger pool of capital to fund their productive activities.

The stability of the value of household market-based financial assets has macro implications, affecting consumption and investment patterns. Yet, the strict discipline of bank supervision, the tight management of monetary policy (with temporary exceptions) and the tough fiscal rules adopted to preserve monetary stability (that all but paralyze political life in several European countries) are not mirrored in an equivalent strong regime governing the interface of the corporate world with the securities markets. Why should lax issuer and financial market operations impact the value of a large proportion of household financial assets?

### Islamic Finance considerations

I hope that the directions for strengthening corporate governance that I have just outlined could be useful to help assess the existing governance arrangements of the operations of Islamic banks.

These institutions are, through *mudaraba* and *musharaka* financing, full business partners with both depositors and clients. They undertake activities that are more complex than those performed by western financial institutions. Thus, the issue of ensuring that the “agent” (i.e., the bank for its depositors and the entrepreneur for the bank) has the appropriate incentives to operate in the interest of the “principal” is truly central to the sustainable performance of this type of financing. The “principals” have to be satisfied, through full monitoring of the activities of the “agent”, that their capital is managed according to the terms and conditions of the financing partnership, in addition to complying with the Sharia principles.

I can only try to help relate my experience to your situation by formulating a few questions:

- How are Islamic banks fulfilling their fiduciary duties vis-à-vis their depositors in ensuring that their clients accurately report the economic profitability of their ventures and equitably share the associated profits with its financiers?
- Are external audit practices adequate to assure depositors of the equitable distribution of profits pursuant to the specific terms of the partnership arrangement?
- Are the in-house oversight functions of the activities of an Islamic bank sufficiently independent from management?
- How are the members of the in-house oversight bodies appointed? Whom are they accountable to and in what form?
- What role do institutional investors play in monitoring the activities of the financial institutions?

### From corporate governance to economic governance

The leadership shown by the business community in enforcing good governance practices, respecting the rights of all shareholders, is essential to keeping adequate financing flowing to support productive activities. But, by experimenting novel ways to foster transparency and encourage participation and accountability in the economic sphere, the business community will also contribute to strengthening governance of economic development at large – the issue that features so highly in the Arab Human Development Report.

The Report states: “*There can be no real prospects for truly liberating human capabilities in the absence of comprehensive representation*”. The business community has an important role to play in society. A strong society is a pillar of national identity. And the world needs strong national identities to govern globalization effectively.