Capital Structure, Agency Theory and Corporate Governance Issues in Islamic Banks

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PROFESSOR SIMON ARCHER
Consultant, Islamic Financial Services Board (IFSB)

PROFESSOR RIFAAT AHMED ABDEL KARIM
Secretary-General, Islamic Financial Services Board (IFSB)

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Capital structure of an Islamic bank

- Islamic banks operate in accordance with the principles of *Shari'ah,* which prohibits, among other things, payment and receipt of *riba* (interest).

- This means that Islamic banks cannot incur or earn interest in their financial transactions.

- Hence, unlike conventional banks, Islamic banks can neither enter into interest-bearing loan contracts nor accept interest-bearing deposits.

- Islamic banks mobilise and utilize funds using Shariah compliant contracts that are not (normally) used by their conventional counterparts.

Table 1: Capital Structure of an Islamic Bank

ASSETS	LIABILITIES
Cash & cash equivalents	Current Accounts (CA)
Sales receivables	
Investment in securities	
Investment in leased assets	**Equity of Profit Sharing Investment Accounts (PSIA)**
Investment in real estate	
Equity investment in joint ventures	Profit Sharing Investment Accounts (PSIA)
Equity investment in capital ventures	Profit Equalization Reserve (PER)
Inventories	Investment Risk Reserve (IRR)
Other assets	**Shareholders' Equity (SE)**
Fixed assets	

Total capital = CA + PSIA + SE

Components of capital structure of an Islamic bank

Shareholders' funds

- Only source of equity funds raised by the bank through sale of common shares to the public.
- No preference shares issued as it would violate the *Shari'ah* to pay fixed percentage dividends to holders of these shares.
- Include reserves accumulated over the years.
- Shareholders have sole control over the bank through the Board of Directors.

Current accounts

- Akin to cheque accounts of conventional banks.
- Customers have the right to withdraw their funds on demand.
- Customers not entitled to receive any returns on their deposits.

Components of capital structure of an Islamic bank

Profit-Sharing Investment accounts (PSIA)

- Mobilised under the Mudaraba contract, PSIA are a profit-sharing financial instrument that is neither a financial liability nor an equity instrument in the conventional senses of these terms. (According to IAS 32, they are a form of capital that is a type of liability, as is the case with some 'puttable stock')

- PSIA supply funds to an entrepreneurial party (Islamic bank or *mudarib*) for trading and investment purposes while the Islamic bank contributes its expertise.

- Profits from operations funded by investment accounts are divided between the bank and PSIA holders according to ratios agreed in advance in the contract.

- As owners of the bank, shareholders receive a proportion of this profit (Mudarib share) as a reward for the work which their agent (the management of the bank) performs in managing PSIA funds.

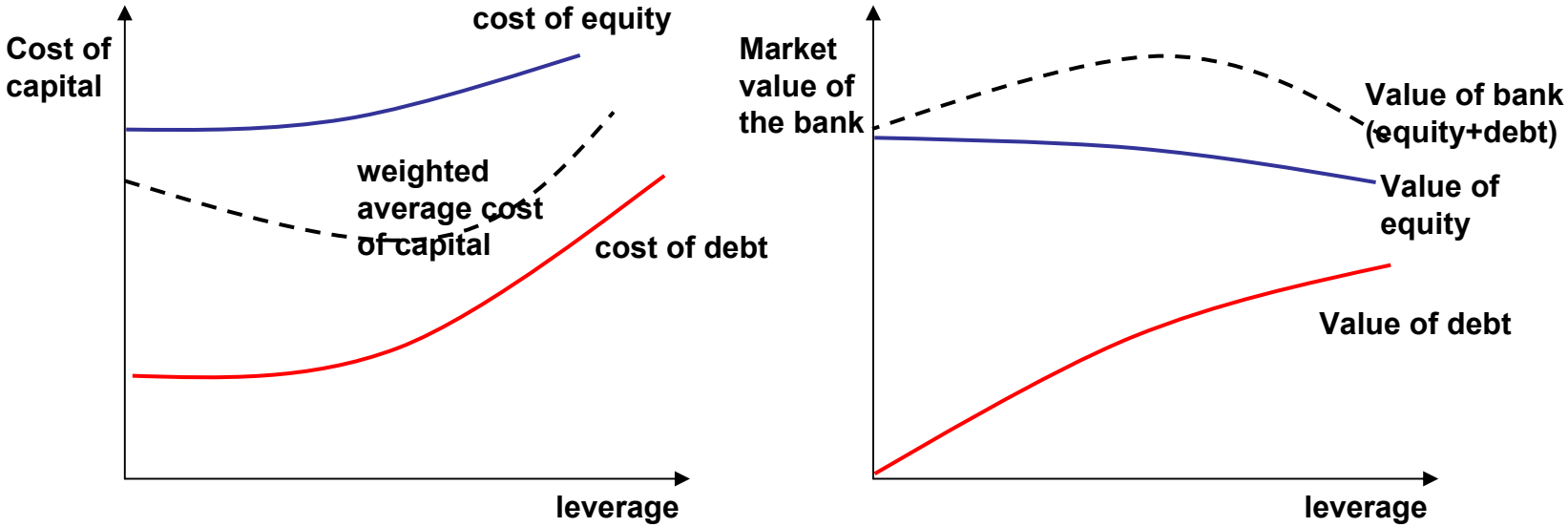
Components of capital structure of an Islamic bank

Profit-Sharing Investment accounts (PSIA)

- In case the aggregate portfolio investment results in a loss from normal business causes or natural causes, PSIA holders bear all the loss pertaining to their investments to the extent of their deposits.
- In that case, shareholders receive no reward for work performed by the management of the bank in managing these funds.
- If the loss is due to misconduct or negligence of the bank, it has to make good the loss, i.e. this turns the loss into a liability of the bank.
- Unrestricted PSIA
  - The contract signed by PSIA holders authorises the bank to invest their funds at its discretion, including commingling their funds with those of shareholders.
- Restricted PSIA
  - The contract signed by PSIA holders specifies, among other conditions, the type of investment in which their funds are to be invested (e.g. real estate, leasing, etc), but it does not give them the right to interfere in the management of the funds.

Modern capital structure theories with regard to conventional banks

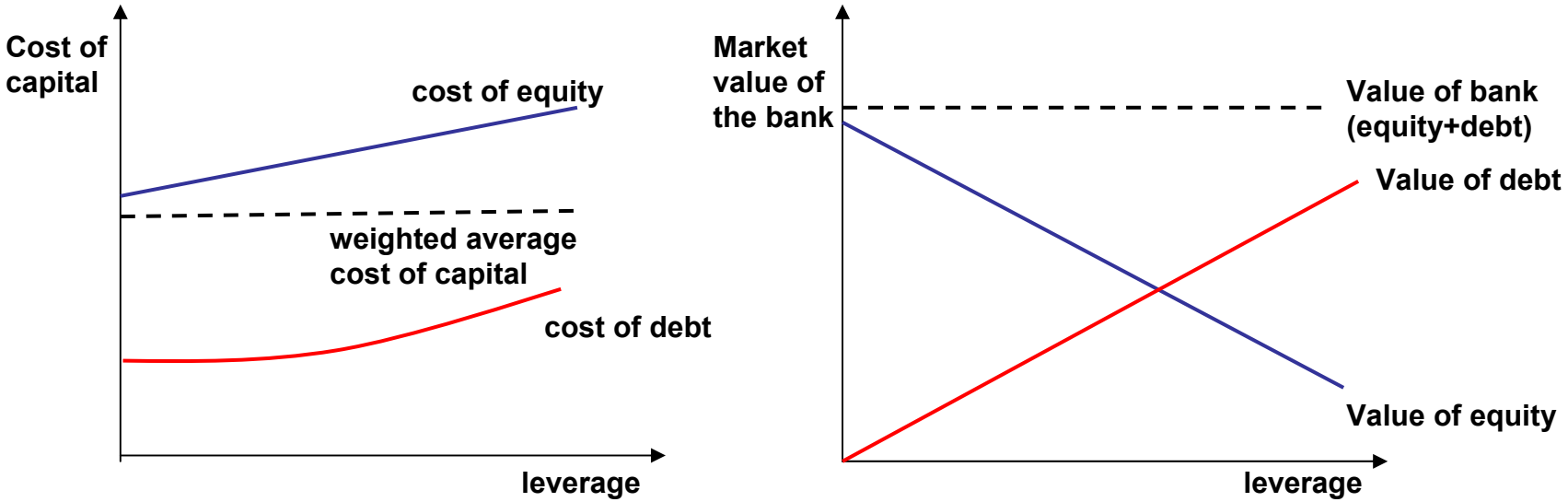
Traditional school



- For conventional banks, the "traditional view" suggests that as debt is increased from a low level, financial risk is first perceived to be insignificant and causes modest change in the cost of equity or debt. This reduces the bank's weighted average cost of capital and simultaneously the market value of the bank rises.
- As a bank increases its use of debt financing, the financial risk perceived by shareholders will increase leading to an increase in the expected cost of equity. The weighted average cost of capital levels off and the bank's market value is maximised.
- Further increases in debt financing lead to an increase in weighted average cost of capital and a decrease in the value of the bank.

Modern capital structure theories with regard to conventional banks

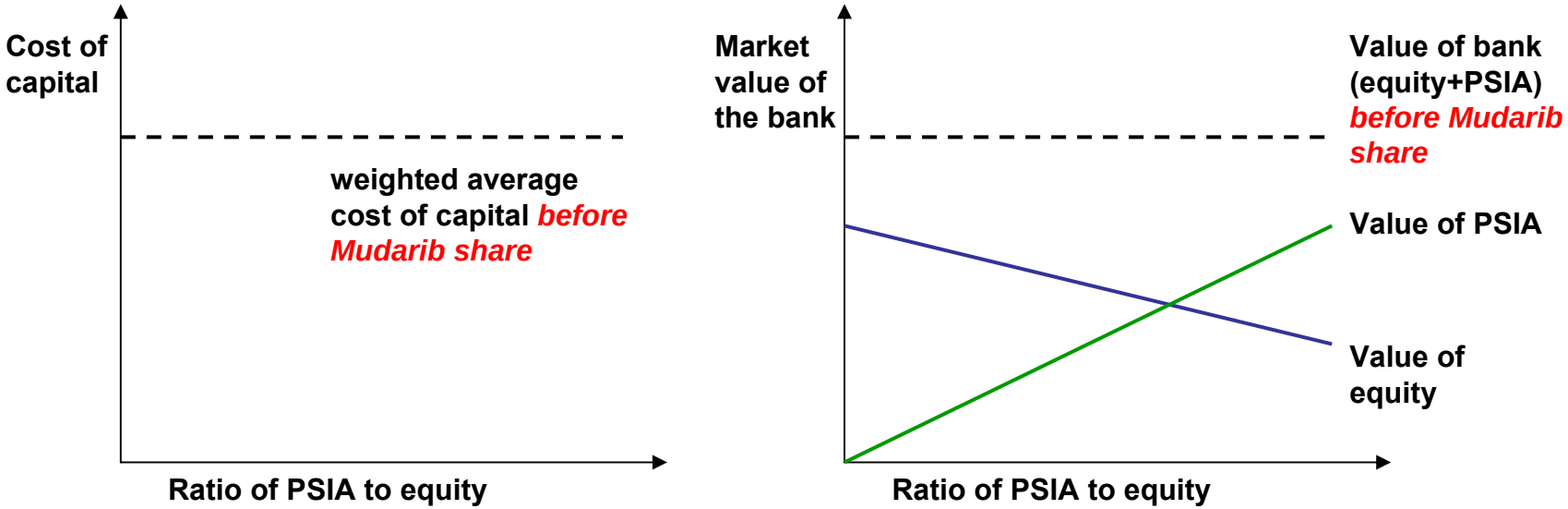
Modigliani-Miller (MM)



- For conventional banks, the "MM model" suggests that as debt financing increases in a bank's capital structure, the cost of equity will always rise so as just to offset any benefits which can be reaped from the lower cost of debt funds relative to equity. This assumes that there are no taxes or transactions costs.
- Hence, under these assumptions the market value of the bank and its cost of capital are independent of the degree of debt financing.
- If MM assumptions of no taxes and no transactions costs are relaxed, the effects of debt tax shields and bankruptcy costs may produce an outcome similar to the 'traditional' model with an optimal level of debt (trade-off theory).

Are modern capital structure theories with regard to conventional banks relevant for Islamic banks?

Islamic Banks' WACC and Value before effect of Mudarib share



- As the terms of the contract that governs the relationship between PSIA and shareholders do not give the former a first claim on Islamic bank's earnings or assets, and as PSIA holders face the same portfolio investment risk as shareholders, thereby expecting an *ex ante* (but not a predetermined) similar return, an increase in PSIA financing will not increase the financial risk to the shareholders but will provide them with additional income from the bank's Mudarib share deducted from the PSIA share of profit.
- *Before deduction of the bank's Mudarib share of profit*, increasing PSIA financing and keeping equity financing constant will neither increase nor decrease the WACC and the Islamic bank's market value.

Reference: Al-Deehani, T., R.A.A.Karim and V.Murinde (1999), "The Capital Structure of Islamic Banks under the Contractual Obligation of Profit Sharing". *International Journal of Theoretical and Applied Finance*, Vol.2, No.3, page 253.

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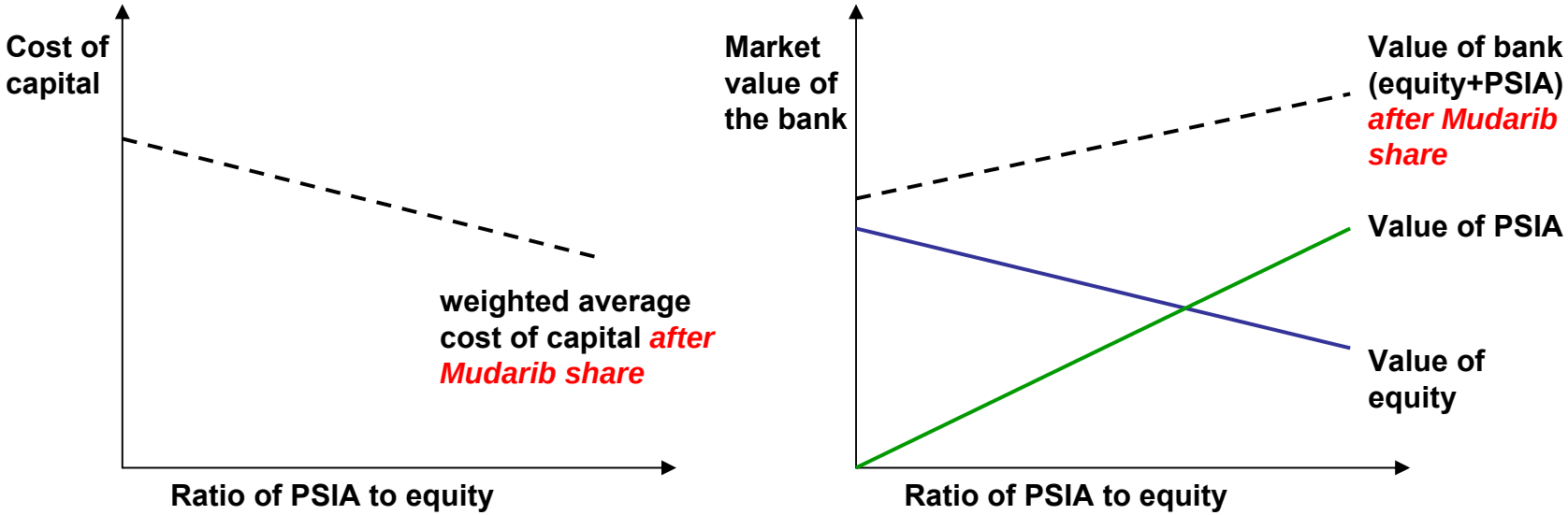
Islamic Banks' WACC and Value after effect of Mudarib share



- *After deduction of the bank's Mudarib share of profit*, increasing PSIA financing and keeping equity financing constant will lower the WACC and the Islamic bank's market value will increase. The cost of equity will not increase because the risk of the assets financed by PSIA is borne by the PSIA holders. This constitutes what may be termed 'Islamic financial leverage'.

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Illustrative example of leverage effect of PSIA

Shareholders' funds	10
PSIA funds	90
Total	100
Mudarib share	40%
Return on assets	3%
Shareholders' profit (3% x 10) + (40% x 3% x 90) =	1.38
Rate of return on shareholders' funds 1.38⁄10	13.8%
PSIA profit 3% x 60% x 90 =	1.62
Rate of return on PSIA funds 1.62/90	1.9%

- The M*udarib* share of profits on PSIA are a major source of revenue for Islamic banks. As the *Mudarib* share is calculated on a profit (but not loss) sharing basis, the use of PSIA by Islamic banks constitutes an interesting form of Islamic financial leverage.
- Thus, with relatively small invested capital, shareholders receive proportionately a large portion of the profits and earn a much higher rate of return on their capital.
- Shareholders of Islamic banks generally earn a higher rate of return compared to IAH due to the leverage ratio of PIA funds to shareholders' funds and the *Mudarib* rate.

Analysis of PSIA in Islamic Banks in Terms of Agency Theory

- The *Mudaraba* contract used by Islamic banks for mobilising and managing investors' funds may be seen as involving a complex agency problem.
- The bank's management acts as agent for the shareholders, while the bank as *mudarib* acts as an agent for the PSIA.
- This gives rise to the possibility of conflicts of interest facing the bank's management between the interests of the two categories of investors (shareholder and PSIA). For example, risk profile of both investors may not be the same, especially for unrestricted PSIA holders.
- One of the basic conditions of *Mudaraba* contract (restricted or unrestricted) is the separation of ownership from management of funds. Like shareholders, therefore, PSIA have no right to interfere in the management of their funds which is the sole prerogative of the Islamic bank.
- However, unlike shareholders, the corporate governance of Islamic banks does not give PSIA any power to appoint (or dismiss) the members of the Board of Directors, the *Shari'ah* Supervisory Board or the external auditors.
- While the capital of both shareholders and PSIA is at risk, unlike shareholders, PSIA neither have control over management nor are they in a position to enforce monitoring measures on the management. In the last resort, they can withdraw their funds.

Analysis of PSIA in Islamic Banks in Terms of Agency Theory

- Hence, PSIA holders have no option but to trust the shareholders to monitor the management (vicarious monitoring).

- Through the *mudarib* share of profit mechanism, shareholders stand to gain from any profit earned from investing PSIA funds. As this *mudarib* share of profit constitutes a valuable source of earnings to shareholders, they have vested interest in employing a performance measure whereby the management of the bank would be expected to achieve a satisfactory rate of return on PSIA, i.e. a rate commensurate with the market rate of return earned by similar financial instruments.

- This would tend to motivate present PSIA to continue their investments with the bank as well as to attract other potential PSIA.

- However, the proposition that PSIA can safeguard their own interests by relying on shareholders' monitoring to operate on their behalf assumes (a) no conflict of interest between PSIA and shareholders; and (b) the existence of a readily available benchmark rate of return in the market for a given level of risk, which is not the case.

Analysis of PSIA in Islamic Banks in Terms of Agency Theory

- The management of an Islamic bank has the incentive to discriminate against PSIA by:

  - ✓ Favouring shareholders to whom they are accountable via the Board of Directors at the expense of PSIA who have no governance rights.

  - ✓ Taking excessive risks through leverage using PSIA funds since the Islamic bank, as a *mudarib*, is exposed only to zero profit, hence very limited downside while PSIA are exposed to the risk of loss.

  - ✓ "Cherry picking" the more attractive projects for investment purposes of shareholders' funds.

  - ✓ "Smoothing" PSIA's profit payouts via transfers of profits into and out of a Profit Equalization Reserve (PER), giving a misleading impression of stable returns.

  - ✓ Masking losses on investments of PSIA funds by use of an Investment Risk Reserve (IRR) formed out of prior period PSIA profits, which acts as an internal buffer to absorb losses on investments of PSIA funds.

IFSB's Guiding Principles on Corporate Governance for Islamic Banks

- The standard recommends best practices on how organs of governance of Islamic banks should deal with issues of potential conflicts of interest between shareholders and PSIA.

- To protect the rights of PSIA, the standard recommends establishing a Governance Committee at Islamic banks to

  - ✓ oversee and monitor the implementation of governance policies through close collaboration with the management, Audit Committee and *Shari'ah* Supervisory Board;
  - ✓ provide the BoD with reports and recommendations based on its findings in the exercise of its functions ; and
  - ✓ ensure adequate and relevant disclosures of investment policies and practices to PSIA in a timely and effective manner and proper implementation of PSIA contracts

IFSB's Standard on Transparency and Market Discipline

- The standard on Transparency and Market Discipline aims to encourage Islamic banks and regulators to disseminate information that is vital to assist PSIA in their decision making. Transparency or public disclosure of reliable and timely information should enable PSIA's assessment of financial conditions and performance, business activities, risk profile and risk management practices of an Islamic bank.
- Market discipline should enable PSIA holders to transmit signals that could exert influence on Islamic bank's behaviour hence forcing Islamic banks to conform to market forces.
- While greater disclosure could lead to more effective market discipline, both transparency and market discipline are indeed necessary to control risk-taking practices of Islamic banks, matching stakeholders' risk appetites (especially of PSIA) as well as to assess whether risks are properly priced.
- However, given that PSIA holders (a) do not execute their investments with the bank through capital markets, and (b) are usually naïve investors, it is unlikely that they play an active role in disciplining Islamic banks.
- A possible alternative means to enhance market discipline could be to develop the information environment, e.g. rating of Islamic banks, financial analyses published by the media etc.

PSIA and IFSB's Capital Adequacy Standard (CAS)

- Under the capital structure theory for Islamic banks, shareholders can in principle increase their rate of return at no extra risk to their equity by increasing their return from the *mudarib* share. It would therefore be in the shareholders' best interests to maintain their equity at a minimum and increase PSIA financing to the highest level possible.

- This capital structure theory holds *in so far as unrestricted PSIA holders bear their own commercial risks and therefore can be treated for capital adequacy purposes purely as investors in a collective investment scheme* (as on Slide 10 above). In this case, α, which refers to the proportion of assets funded by unrestricted PSIA, would take the minimum value of **zero.** In this case, an Islamic bank is not required to allocate capital for the risky assets financed by PSIA (except for operational risk).

ELIGIBLE CAPITAL

TOTAL: RWA (CR + MR) + ORW	**LESS**	**(1-α)**	**FUNDED BY PSIA: RWA (CR + MR)**	**LESS**	**α**	**FUNDED BY PER/IRR: RWA (CR + MR)**

PSIA and IFSB's Capital Adequacy Standard (CAS)

- However, if unrestricted PSIA holders are treated more like depositors because of regulatory requirements or market pressures, the capital structure theory for Islamic banks no longer holds as unrestricted PSIA would be treated in the same way as liabilities for capital adequacy purposes.
- In this case, α would take the maximum value of **one** and an Islamic bank would be obliged to allocate capital to protect PSIA holders as part of the mechanism to maintain the benefits of PSIA financing and minimise withdrawal risk that may jeopardise the commercial position of the Islamic bank and systemic stability of the financial system. The bank's capital structure would thus behave much like that of a conventional bank (WACC would remain constant under MM assumptions).
- α may of course take a value between zero and one (0< α <1), as in Bahrain. WACC would then decrease as the PSIA increase but by less than shown on Slide 11.

ELIGIBLE CAPITAL

TOTAL: **RWA (CR + MR) + ORW**	**LESS**	**(1-α)**	**FUNDED BY PSIA:** **RWA (CR + MR)**	**LESS**	**α**	**FUNDED BY PER/IRR:** **RWA (CR + MR)**

PSIA and IFSB's Capital Adequacy Standard (CAS)

- Note that α is a measure of the extent of displaced commercial risk (DCR), i.e. volatility of returns on PSIA-funded assets 'displaced' onto shareholders in order to smooth the profit payouts to PSIA.
- Note also that the PER mentioned earlier is used specifically to mitigate this DCR, i.e. PSIA holders are made (they have no choice in the matter) to smooth their own payouts instead of the shareholders doing this for them.

ELIGIBLE CAPITAL

TOTAL: RWA (CR + MR) + ORW	**LESS**	**(1-α)**	**FUNDED BY PSIA: RWA (CR + MR)**	**LESS**	**α**	**FUNDED BY PER/IRR: RWA (CR + MR)**

Thank you for your attention

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