Corporate Governance of Islamic Banks

Why is Important, How is it Special and What does this Imply?

Stijn Claessens (World Bank)

Islamic Finance: Challenges and Opportunities

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Outline of presentation

- Why care about the CG of banks? What is special about CG of banks?
- What do we know about CG of banks? What does this imply for bank CG, regulation/supervision?
- What is special about CG of Islamic banks? What does this imply for CG of Islamic banks?
- What are policy and research questions?

Why care about CG of banks? (I)

- Banks are corporations themselves
  - CG affects banks' valuation and their cost of capital. CG of banks thereby affects the cost of capital of the firms and households they lend to
  - CG affects banks' performance, i.e., costs of financial intermediation, and thereby cost of capital of the firms and households they lend to
  - CG affects banks' risk-taking and risks of financial crises, both for individual banks and for countries' overall banking systems

Why care about CG of banks? (II)

- Bank behavior influences economic outcomes
  - Banks mobilize and allocate society's savings. Especially in developing countries, banks can be very important source of external financing for firms
  - Banks exert corporate governance over firms, especially small firms that have no direct access to financial markets. Banks' corporate governance gets reflected in corporate governance of firms they lend to
- Thus, governance of banks crucial for growth, development, and risk management

What is special about CG of banks? (I)

- Banks are "special," different from corporations
  - Opaque, financial information more obscure: hard to assess performance and riskiness
  - More diverse stakeholders (many depositors, claimholders and often more diffuse equity ownership, due to restrictions): makes for less incentives for monitoring
  - Highly leveraged, many short-term claims: makes them risky, easily subject to bank runs
  - Heavily regulated: given systemic importance, as failure can lead to large output costs, more regulated

What is special about CG of banks? (II)

- Because special, banks more regulated, with regulations covering wide area
  - Activity restrictions (products, branches), prudential requirements (loan classification, reserve reqs. etc)
  - Regulations often more important than laws
- Government, instead of depositors, claim, debt or equity-holders, monitors
  - Power mostly lies with government, e.g., supervisor, deposit insurer, central bank
  - Raises in turn public governance questions

What is special about CG of banks? (III)

- Banks enjoy benefits of public safety net
  - Banks, as they are of systemic importance, get support, i.e., deposit insurance, LOLR, and other (potential) forms of government support
  - Costs of support provided often paid for by government, i.e., in the end taxpayers
- Implies banks less subject to normal disciplines
  - Debt- claim holders less likely to exert discipline
  - Bankruptcy is applied differently or rarer
  - Competition is less intense as entry restricted
  - Public safety net is large, creating moral hazard

What is special about CG of banks? (IV)

- Same time, banks more subject to CG-risks
  - Opaqueness means scope for entrenchment, shifting of risks, private benefits and outright misuse (tunneling, expropriation, insider lending,, etc.) larger than for non-financial firms
- As for any firm, bank shareholder value can come from increased risk-taking
  - Shareholder value is residual claim on firm value
  - Increased risk-taking raises shareholder values at expenses of debt claimholders and gov't
  - Risk greater for highly leveraged banks

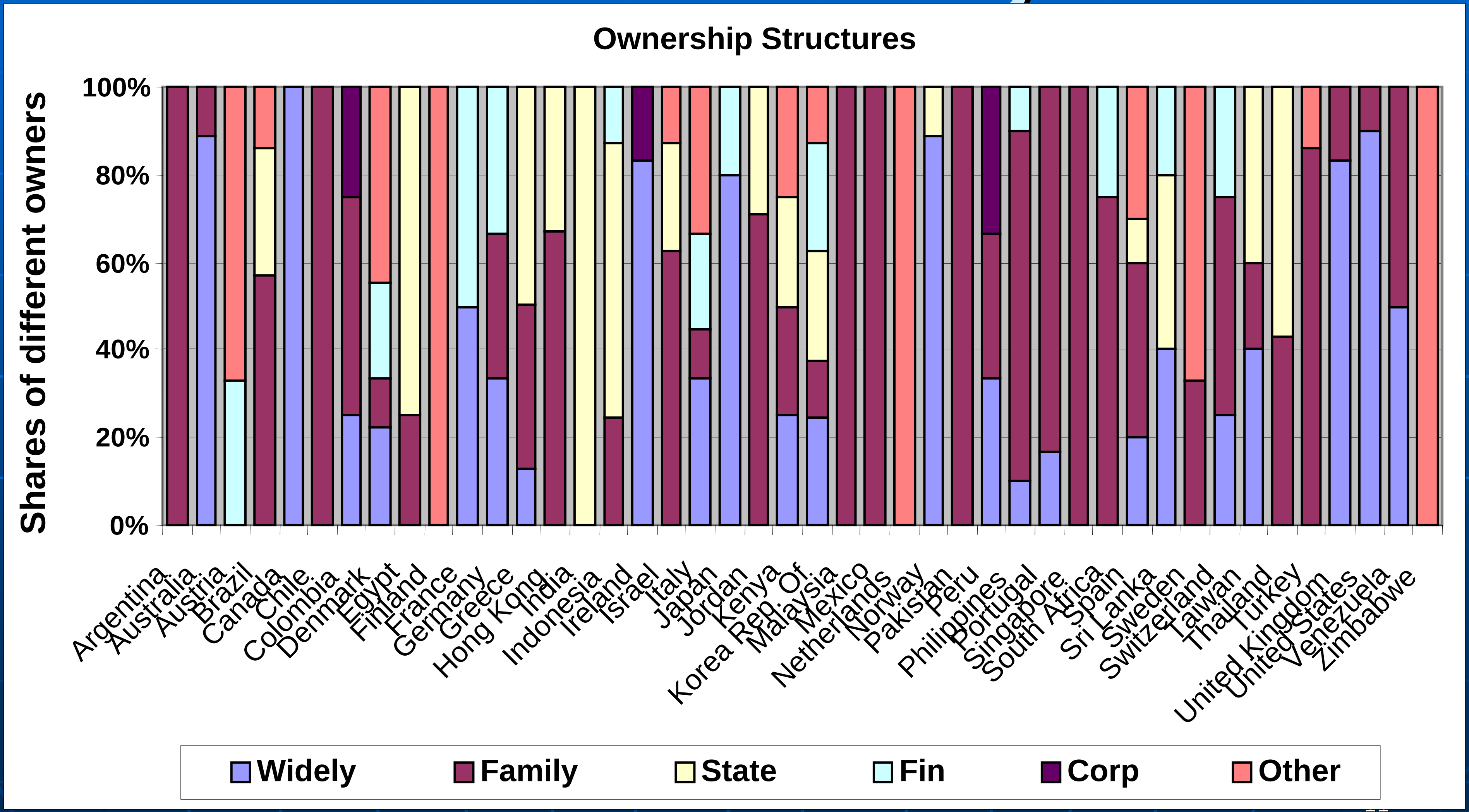
What do we know about CG of banks?

- So far, little evidence on the standard CG-questions and even less on the more complex issues of CG and regulation, supervision
- Some have documented effects of bank ownership
  - LSV/BCL: banking systems with more state-ownership: less stable, less efficient, worse credit allocation
  - More foreign banks: more stable, efficient, competitive
- Few so far investigated bank governance
  - Many studies on effects of laws & regulations for corporations
  - But few on banks, except for recent evidence from Caprio, Laeven, and Levine (2006)
  - Starting point is effects of ownership structures on valuation and performance

Bank ownership: possible ownership and control patterns

- Widely-held, not-controlled by any single owner
- Controlling owner
  - Family (individual)
  - State
  - Widely-held (non-financial) corporation
  - Widely-held financial institution
  - Other (trust, foundation, which may be “shell”)
- With small or large deviations of control rights from ownership (cash-flow) rights

Bank control varies greatly internationally

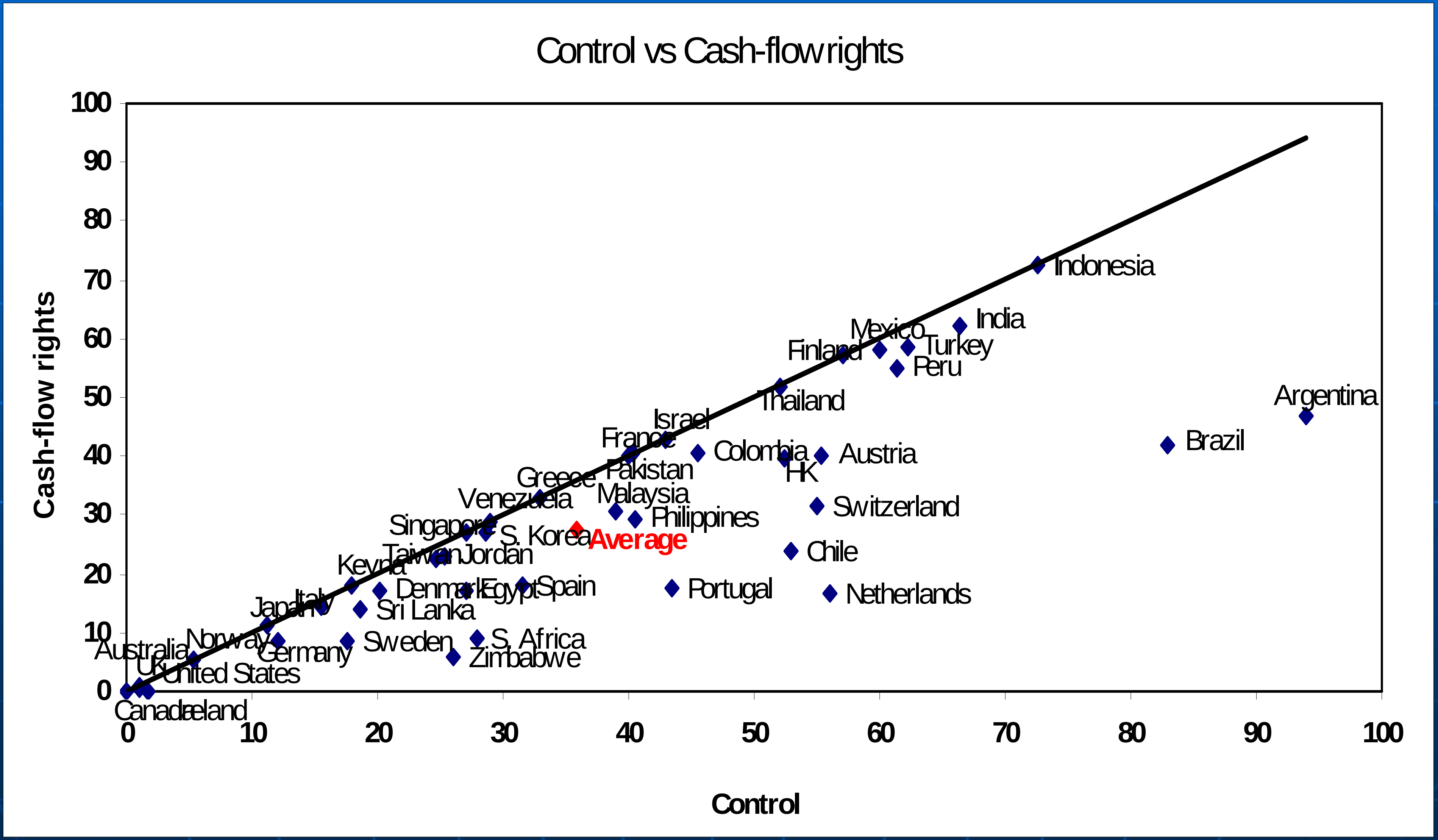


Bank control internationally

	CF	Widely	Family	State	Fin	Corp	Other
Country mean	27.45%	25%	39%	14%	7%	2%	14%

1. Banks are generally not widely-held
2. Family ownership of banks is very important, and so is the state ownership
3. Cross-country differences are large, though
   - In 14 of 44 countries, the controlling owner has more than 50% of voting shares. But in Australia, Canada, Ireland, UK, and US, either NO bank has a controlling owner or the average is less than 2%
4. Legal protection of shareholder is associated with more widely-held banks, i.e., with better legal protection less need/desire for close control

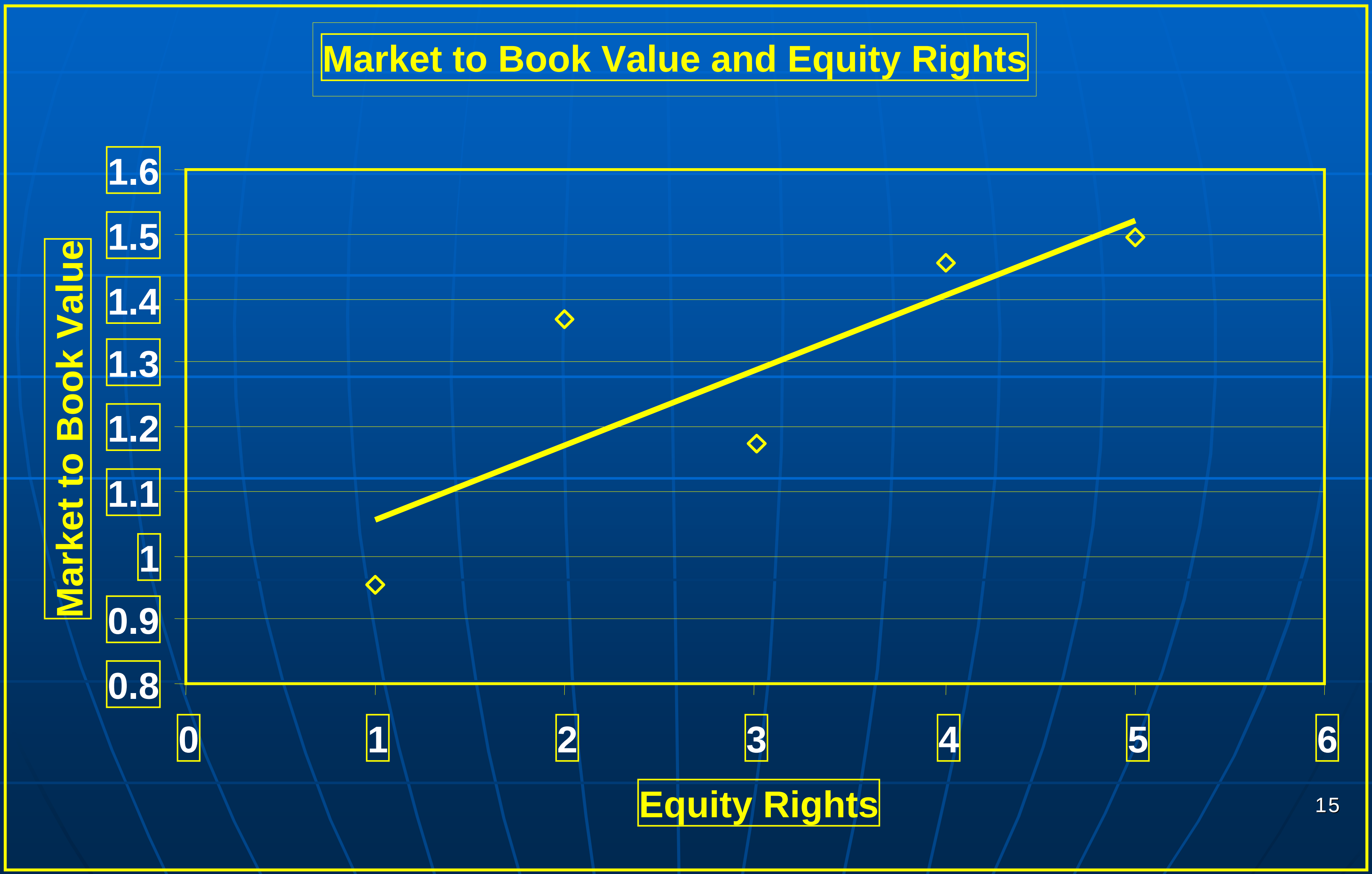
Ownership and control can deviate



Valuation effects of bank ownership and equity rights

- When cash-flow rights of controlling owner higher and equity rights stronger, bank valuation higher. Effects can be large:
  - A one-standard deviation increase in cash flow rights (0.27) raises market-to-book by 0.42, or 31 percent of mean
  - A one-standard deviation increase in shareholder protection laws (1.25) raises market-to-book by 0.28, or 21 percent of mean
- More cash-flow rights can even offset some of negative effects of weak equity rights
- Suggests strong owners, both in share and in their equity rights, can help CG of banks
- Surprising, perhaps, quality of supervision and the degree of regulation does not robustly influence valuations

Bank CG and Valuation: Impact of Equity Rights



What do we know about CG of banks? Monitoring and risk

- Banks are indeed more difficult to monitor
  - Moody's and S&P disagreed on only 15% of all non-financial bond issues, but disagreed on 34% of all financial bond issues
- Banks are more vulnerable
  - Recessions increases spreads on all bond issues, but increases spreads on riskier banks more than for non-financial firms
  - Partly result of a flight to safety, but also greater vulnerability of banks compared to non-financial firms

What do we know about CG of banks?
Bank failings and financial crises

- Banks with weak corporate governance have failed more often
  - Accrued deposit insurance, good summary measure of risks of banks, higher for weaker CG
  - State-owned banks enjoy even larger public subsidy, that is often misused: poor allocation, large NPLs, e.g., Indonesia, South Korea, France, Thailand, Mexico, Russia
  - Case study evidence, also for Islamic banks
- Countries with weaker corporate governance, poorer institutions: more crises
  - Fiscal costs of government support up to 50% of GDP, large output losses from financial crises

What does this imply for bank CG and regulation and supervision?

- Quality of bank CG interfaces with supervision and regulation
  - More effective banks' CG can aid supervision since with better CG, banks can be sounder, valuations higher, making supervision easier
  - Good CG-framework can make bank regulation and supervision less necessary, or at least, different
- Need to consider therefore bank CG and regulation and supervision together

What does this imply for bank CG and regulation and supervision?

- Two approaches to CG and supervision
  - Capital standards **I** and powerful supervisors **II**
    - Market failures/externalities, so need regulations
    - Market failures, but also government failures
  - Empower private sector through laws & information **III**
    - Give market incentives and means
- Approaches not mutually exclusive
  - What is best mix of private market and government oversight of banks?
  - What does this imply for bank CG?

Implications for CG of banks

- Bank ownership
  - Be very careful on state ownership: negatively related to valuation, stability and efficiency
  - Consider inviting private, foreign owners
- Bank governance, regulation and supervision
  - Strong private owners necessary, but they need to have their own capital at stake
  - Better shareholder protection laws can improve functioning of banks
  - Supervision/regulation less effective in monitoring banks
- Responses
  - OECD & BCBS Guidelines on CG

What is special about CG of Islamic Banks?

1. The Shariah Law
    - Risk of non-compliance can create financial turmoil
2. The Unrestricted Investment Accounts Holders
    - Co-mingling of funds and smoothing of returns
3. Institutional environment in which Islamic banks operate
    - Less transparent, weaker market forces and sometimes weaker government oversight

1. Shariah Law

- Risk of non-compliance
  - Conceptually not different from the type of financial, operational and reputational risks faced by any financial institutions
- Safeguards
  - General CG of financial institution
    - Use OECD, BCBS, other guidelines
    - No specific changes, except that Shariah needs to be part of CG, e.g., part of CG committee

1. Shariah Law

- Internal Shariah Supervisory Board (SSB)
  - Can be seen like audit board. Guidelines & regulations and oversight by market (and government) may help in its functioning.
  - Quality of the internal SSB maybe hard to signal to the outside, e.g., small claimholders. Some certification possible by markets, e.g., ISS, GMI, etc.
- External, akin to Pillar II & III in Basel II
  - Central Shariah Boards: raises issues of governance of such boards, like those in traditional supervisors
  - Market forces, "Islamic Rating Agencies" or another "SRO." But: do they exist? do they have the information to judge? do they have the standards to judge by?

2. Unrestricted Investment Account Holders (IAH)

- Co-mingling of IAHs and shareholders' stakes & returns and co-mingling among IAHs, leading to principal agent & conflict of interests issues
  - Good general CG of bank first defense
  - Specific (internal) guidelines second defense
    - Separate accounts within banks, have good accounting and auditing, clarify the reserve schemes, provide information in a meaningful way to IAHs and outsiders, adopt firewalls
  - Adopt mutual fund / collective investment scheme approach to CG
    - Since bank run essentially various mutual funds, bank should be seen as asset manager/sponsor
    - Need to clarify & separate various roles: custodian, manager, account holder, etc. and organize accounting, & control functions
    - Adopt CG of each IAH as in CIS (IOSCO CIS-principles)

2. (Unrestricted) Investment Account Holders (IAH)

- Other solutions not easy
  - Have IAHs also represented in the CG of bank, e.g., “codetermination” as employees in Germany or other stakeholders
    - But IAHs small, poorly organized, ill-informed, etc.
    - Many principal agent issues among various types of IAHs, e.g., different risk profiles; makes it difficult to form single opinion for CG of banks
  - Make IAHs more explicit debtholders
    - But then violate Shariah laws
  - Government oversight
    - Hard to oversee all types of transactions

3. General institutional environment is often weaker

- Apply general lessons of CG (of banks) in less-developed institutional environments. Ownership structures to monitor in particular
- Put most emphasis on market forces: better accounting (rules and practices), strengthen firewalls, and enhance disclosure
- Government to be careful to step in and take too large a role in overseeing banks, also as market is still evolving
- Facilitate/provide specific role for market monitoring of Shariah requirements

What policy and research questions on CG of Islamic Banks?

- What are CG practices and do they differ from other firms/FIS?
  - General CG
  - Setup of SSBs
  - Actual accounting, disclosure practices
- Impact: are there differential effects of CG?
  - Performance, e.g. ROA
  - Valuations, e.g. market to book
  - Financial stability, e.g., ratings, volatility
- Policy issues
  - Impact of overall institutional environment: are there relations between performance, valuation, stability and measures of institutional environment?
  - Specific regulations and oversight: what works best?

End of presentation