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Corporate Governance Dilemma with Unrestricted Profit Sharing Investment Accounts in Islamic Banks

The effect of conflict of interest between UPSIA holders and shareholders

By

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More than a decade since my dear dad passed away, l dedicate this PhD thesis to him.

To my late Father, with love

True wisdom comes to each of us when we realize how little we understand about life, ourselves, and the world around us.

Socrates

Declaration of Original Authorship

I confirm that this is my own work and the use of all material from other sources has been properly and fully acknowledged.

Salah Alhammadi

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Abstract

The aim of this research is to focus on a key issue in Islamic finance, i.e. the corporate governance (CG) of Islamic banks, which arises because of the way they raise deposits using profit-sharing contracts. More specifically, the research addresses some key CG issues relating to unrestricted investment account holders (UIAHs) as major stakeholders, comparing their status, as a type of equity investor, to that of shareholders. In fact, UIAHs do not have any governance rights (other than the right to withdraw their funds) and there is a lack of transparency in banks' dealings with them. The research reviews the relationship of UIAHs with the Islamic banks (IBs), since UIAHs as savers or depositors are likely to have different risk-return preferences compared to shareholders, and in particular to be more risk-averse. This research shows that this lack of governance rights and transparency leads not only to unfair treatment in a significant number of cases, but also to ambiguity regarding their status and rights.

A comparative analysis of the rates of return received by shareholders and UIAHs was carried out using the coefficients of variation (CV) as a measure of risk-adjusted rates of return, to test whether current CG practice in IBs shows fairness of treatment to UIAHs in terms of risk-adjusted returns. Both UIAHs and shareholders face the same investment risk in the asset pool held by an Islamic bank in which their funds are invested, whereby banks utilise these funds to finance their operations. The results showed not only that there was a difference in rates of return, since on average shareholders received far higher rates of return than UIAHs with comparable levels of variation, but also that more than 32% of the UIAHs had a higher CV of rates of return than shareholders, which indicates that on a risk-adjusted basis the UIAHs in these banks had lower rates of return for the same level of risk.

An empirical study was conducted using a panel data model to test certain relevant and well-established CG variables that might have influenced the difference in rates of return. Again, the results showed a bleak picture for the UIAHs in many of the banks. The panel

data analysis focused on the profit sharing and revealed that the main driver, which seems to have great explanatory power, is the size of the return on assets (ROA).

It seems important to look at other aspects besides the sharing of the accounting profit, especially in the light of the interview with Kuwait Finance House (KFH-Kuwait) management, by further investigating the UIAHs' issue of fair treatment. This was done in the first place through conducting a mixed methods approach that involves a two-phase project called explanatory sequential design. The focus was the behaviour of the stock market: the amount of value for shareholders that could be attached to retained earnings as suggested by the Gordon growth model. However, the value of retained earnings to shareholders depends on such earnings flowing through into share prices, but, given the lack of market efficiency in the Gulf Cooperation Council (GCC) stock markets, it is not possible to base a significant conclusion on the behaviour of share prices. In addition, because of the 2008 financial crisis and its effects in the following years, any share price benefit to shareholders from retained earnings was effectively wiped out.

These results led to another look at the difference in rates of return between the shareholders and the UIAHs, emphasising the dividend yield against UIAHs' yield, which are similar in that both are based on cash payments. For a sample of 20 IBs, the result was that the mean dividend yield was 83 basis points higher than the rate of return of payouts to UIAHs. It was also found that in one third of the cases the CV of the rates of returns paid out to UIAHs was higher than that of the dividend yields. The issue of whether such a difference of 83 basis points is justified (for example, as a return for the bank as asset manager) is not easy to resolve because of the lack of transparency which makes it virtually impossible for UIAHs to make that judgement for themselves; in addition, this was the mean for the entire sample, not the difference for any individual bank. By contrast, the fact that the CVs of the rates of return paid to UIAHs were higher than the CVs of the dividend yields for a significant proportion of IBs in the sample is clearly indicative of a lack of fairness and raises an important CG issue with respect to such banks.

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List of Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BCBS	Basel Committee for Banking Supervision
BOD	Board of Directors
BLUE	Best Linear Unbiased Estimator
CAR	Capital Adequacy Ratio
CBK	Central Bank of Kuwait
CCB	Central Bank of Bahrain
CEO	Chief Executive Officer
CG	Corporate Governance
CMA	Capital Market Authority
CMT	Commodity *Murabahah* Transactions
CV	Coefficient of Variation
DCR	Displaced Commercial Risk
FDIC	Federal Deposit Insurance Corporation
FSA	Financial Services Authority
GLS	Generalised Least Squares
GM	General Manager
IAH	Investment Account Holders
IASB	International Accounting Standards Board
IB	Islamic Bank
IDB	Islamic Development Bank
IFI	Islamic Financial Institutions
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IIFS	Institutions Offering Islamic Financial Services
IMF	International Monetary Fund
IRR	Investment Risk Reserve
KFH	Kuwait Finance House
KSA	Kingdom of Saudi Arabia
LOLR	Lender of last resort
LSE	London Stock Exchange
MD	Managing Director
NAV	Net Asset Value
OECD	Organization for Economic Co-operation and Development
OLS	Ordinary Least Squares

PBUH	Peace be upon him
PER	Profit Equalization Reserve
PLS	Profit and loss sharing
PSIA	Profit Sharing Investment Account
RIAH	Restricted Investment Account Holders
RM	Malaysian Ringgit
ROA	Return on Asset
ROAE	Return on Average Equity
ROE	Return on Equity
RPSIA	Restricted Profit Sharing Investment Account
RWA	Risk Weighted Average
SD	Standard Deviation
SSB	*Shari'ah* Supervisory Board
UK	United Kingdom
UIAHs	Unrestricted Investment Account Holders
UPSIA	Unrestricted Profit Sharing Investment Accounts
USA	United States of America

Chapter One: Introduction to the Thesis

1.1 Research Background and Problems

This thesis is concerned with certain issues of corporate governance (CG) in Islamic banks. These institutions face some specific CG issues because their operations require compliance with the principles and rules of *Shari'ah*[1], or Islamic religious law, and the *Fiqh al Muamalat*, or *Shari'ah* commercial jurisprudence. One of the most important of these principles is the avoidance of interest, which has major implications for the business model and operations of Islamic banks (IBs).

This chapter sets the background to the thesis in terms of an initial discussion of CG with reference to some authoritative definitions of it, both in general terms and with specific reference to banks. This is followed by an overview of the reasons why IBs face some specific CG issues, one of which goes to the heart of their current business model and constitutes the subject of this thesis.

CG is a key component of a corporation's top management policy and development, and it plays an essential part in the operation of its business model. It is concerned with the relationships within the social and economic environment of any organisation, where the policy, laws and regulations come together to define the way that the corporation should be directed and controlled, as well as its relationships with its various categories of stakeholders. CG has become a vital element for businesses in guiding the creation of value

[1] *Shari'ah* is the law and moral code of Islam, which governs how Muslims interact and integrate their daily life. *Shari'ah* includes both faith and practice, comprising worship, individual attitude and conduct. It also deals with social norms and laws, such as crime, politics, economics, family and civil matters. *Shari'ah* is often interchangeably used with the word *Din* (religion), meaning the way of life. There are two main sources of *Shari'ah* law: The Muslim holy book, the "Quran" as the law of God, and the *Sunnah,* illustrated by Prophet Muhammad (Elasrag, 2014). Also important is Islamic jurisprudence: human interpretation of the laws commonly called *Fiqh*, *Ijma* (consensus), *Maslaha* (consideration of the public good or common need), and *Quays* (reasoning by analogy).

and maintaining sustainability and growth. According to Grais and Pellegrini (2006), good CG can facilitate a firm's relationships with providers of external finance; if investors feel satisfied with its CG, they are likely to be more confident about investing in the firm. According to Claessens (2006), good CG can lead to a firm's improved growth and development by lowering the cost of capital, reducing the internal risk and facilitating access to external finance, and to better operational performance by having an enhanced allocation of resources and an effective management that creates wealth.

Furthermore, CG can be an even more essential factor when it comes to the banking industry since this sector plays an important role in a country's economy (Anderson and Campbell, 2004). In fact, banks deal with the public, and poor corporate governance may lead to a bank's management engaging in illegal practices which expose the bank to large fines as well as severe reputational damage, potentially leading to massive withdrawals of funds, which may in turn cause systemic risk that impacts the whole economy of a country. In addition, in emerging economies, banks play a crucial role in capital allocation since they act as financial intermediaries between parties that have surplus funds for investment and firms in need of funds for their development, thus promoting capital formation and increasing productivity growth (Levine, 2003).

An important task of CG is to ensure the accountability of certain individuals within an organisation, using mechanisms that reduce or eliminate the so-called principal-agent problem. This involves resolving the problems that exist in the agency relationships between shareholders as principals and company executives as agents of the principals. For example, some of the problems that agency theory endeavours to address exist when a situation arises between the principal and the agent involving conflicts in their interests or goals, and there is asymmetry of information between the agent (who is better informed about the organisation's affairs) and the principal. Such a situation arises, for example, when the principal and agent have different attitudes towards risk.

The issue of CG has been discussed in depth in the related literature and it continues to receive significant attention, particularly since the last global crisis and the major collapse

of dominant corporations. The CG of Institutions Offering Islamic Financial Services (IIFS), notably including Islamic banks (IBs), is even more complex, yet an interesting and important area of research.

Even though the issues of CG that arise in conventional financial institutions have been extensively analysed, specific issues of CG that arise in Islamic financial institutions (IFIs) have not been examined to anything like the same extent, which makes them more challenging to discuss and investigate. Nevertheless, some of these specific issues are of great importance and urgently need addressing. Despite the fact that the Islamic financial industry is still at a relatively early stage of development, and notwithstanding its small share of the global financial system, it forms an increasingly significant part of the global financial market (Grais and Pellegrini, 2006; Ariss and Sarieddine, 2007). According to the Global Financial Development Report produced by the World Bank (2014), there are more than 400 institutions offering Islamic financial services worldwide, serving both Muslims and non-Muslims alike, with an annual growth rate of more than 15 per cent in the last five years.

The main target of IIFS is Muslims seeking Islamic financial services for religious reasons. This group represents approximately 22 per cent of the world's population, primarily in developing countries. Although the initial establishment of IIFSs in the 1970s (Asutay, 2010), was originally intended to attract Muslims who had previously avoided the conventional interest-based financial system into the financial market (Rammal and Parker, 2010), nowadays, in addition to IBs, conventional banks globally are offering Islamic "windows" to customers who are seeking *Shari'ah*-compliant financial services. Furthermore, IIFSs are attempting to attract foreign investors and to expand their businesses worldwide.

The Islamic banking system faces different challenges in its structures and operations as a result of the additional risks carried in comparison to the conventional banking system (Makiyan, 2008). This is in spite of the fact that IBs avoid speculation as a matter of *Shari'ah* compliance. For not only are a number of the hedging methods used by conventional banks impermissible for IBs, some of their transactions expose them to risks that conventional

banks do not face. For example, according to Ahmed and Chapra (2002), conventional banks have a number of factors that determine the level of credit risk, such as credit ratings of counterparties, quality of collateral, the legal system's environment, the size of the bank and its trading books, maturity of credit facilities, utilisation of credit derivatives, and internal control systems. Because the Islamic banking sector has only existed for a few decades, IBs do not benefit fully from such factors, and *Shari'ah* constraints forbid them from using certain risk management tools such as credit derivatives. Moreover, IBs face additional factors due to the nature of their business, which means, for example, that they may be exposed to market risk in financing transactions as well as credit risk (Ahmed and Chapra, 2002). In addition, IBs run the risk of failing to comply with the requirements of the *Shari'ah* principles and rules that are the fundamental aspect of their business model (*Shari'ah* non-compliance risk), in connection with which they may be faced with different opinions among *Shari'ah* scholars about matters such as the permissibility of the introduction of a new product to the market, which may result in a loss of potential profit[2].

As well as resulting in the inability of IBs to use credit derivatives, *Shari'ah* restrictions impede the rescheduling of debts under certain credit contracts which involve a mark-up in place of interest. Therefore, IBs may face different challenges in their corporate governance development, and it is the duty of the management and supervisory authorities to understand and pay attention to these additional risks as they may affect the structure of their CG.

Apart from the potential CG implications of the risk exposures just mentioned, there is another major CG issue with IBs that results from the way in which they typically raise retail deposits which pay returns based on profit sharing instead of interest. Thus, depositors at

[2] For example, if an Islamic bank wants to invest in a successful Western hotel that serves alcohol or in a restaurant that sells pork, *Shari'ah* opinions may cause the BOD not to proceed with the investment.

IBs face different levels of risk, since, as profit sharing investment account[3] holders, they face risks not borne by conventional depositors. In particular, this applies to unrestricted profit sharing investment accounts, widely used as a *Shari'ah*-compliant alternative to interest bearing deposit accounts, where the funds are commingled in the bank's pool of assets with other funds such as those of shareholders and current account holders. Thus, the issues of asset allocation, profit seeking and risk appetite, given the likely differences between those of shareholders and those of depositors, raise additional challenges and uncertainty in IBs, whose existing governance structures deny UPSIA holders any monitoring mechanism, although in principle they are a type of equity investor (Archer *et al.*, 1998).

1.2 Profit Sharing Investment Deposits

IBs have developed PSIA for customers' savings and repository accounts in place of conventional interest bearing deposit accounts, in order to mobilise funds on which IBs and their customers can earn *Shari'ah*-compliant returns (Archer and Karim, 2007d). Customers deposit their funds in so-called "profit sharing investment accounts" as capital providers, and the bank invests these funds on the customers' behalf in return for a share of the profit or for a fee as remuneration for management. There are two types of PSIAs:

1. A restricted profit sharing investment account (RPSIA), a separately managed fund that does not commingle with other funds of the IIFS. This is similar to mutual funds and is considered by Islamic banks for the purpose of financial reporting as "off balance sheet funds" under management.

[3] A profit sharing investment account (PSIA) is a product structure based on a *Mudarabah* (profit sharing) contract, where PSIA holders and an Islamic bank agree to share the profit generated from the assets funded by the PSIA based on an agreed ratio. However, losses will be borne by PSIA holders except in cases of misconduct or negligence.

2. An unrestricted profit sharing investment account (UPSIA) refers to an account where an Islamic bank has full discretion to utilise and invest UPSIA funds. These are widely used by IBs in place of conventional interest bearing deposits.

The contractual bases for this type of account are the *Mudarabah* or *Wakalah* contracts, where in a *Mudarabah* the customers as *Rabb Almaal* (provide capital) and the bank provides work as *Mudarib* (entrepreneur or asset manager) and shares profit, or the bank in *Wakalah* acts as *Wakeel* (agent) and receives a fee plus (typically) a performance related bonus (Archer and Karim, 2006).

This profit sharing concept leads to a quite different business model in comparison to that of conventional banks. Under the *Mudarabah* model, which is most commonly used, UPSIA holders as *Rabb Almaal* and the bank as *Mudarib* agree to share the profit generated from assets funded by UPSIA based on an agreed ratio (Agil *et al.*, 2011). However, losses will be borne by UPSIA holders except in cases of misconduct or negligence. This is strikingly different from the treatment of conventional bank depositors whose funds are remunerated based on a predetermined interest rate or a predetermined spread over a benchmark, while the principal amount is "capital certain" (i.e. guaranteed by the bank) and, in a number of countries, protected at least up to a certain level by a deposit guarantee scheme such as that offered by the Federal Deposit Insurance Corporation (FDIC) in the USA. Therefore, unrestricted investment account holders (UIAHs) are significantly exposed to the performance of the IB's management in earning profits and protecting their capital. Yet, despite the fact that UIAHs are major stakeholders, in many cases contributing (in the form of UPSIA) the majority of the funds managed by the bank, they nevertheless have no governance rights. This lack of governance rights, including rights to information about the performance of their investment, prevents UIAHs from being able to monitor management or receive appropriate financial reports, since the contents of the financial reports are aimed at shareholders.

1.2.1 Issues with Profit Sharing Investment Deposits

It has been observed by different researchers that IBs do not sufficiently address the issue of UIAHs rights, especially with regard to UPSIA. IBs lack clarity regarding their relationship with UIAHs; that is, are the latter a type of equity investor or a type of creditor? This issue raises a major concern from the perspective of CG in terms of UIAHs' rights as major stakeholders, as well as that of banks' behaviour towards the rights of UIAHs. The IBs are using contracts that deny the rights that should be granted to UIAHs as a type of equity investor in terms of transparency and fairness in return on investment as compared to shareholders, since both share the same degree of risk in the *Mudarabah* asset pool. Such ability and governance rights are normally granted to equity investors. In fact, it may be said that there is an anomaly from a CG perspective as UIAHs are a type of equity investor with no governance rights. According to Williamson (1996), equity investors need to have a governance structure to be able to follow their investment and conduct any monitoring as part of their expectation of the transaction costs of governance.

By contrast, shareholders have the right to vote in general meetings, to elect the members of the BOD, and thus typically have a powerful influence to appoint or dismiss senior management through their control of the BOD. In fact, the BOD answers to shareholders in general meetings. However, if UIAHs are dissatisfied, they can only withdraw their funds from IBs with a possible loss according to the contractual agreement between them and the bank. Moreover, they typically lack the information to establish a sound basis for such decisions.

In line with the above-mentioned challenges, adequate policies and effective regulations are required to accompany the recent expansion of IBs and to maintain their growth and integration into the global financial system. The Islamic Financial Services Board (IFSB)[4] has

[4] The IFSB is an international standard-setting organisation based in Malaysia that issues many standards and principles to enhance the stability of IFIs. It also establishes many guideline principles to regulate and ease the implications of Islamic banks.

issued a variety of standards and guideline principles to enhance prudent management and governance in IBs. For example, in December 2005, it issued its first capital adequacy standard (IFSB-2, 2005) (based on Basel II) for IBs, so as to meet the specific characteristic of *Shari'ah* compliance. In addition, the IFSB introduced a Principles of Corporate Governance Standard in December 2006 (IFSB, 2006). The IFSB's corporate governance standard proposed to establish a governance committee attached to the board of directors that could monitor and act on behalf of UPSIA holders. However, the evidence in Chapter 5 below suggests that this proposal has not been generally adopted or used effectively by IBs.

1.3 Research Aim, Objectives and Questions

The aim of this research is to focus on CG of IBs, which arises because of the way they raise deposits using profit-sharing contracts. In particular, the issue of UIAHs lack of governance rights in spite of being a type of equity investor, since their funds get commingled with other funds such as shareholders. Also to examining the difference in the rates of return between the two investors and to see whether the current CG practice in IBs shows any fairness of treatment to UIAHs in terms of risk-adjusted returns. Although, it has been well discussed in the literature about the lack of governance rights for UIAHs, however still there is a gap in the empirical work of the topic, in specific what is the consequences of that absence of governance rights, with the objectives to:

1. Address the CG issues related to UIAHs as major stakeholders, comparing their status, as a type of equity investor, to that of shareholders, and evaluate the CG practice.

2. Examine the exercise of profit distribution between two categories of stakeholders (shareholders and UIAHs), since both are considered equity investors, and face the same risk in the commingled fund, where IBs utilize the funds to finance its operations, however with different rewards to both stakeholders.

3. Address the issue of whether UIAHs are treated fairly as providers of funds to IBs, given the potential conflict of interest between UIAHs and shareholders and UIAHs' lack of governance rights.

In this context, the research will examine whether the basis of remuneration of UIAHs (as UPSIA holders) is straightforward profit sharing or a particular form of profit sharing where the "profit shares" paid to UIAHs are largely a result of management decisions based on market conditions. The absence of UIAHs' control rights is well attested to in the literature, including in research conducted by Archer *et al.* (1998); Sundararajan (2007); Archer and Karim (2013b); Magalhães and Al-Saad (2013). The focus of this thesis is the consequences of this absence of control rights rather than the control rights themselves. As a result, in order to achieve the objectives of the research, the aim is to answer the following questions:

1. ***Insofar as UPSIA holders place their funds with Islamic banks on a profit-sharing and loss bearing basis, to what extent do the lack of governance rights and the absence of control rights have consequences in terms of the fairness of the level of returns paid to UIAHs? Moreover, what are the implications of the UIAHs' lack of information for monitoring management in considering fairness of treatment?***

In this context, it is relevant that shareholders and UIAHs are likely to have different attitudes to risk, with UIAHs probably being considerably more risk averse.

2. ***How in fact is the profit sharing and loss bearing principle for UPSIA implemented in Islamic banks?***
    a. ***Given that UPSIA are a Shari'ah-compliant substitute for conventional deposits, to what extent do Islamic banks attempt to make them behave similarly to conventional deposits, in terms of:***
        i. ***Stability of returns?***
        ii. ***Protection against losses?***

Given that, in principle, shareholders and UIAHs share the same risk in the commingled funds used to finance the bank's asset pool, yet are likely to have different risk-return preferences, it is important to examine the rates of return on investment for both UIAHs and shareholders and to evaluate how IBs treat UIAHs in comparison to shareholders. Hence, the rates of return adjusted for risk will be analysed for a sample of IBs, and the differences in rates of return will be analysed as dependent variables in order to evaluate the possible influence of corporate governance factors.

1.4 Rationale and Motivation of the Research

This study undertakes an analysis and comparison of risk-adjusted returns to examine whether, in the absence of governance rights, the UIAH are treated equitably compared to shareholders in IBs and tests whether the current practice of CG in IBs does balance the rights of UIAHs with those of shareholders. One way to look at the governance issues is to examine the difference in the rates of return between shareholders and UIAHs. The study will also attempt to ascertain what drives the difference in the risk-adjusted profit distribution between shareholders and UIAHs and the extent to which independent CG variables influence this difference, a topic that has not yet been researched. The results will have policy implications and may help the supervisory authorities or central banks better understand how IBs are treating UIAHs, which may help them to evaluate the current CG standards and practices. The research will contribute as well to the existing body of knowledge concerning CG in IBs and fill the gaps in the literature related to UIAHs' lack of governance rights and lack of transparency, which lead to unfair treatment in terms of return and to ambiguity regarding their status and lack of rights. UIAHs do not have any governance rights (other than the right to withdraw their funds) and there is a lack of transparency in banks' dealings with them. The background of the research has centred on the issue of the fair treatment of UIAHs from CG perspective of the rights of stakeholders. As the results of the research show that this lack of governance rights and transparency leads not only to unfair treatment in a significant number of cases, but also to ambiguity

regarding their status and rights. Also the research will be useful in policymaking, especially regarding regulation and supervision of how UIAHs are paid returns on their funds which call for urgent reform of the CG of IBs. To shed light on the effect of UIAHs' lack of governance rights and how they may be exposed to a potential conflict of interest with the management of IBs and ways in which management may look after the interests of shareholders at the expense of UIAHs.

1.5 Research Structure

To achieve the goal of this thesis, it is important to set out the significance of CG and to explain how it plays a key role in the world of finance. Therefore, the thesis will firstly raise the issue of the nature of UPSIA, and chapter 2 will provide a brief outline and discussion of Islamic financial transactions and governance, as well as setting the scene and providing some history about specific aspects of Islamic finance. It will also shed light on the importance of the issues of transparency and market discipline in IBs. Chapter 3 will present an overview of the relevant literature and provide some background on CG from a theoretical perspective. Chapter 4 will discuss the risk and return involved in UPSIA and present the coefficient of variation test as a measure of risk-adjusted accounting rates of return on equity (ROE) of shareholders and the rates of return (return on investment) paid to UIAHs, respectively, for a substantial sample of IBs. A special case of Saudi banks (since they use a type of restricted PSIA instead of UPSIA) will also be examined in the Appendix A to chapter 4. ROE is used to measure shareholders' rates of return rather than stock market returns for two reasons: in the first place, UIAHs are profit sharing and profit sharing is supposed to be the essence of UPSIA, so how the profits are shared in practice is highly relevant. Secondly, stock market returns are not a reliable measure in the inefficient stock markets on which the IBs' shares are listed. However, dividend yield information, which was available for only a subset of the sample IBs, is considered in chapter 7, with results that are largely similar to those obtained using ROE.

Chapter 5 will analyse the impact of CG on rates of return and differences in these between shareholders and UIAHs, using panel data, to examine to what extent CG variables may explain the differences in the rates of return of shareholders and UIAHs, respectively, which, as well as being of interest *per se*, can also serve as a proxy for differences in the CVs of returns which cannot be handled cross-sectionally in a panel data approach. Chapter 6 will focus on a Kuwait Finance House case study by examining why the UIAH of the subsidiary banks have a better risk-adjusted return than those of the parent company. This chapter will include an interview with Kuwait Finance House management in Appendix F, and an analysis thereof. Chapter 7 will focus on comparing the cash payouts using dividend yield for shareholders to evaluate the differences between the levels and variability of the rates of return of shareholders and those of UIAHs. Chapter 8 will present a general discussion and conclusion of the research as well as some final remarks. It is worth noting that, in this research, the terms UIAHs and UPSIA are used to refer to UIAHs as a type of depositor. This does not include restricted IAH, which are generally considered to be a form of off-balance sheet funds under management.

Chapter Two: Overview of Islamic Financial Transactions and Governance

2.1 Introduction

This chapter will discuss the background of Islamic finance with regard to *Shari'ah* as well as some aspects of central bank regulations in Islamic banking. Furthermore, it will examine the ideological context of IBs in terms of shareholder and stakeholder theory relating to PSIA and the CG issue of UPSIA in respect of transparency and market discipline. Finally, there will be an analysis of the smoothing technique employed by IBs.

2.2 Background to Islamic Finance

As Islamic finance and banking structures are based on *Shari'ah* (Islamic religious law), their business model differs from conventional banks. For example, IBs are prohibited from using *Riba*[5] (interest, a term that connotes "usury" but is interpreted by the vast majority of modern Islamic scholars to mean any interest (Archer *et al.*, 1998)) to generate money and therefore they use different methods to employ their funds. This means that IBs face different challenges because of the additional risk carried, such as *Shari'ah* non-compliance risk, in comparison to the conventional banking system. Another potential difficulty involves liquidity risk where IBs cannot borrow money when needed, while the liquidity facilities available from central banks to IBs are more limited than those available for conventional

[5] According to Lewis (2001), *Riba* could be translated as usury, meaning an addition or increase or expansion or growth. There are different meanings of the Arabic word *Riba*, one of which could be defined as paying or receiving interest, which is forbidden by the Quran. Lewis also states that *Riba* means a loan in which the borrower makes a return to the lender that is more or better than what was borrowed. No financial transaction should be based on the payment or receipt of interest. Profits from indebtedness or the trading of debts are seen to be unethical. Instead, the investor and investee should share in the risks and profits generated from the project. However, not every increase or growth is prohibited by Islam. Under *Shari'ah*, *Riba* technically refers to the premium that must be paid without any consideration.

banks, which makes liquidity risk management particularly challenging for IBs. *Shari'ah* imposes different requirements from the models and methods employed in conventional financial services (Archer and Karim, 2007a). In addition to avoidance of *Riba*, IBs have to comply with the prohibition of *Maysir* (speculation) and *Gharar* (uncertainty of contract or contractual outcomes; for example, contingent liabilities or contingent assets such as guarantees and insurance contracts). IBs are also prohibited by *Shari'ah* law from making any profit from gambling, alcohol, pornography or pork products. Therefore, the fact that the Islamic banking model is based on the principles of *Shari'ah* imposes different restrictions compared to the conventional profit-seeking banking practices. However, Islam by no means rejects the profit motive. *Shari'ah* prohibitions are constraints on profit-seeking behaviour, such as the ethical constraints advocated by the proponents of ethical or responsible finance. Therefore, *Shari'ah* is not against profits but against *Riba* and speculation, and it is in favour of social responsibility[6].

2.3 Meaning of *Shari'ah*

Shari'ah[7] comes from the Arabic term for the way to the source of life, or the path, or also the waterway which leads to a main stream, but it is also used to refer to the set of Islamic legal principles and rules (Anas and Mounira, 2009) which is intended to regulate the relationship between God and Muslims. In addition, it regulates the relationship between Muslims socially, economically and spiritually (including both faith and practice, incorporating worship, individual attitude and conduct). Therefore, *Shari'ah* extends to influencing the economic, banking and financial activities of Muslims.

[6] In modern Islamic finance, *Riba* is equated with a "pure rent on money" which is deemed to be unethical. However, a small minority of Islamic scholars interpret *Riba* in its more conventional sense of "usury", i.e. excessive or exploitative interest (as in the "payday loans" industry).

[7] *Shari'ah* literally means a road, which refers to Islamic law as ordained by Allah, or the Law of Allah. Most prominent in this category are the *Quran* and *Sunnah* (Lewis, 2001). *Shari'ah* governs all secular and religious life of Muslim people, including day-to-day activities, religious rituals, politics, economics, banking and law. *Shari'ah* is the legal and social modality of a people, which is based on the revelation of Prophet Muhammad (PBOH).

2.3.1 Sources of *Shari'ah*

There are two main sources of *Shari'ah* law. The primary source consists of the Islamic holy book the "Quran" as the law and Word of God revealed to Prophet Muhammad (PBUH) (Elasrag, 2014), and of *Sunnah* (the teachings (Hadith) and practices of Prophet Muhammad), illustrated by Prophet Muhammad. The secondary source of *Shari'ah* comes from Islamic jurisprudence and human interpretation of the laws, commonly called:

1. *Fiqh* (Islamic jurisprudence) *and ijtihad* (endeavour of a Muslim scholar to derive a rule of divine law from the Quran and Hadith).

2. *Fatwa* (personal opinion on a *Shari'ah* issue expressed by an authoritative person or institution, but not a law based on one of the different schools of Islamic jurisprudence)[8]. A *fatwa* may perhaps be compared to a barrister's opinion obtained in a consultation in the barrister's chambers.

3. *Ijma* (consensus).

4. *Quays* (reasoning by analogy).

5. *Al-masala Almursala* (consideration of the public interest).

6. *Istihasan* (juristic preference).

7. *Urf* (custom or knowledge).

8. *Istishab* (presumption of continuity).

[8] There are different schools of jurisprudential thought; however, the main four schools of thought from which jurists and scholars derive their *Fiqh* when making a *fatwa* are*:*

1. *Hanafi* School, which is followed mainly in the Middle East and South Asia: Lebanon, Iraq, Syria, Turkey, Jordan, Afghanistan, Pakistan, Bangladesh and India.
2. *Maliki* School (traditionalist), which is followed in Africa.
3. *Hanbali* School, which is followed in Saudi Arabia.
4. *Shafii* School, which is followed in South East Asia.

9. *Fiqh al Muamalat* and the "nominate contracts" which form the basis of *Shari'ah*-compliant financial instruments.

2.4 Regulation of Islamic Financial Institutions

2.4.1 Central Banking System and Islamic Banking

The rapid growth in the Islamic financial industry required the central banks in some jurisdictions to modify their regulations and create an environment to suit the Islamic banking system. Central banks have to adopt new regulations for the Islamic banking system that give other alternatives and functions to IBs that enable them to work efficiently and differently from conventional banks. For example, in 2008, the Central Bank of Bahrain (CBB) issued a new regulation allowing Islamic *Sukuk* (investment certificates that are a *Shari'ah*-compliant alternative to bonds), which were to be issued as a liquidity instrument to provide a much-needed liquidity management tool for IBs[9] (Islamic Finance Review Bahrain, 2008). Depending on the national central bank laws, banking systems can adapt new regulations to be appended to the current ones or have a completely new Islamic system that best suits the Islamic bank. Generally, systems of banking regulation may be classified according to the jurisdiction, for example:

1. Single system (only Islamic law is provided) such as in Iran and Sudan.

2. Two systems with two sets of laws (conventional and Islamic law), mostly in the Middle East and Asia.

3. Hybrid systems such as the UK's (which cannot offer or implement all laws of Islamic finance).

[9] The CBB Salam Sukuk are not tradable but have a tenor of 90 days which makes them fairly liquid.

2.4.2 Business Transactions

Since the establishment of Islamic financial institutions in the 1970s as a part of the large example of Islamic moral economy (Asutay, 2010), IBs have been developing different approaches to generate profit in place of the conventional interest rate spreads between interest received on assets and interest paid on deposit accounts. As noted in chapter 1, a common approach is the *Mudarabah* contract, where customers deposit their funds in UPSIA as *Rabb Almaal* (capital provider), and the bank as *Mudarib* (entrepreneur or asset manager) invests these funds on the customers' behalf in return for a share of the profit as management remuneration[10] (Archer *et al*., 1998; Sundararajan, 2008). Under the rules of *Mudarabah*, losses on investment due to market or credit risk are carried only by UIAHs as *Rabb Almaal*, but losses due to misconduct or negligence due to operational risk are carried by the Islamic bank as *Mudarib*[11]. In another type of profit sharing contract, *Musharakah*, the investment losses are borne in proportion to the partners' ratios of invested capital (in *Mudarabah*, the *Mudarib* as such invests no capital, only effort). Musharakah contracts are not generally used by IBs to raise funds, except in certain Sukuk structures. In the case of UPSIA, the funds on an IB's balance sheet can be considered to contain a *Mudarabah* nested within a (*de facto*) *Musharakah* between the *Mudarabah* fund and the other funds managed by the bank. IBs usually mobilise funds using two main sources that constitute their capital structure: shareholders' equity and UPSIA. Additionally, current accounts as non-investment deposits are used by the bank which is entitled to any profits and bears any risk of loss as it guarantees to pay the related balances on demand. Current account holders are not entitled to any returns since current accounts are considered to be *Qard Hasan* (beneficial loan) from depositors to the bank under *Shari'ah*. Because of the prevention of

[10] Fees are paid to the bank when the accounts operate on the basis of *Wakalah*, where the bank acts as Wakeel (agent) for a fee which may have a performance-related component.

[11] In principle, according to the *Mudarabah* contract, *Mudarib* has no financial capital in the venture to lose, but in some cases, such as mismanaged risk (speculation or lack of due diligence), *Mudarib* carries the losses.

Riba, Islamic financial institutions cannot offer conventional financial products. Instead, the financial institutions have introduced products that are acceptable under Islamic law, including *Mudarabah* and *Musharakah* (profit and loss sharing products), *Murabahah*[12] (mark-up-based credit products), *Ijarah* (leasing) and *Sukuk* (Islamic bonds) (Rammal, 2004). In addition, IBs are now raising CMT-based term deposits, whereby a commodity is bought on credit with a mark-up using a *Murabahah* contract and sold on the spot market to raise immediate funds.

2.5 Islamic vs. Conventional Finance

There are considerable differences between Islamic and conventional banks including their structure, their products and their business models, with differing associated risks. Errico and Sundararajan (2002) argued that IBs have different challenges with regard to risk in comparison to conventional banks; this is natural due to the fact that greater difficulties arise from the nature of the specific risks and profit/loss sharing concepts with which IBs deal. The main argument about the differences in practice between Islamic and conventional banks is concentrated on the business structure of their models. IBs were constructed using *Shari'ah* compliance (Islamic law) and their banking products are derived from *Shari'ah* law which prohibits them from charging interest on their business transactions, especially the nominate contracts of *Fiqh al Muamalat*, which creates a significant difference in operating conditions compared to conventional banks. Samad (2004) studied the financial performance of interest-free Islamic banking against interest-based conventional banking in Bahrain with respect to profitability, liquidity risk and credit risk during the period 1992–2001 (the post-Gulf War period). Nine financial ratios were used to make this comparison. The results showed that there is no significant difference between IBs and conventional banks in terms of profitability and liquidity. However, there are some degrees of difference in credit performance.

[12] *Murabahah* is a sale based on a cost-plus mark-up basis where payment of the price (including the mark-up) is deferred to a later date.

2.6 Islamic Banks' Business Models

The discussion in the literature of Islamic financial institutions originates with the prohibition of transactions involving interest (*Riba*), regardless of how low the rate of interest is (Gafoor, 1996). Because of this restriction, Islamic financial institutions cannot offer conventional financial products. Instead, IBs have introduced financial instruments on both sides of the balance sheet that are acceptable under *Shari'ah*, being based on the nominate contracts of *Fiqh al Muamalat*. Islamic financial institutions and financial products are now available in Muslim and non-Muslim countries, and the total assets of the sector were expected to exceed USD 1 trillion by the end of 2010 (Čihák and Hesse, 2010); in the 2016 Islamic finance market, assets range from USD 1.66 trillion to USD 2.1 trillion, and could reach USD 3.4 trillion by the end of 2018[13].

Even though the mission statements of IBs can vary, the foremost objective is to meet the stakeholders' needs by conducting business according to *Shari'ah* compliance (Grais and Pellegrini, 2006). This obligation to stakeholders makes the IBs adopt social responsibilities, which might suggest that they are leaning towards the Franco-German "stakeholder model"[14]. However, in fact, the evidence suggests that IBs tend to adopt a shareholder-oriented (neo-classical) approach in their business model.

2.6.1 Islamic Moral Economy Model

The moral economy nature of Islamic finance distinguishes it from conventional finance and banking, and the direct reference to the moral economy brings social justice, growth, allocation of resources, prohibition of interest, where Islamic moral economy is a novel mechanism of looking at economic and financial reality. According to Asutay (2010),

[13] Source: Islamic Financial Market, "Saudi IPO Drive May Push Global Islamic Finance Assets Past $12 Trillion". Retrieved 5 March 2016 from: https://www.islamicfinance.com/2014/12/size-islamic-finance-market-vs-conventional-finance/

[14] See Chapter 3 for the shareholder and stakeholder model.

“against the rationalist, self-maximizing and efficiency-oriented capitalist market economy, Islamic moral economy emerged to stress the importance of moral behaviour in the market place by filtering the market mechanism to produce socially optimal economic choices in which social justice was claimed to be the essential element. Thus, with such construction emphasis comes the expected shift from a neo-classical notion of efficiency to a morally informed equity. Consequently, in addition to the normative principles found in the Qur’an, with the positive and normative principles derived from the tradition and sayings of the Prophet Muhammad (Sunnah), a new economic and financial paradigm has been attempted in its modern version". However due to the globalisation, IBs now focus on efficiency and profitability rather than social justice, including fairness to UIAHs, which represent a convergence to conventional finance. Even the prohibition of *Riba* (interest) was mainly for social justice but also have the economic reasons, and IBs nowadays work with the same objectives as conventional banks without interest. As well, certain level of *gharar* (uncertainty) is now acceptable by some scholars to facilitate modern financial instruments for IBs, which was prohibited with the same rationale as interest. This makes IBs divergence away from the moral economy nature, which makes IBs serve the markets for profit instead of serving the communities and eliminate the social expectations as part of Islamic financial principles such as justice, fairness to stakeholders, i.e. UIAHs do not get their fair share from their investment as compared to shareholders (Asutay, 2007). In fact, Islam does not object to the profit motive as such, but insists on equity and fairness. Islamic economics seeks to promote profit and loss sharing (PLS) on both sides of the balance sheet. The reason why IBs don’t follow this is the agency and transactions costs involved when banks offer financing on a PLS basis. In addition, IBs are driven more by juristic considerations (*Fiqh al Muamalat* and the Nominate Contracts) than by the ethical notions of the ‘moral economy’ and *Shari’ah* Boards have a similar perspective.

On the other hand, various mission statements of the IIFS, *Shari'ah* compliance tends to come in three parts. First is the prohibition of *Riba*[15] (Ayub, 2008; Masood, 2011; Iqbal and Llewellyn, 2002) which is the key difference between Islamic business and conventional commercial business. Second, the IIFS should promote social goodwill, and third they should develop the combined Islamic financial system which covers capital formation, capital markets, financial intermediation and risk transfer. As Masood (2011) argued, the Islamic system puts equal emphasis on the ethical, moral, social and religious aspects, pursuant to equality and fairness in society as a whole. This prompts the IBs to lean more towards a comprehensive banking system that is based on *Shari'ah* principles rather than a specific financial system to serve the needs of Muslim people who are trying to avoid *Riba*. As pointed out by Grais and Pellegrini (2006), the need for a combination of *Shari'ah* compliance and business performance raises specific challenges and agency problems in the daily operations of IBs, hence the necessity for distinctive CG structures. To achieve this and to meet acceptable standards of business conduct, IBs need to have a sound CG structure. Because IBs face some limitations in terms of *Shari'ah* compliance (for instance, different restrictions on the type of business to engage in, or the financial operations which forbid interest-based transactions), they have an obligation to establish a sound CG structure.

As a result of *Shari'ah* prohibitions, IBs are constrained by a shortage of *Shari'ah*-compliant liquid assets, as well as by a lack (in most jurisdictions) of a *Shari'ah*-compliant interbank market and lender of last resort (LOLR) facilities. This presents them with specific problems

[15] Islam prohibited *Riba* but allowed trade and commercial activities (al-bay'). *Riba* means excess or increase, the extra earnings obtained without the medium of exchange. *Riba* can also be translated as usury but it is interpreted by the modern Islamic scholar as interest and is forbidden in Islamic economic jurisprudence. In the holy book of Muslim, the "Quran", Surah Al-baqarah verse No. 275 states: "Those who devour usury will not stand except as stands one whom Satan by his touch has driven to madness. That is because they say, 'trade is like usury', but Allah has permitted trade and has forbidden usury." Islam recognises trade and commerce not only as a lawful profession but also as a moral duty, and it forbids *Riba*, which is a loan with the condition that the borrower will return to the lender more than and better than the quantity borrowed.

in terms of liquidity risk management and it obliges them to hold large cash balances on which they earn no returns. This may affect their profitability and business growth, and create a scarcity in investment opportunities. It also contributes to difficulties in refinancing their capital which reduces profits and in extreme cases may drive them to bankruptcy[16].

2.7 *Shari'ah* and Stakeholders

One purpose of *Shari'ah* is to protect the interests of the public (*Maslaha* al-*almmah*), as explained by Masood (2006), including the protection of property (al-maal). While IBs may pursue different business aims and strategies, their overall mission is to meet their stakeholders' needs by conducting business in compliance with *Shari'ah* (Grais and Pellegrini, 2006). Besides the avoidance of *Riba* and the other prohibited transactions mentioned above, IBs are involved in implementing *zakat*[17] (a form of levy on wealth for charitable purposes), payment of which is one of the Five Pillars of Islam (Masood, 2011). This obligation to the indigent is consistent with IBs' duties towards a wide set of stakeholders and with the undertaking of activities for the public good.

Therefore, there is a need to develop adequate *Shari'ah* governance as IBs should be concerned about their stakeholders. From an Islamic perspective, *Shari'ah* governance has been further defined by the Islamic Financial Services Board (IFSB) as a set of institutional and organisational arrangements through which institutions offering Islamic financial services provide an effective independent oversight of *Shari'ah* to comply with issuance of relevant *Shari'ah* pronouncements and resolutions. Another function is to ensure the effective independent dissemination of information on such *Shari'ah* pronouncements and resolutions to the operative personnel of the institutions offering Islamic financial services who monitor the day-to-day compliance with *Shari'ah* pronouncements and resolutions (IFSB-10, 2009).

[16] Arcapita bank filed for bankruptcy in March 2012.
[17] Zakat is payable by physical persons (i.e. investors in Islamic banks) but the banks typically collect and pay the tax on their behalf.

Each Islamic financial institution has a *Shari'ah* supervisory function, typically a *Shari'ah* Supervisory Board (SSB) consisting of three *Shari'ah* scholars, which supervises the institution's business operations to ensure compliance with *Shari'ah* law. The function of the SSB is to certify that the financial institutions operate under *Shari'ah* law (Greuning and Iqbal, 2007), and to clarify any *Shari'ah*-related questions that the financial institutions may have (Safieddine, 2009; Usmani, 1998). These SSBs are appointed by the management of the financial institutions and they act as an internal control body within the organisation (not as external auditors), enhancing the credibility of the Islamic financial institutions in the eyes of its customers or anyone they exchange business with, and also strengthening its Islamic credentials (Algaoud and Lewis, 1997).

2.8 Importance of Transparency and Market Discipline

According to the BCBS (2010), the practice of good CG can be emphasised and reinforced by transparency, whereby reliable information made available to investors on a regular basis with easy access reduces the asymmetric information and the uncertainty of the financial market (IFSB-5, 2007). Crowther and Sefi (2010) discussed eight principles of governance that account for good governance practice, namely transparency, rule of law, participation, responsiveness, equity, efficiency and effectiveness, sustainability, and accountability[18]. The principle of transparency is more important to external users or investors than to internal ones since the former cannot access the information available to the latter. Even though UIAHs are supposed to be insiders, it seems that they are treated as "outsiders" when it comes to information rights. In order to be beneficial, transparency should involve a useful public disclosure of information, including business activities, rates of return and risk[19], to enable investors to make well-informed decisions about their investments. Having the disclosed information available in a regular and timely manner will

[18] For more details on the principles of governance, see Crowther and Sefi (2010).

[19] Under Basel II Pillar 3, there is certain issues that banks are required to disclose. Also, under IFRS 7, for example, banks could disclose the market risk and the credit risk issues. However, this is not the same as disclosing the risk on rate of return in the annual report.

help the users of this information to have a better understanding of the financial condition, performance, governance structures and policies of the invested firm or bank or even the market (OECD, 2004). The study conducted by Healy and Palepu (2001) on financial reporting and voluntary disclosure of information by management suggested that better disclosure would have a positive impact on the efficiency of the capital market; for example, the increased level of entrepreneurship and globalisation has increased the sound information provided by firms in capital markets.

In contrast, other people may argue conversely that too much disclosure may give more information to rivals about future opportunities and investments. However, the efficiency of market discipline largely depends on the type of disclosure and the efficiency of information available to the participants in the market and the investors, especially the information about risk and the financial condition of the firm or banking organisation (Ariffin *et al.*, 2007). The disclosure of material information modifies the market environment in response to such information and thereby provides incentives to IBs to limit excessive risk-taking and to pursue good governance. To be effective, market discipline requires a set of mechanisms through which markets can penalise excessive risk-taking or inadequate transparency (IFSB-4, 2007).

Good practices in financial policy transparency are found in a number of sets of international standards; for instance, in September 1999 the International Monetary Fund (IMF) issued the Code of Good Practices on Monetary and Financial Policy Transparency. These policies encourage sound CG through the effect of monitoring, and the capacity to influence banks in this manner. Moreover, international efforts to develop standards in an attempt to regulate and help supervision of banking industries, such as BCBS Basel II Pillar 3, aim to improve public disclosure which increases market discipline and helps to improve the supervisory role.

2.9 Banking and Risk Environment of IBs

Since the development of Islamic financial institutions in the 1970s and their fast growth and increasing presence in the global financial markets, a number of research studies have been conducted focusing mainly on the viability, design and operations of profit sharing in IBs. However, little has been done concerning the transparency issue in these institution, apart from the IFSB standards and those of AAOIFI. Despite the obstacles, risks and challenges faced by IBs, significant progress and steady growth in market penetration have been achieved. As a result, they have gained recognition worldwide in the financial markets. This vast growth and recognition has created a need to develop appropriate policies to help IBs identify their risk exposures and to work in healthy environments and continue their integration into the global financial system.

According to Greuning and Iqbal (2007), banking risk falls into four categories: financial, operational, business and event. However, to a certain extent, risks in IBs are different from those in conventional banks. To understand the key differences in the nature of risk between conventional and IBs, it is important to differentiate the function of the bank in terms of being a financial intermediary; IBs use other financial products such as *Musharakah*[20], *Wakalah* and *Mudarabah* contracts to mobilise funds and generate money, which conventional banks do not carry. For example, UIAHs provide the capital under a *Mudarabah* contract for a return, which forces them to face different types of risk compared to conventional banks. As a result, UIAHs logically require specific disclosures in connection with profitability and the associated risks. IBs should therefore logically provide information concerning the disclosure of profit allocation, while providing clarity and transparency in respect of the policies used in managing the rate of return sought and the associated risks. In addition, this disclosed information should be simplified in the reporting, using simple language which can be understood by the majority of UIAHs, since most of

[20] There is not much *Musharakah* on the liabilities side, except for *Sukuk*. *Murabahah* (CMT) is increasingly being used as an alternative to *Mudarabah*.

them are inexperienced retail customers seeking a *Shari'ah*-compliant alternative to conventional deposits. On the other hand, some may argue that more transparency is not in the interests of IBs (or at least their management) since they (in common with other banks) regard greater transparency as exposing them to "withdrawal risk", i.e. depositors withdrawing their funds and causing a liquidity crisis. Therefore, there is a lack of interest on the part of the banks' management in providing greater transparency, which may be quite rational from their point of view.

This alternative means that the relationship between the depositors and the bank is based on a profit sharing and loss bearing "investment" account, not an interest bearing deposit. Consequently, it may be argued that IBs should strengthen transparency in reporting the risk associated with the depositors' funds, especially since the depositors have no representative on the banks' BOD. Providing a high-quality standard of transparency to UIAHs leads to meeting their best interests and to better management of their investments. It is important to disclose adequate information to UIAHs as this would help them to determine whether or not they leave their funds invested with the bank. According to IFSB-4, disclosure to UIAHs should include information about how the funds are being managed and where they have been invested, in accordance with *Shari'ah* requirements. This disclosure would show UIAHs the level of risk they are facing. Also, the basis of asset allocation, expenses and profit to UIAHs should be included in the general qualitative disclosures. The ratios of PER, IRR, return on assets, return on equity and other information such as profit distribution to UPSIA should be included in the general quantitative disclosures (IFSB-4, 2007), but banks will not follow this unless compelled to do so by the industry regulator or supervisors. In addition to the above-mentioned disclosures, other important disclosures should be included in the annual reports, such as risk sharing policies including commingling of UIAHs fund, methods showing how profit distribution has been calculated and governance rules on how PER and IRR are being used and transferred.

2.9.1 Smoothing Technique Exercise by IBs

The practice of PER and IRR as smoothing mechanisms at IBs raises some governance issues that need attention. The PER is set up in order to maintain a certain level of return on investment for UIAHs, by making appropriations to this reserve in periods of high returns on the underlying investments and releasing amounts from the reserve when the returns are low. The appropriations are made from the *Mudarabah* income, and the releases are made before allocating the *Mudarib* share. Even though the Islamic bank has full discretion to make appropriations to this reserve out of the profits on UPSIA funds, the basis for computing the amounts appropriated is predefined in the contractual conditions accepted by UIAHs, and after formal review and approval by the BOD. In certain jurisdictions, the supervisory authority lays down requirements relating to the maintenance of the PER.

As Archer and Karim (2012) described, from an accounting point of view, PER consists of two components: one is made up of the proportion of appropriations attributable to the *Mudarib* share and included as shareholders' equity, while the other consists of the proportion attributable to the share of the UIAHs as UPSIA equity. However, the latter do not have any influence over the decision as to the use or distribution of the PER. Furthermore, use of the PER does not "equalise" profits, it only smooths profit payouts. This in fact adds to the lack of transparency, as returns on the underlying investments typically appear more stable than they actually are.

The other smoothing mechanism reserve that IBs have developed, to smooth losses to UIAHs, is the IRR. This reserve is constituted by appropriations from the UIAHs share of profits after allocating the *Mudarib* share, and may be released to cover losses on UPSIA funds. Using the IRR in conjunction with the PER can enable an Islamic bank to make a payout to UIAHs even when the underlying result is a loss. This practice, which aggravates the bank's lack of transparency from the UIAHs' point of view, is thus used to cushion the effects of the risk of future investment losses on UPSIA. UIAHs have neither control over, nor adequate information about, the use of these reserves, which is determined by senior management and the board of directors at IFIs.

The PER and IRR reserves are somewhat analogous to conventional revenue reserves used to smooth dividend payouts to shareholders; however, in the case of IBs, UIAHs have no right to participate in the decision about the distribution of PER or IRR, which is decided by the bank's board of directors (Archer and Karim, 2006; Archer *et al.*, 2010; Sundararajan, 2007; Sundararajan, 2008; Farook *et al.*, 2012). In addition, UIAHs face a lack of transparency in financial reporting, which includes the above-mentioned smoothing mechanism; for example, the lack of information on how and when IBs use these reserves, and the fact that the bank usually has full discretion over managing these reserves. Even though UIAHs agreed with the smoothing practice on entering into the *Mudarabah* contract, and there is no legal issue here, there is also no guarantee that the practice of smoothing is done in the best interests of UIAHs rather than those of shareholders (as a mitigant of DCR) or management (Nienhaus, 2007). Therefore, the practice of smoothing the returns to UIAHs tends to be a substantial obstacle to transparency.

As result of these governance conflicts, the IFSB (IFSB-3, 2006) has recommended that IBs should establish a governance committee attached to the BOD to monitor and act on behalf of UIAHs. IBs should increase transparency in terms of profit allocation between UIAHs and shareholders. They should disclose information on smoothing mechanisms including the use of reserves such as PER and IRR (IFSB-4, 2007). In addition, AAOIFI[21] FAS 11 has a clear definition in terms of regulations and guidance; in particular, it requires IBs to disclose actual profits and returns before any deduction, and the profit part kept in PER and IRR (AAOIFI, 1999b; AAOIFI, 1999a). From a CG perspective, the UIAHs voice should be counted

[21] The acronym AAOIFI refers to the Accounting and Auditing Organisation for Islamic Financial Institutions, an international autonomous non-profit organisation based in Bahrain responsible for developing accounting, auditing, ethics, governance and *Shari'ah* standards for the international Islamic banking and finance industry. The AAOIFI was created on February 26, 1990 and is supported by over 200 institutional members of 45 countries. It has issued some accounting standards and guidance in common with the International Accounting Standards Board (IASB). However, according to (Archer *et al.*, 1998), the AAOIFI lacks the power to enforce its standards. Now, it is working on having its standards adopted by IFIs and regulatory and supervisory countries. Furthermore, market forces are driving IFIs to adopt AAOIFI standards since international credit rating agencies now include compliance with the AAOIFI in their criteria for evaluating Islamic banks.

in the decision-making process or at least they should have a representative on the BOD. For this reason, CG is important to any business, including Islamic, to protect and define the interests of its stakeholders (Grais and Pellegrini, 2006).

2.9.2 Strategy towards Risk

The Muslim community seeks IBs in preference to conventional banks mainly because of the *Shari'ah* compliance issue. On the other hand, choosing one Islamic bank over another depends on potential customers' degree of confidence in the bank (Dusuki and Abdullah, 2007). The level of transparency in terms of rates of return and investment risk would logically have a bearing on this degree of confidence. If UIAHs lack such confidence, this may result in them withdrawing or withholding their funds, which in turn reduces the bank's liquidity and its opportunity to invest in assets and hence earn more profit. According to Ariffin *et al.* (2007), because of the nature of the Islamic bank's capital structure and business model, including the use of unrestricted profit sharing (and loss bearing) investment accounts as a type of deposit product, transparency of risk is more important than it is for conventional banks, especially to UIAHs. Since these UIAHs do not have similar governance rights to those of shareholders, and for information can only rely on annual reports at the very most, financial statements in annual reports should be reliable and easily accessible by them. However, if the bank has inadequate financial reporting disclosure, this will prevent UIAHs from receiving the necessary information and will lead to them not being able to make well-informed decisions about their UPSIA with the bank, which significantly increases moral hazard. In addition, transparency and adequate accounting disclosure in a timely manner is a costly process, involving such matters as hiring independent auditors to have high-quality financial reporting consistent with international standards. For this reason, certain banks favour poor transparency. In fact, IBs see no advantage in greater transparency with regard to the returns payable to UPSIA. Indeed, they engage in "smoothing" to give the impression of very stable returns and do not wish to disclose the true underlying returns and reduce the level of transparency (Archer and Karim, 2007c).

Although this does not appear to be very enlightened behaviour on their part, the argument that greater transparency would be in their interests is not supported by their behaviour.

In general, market discipline can also be a useful tool to limit the bank from taking unnecessary risks, and to make the process of taking excessive risks very costly, which in return reduces the moral hazard problems. However, to make market discipline effective, investors need to have sufficient and reliable information on a regular basis. Having the correct transparent reporting practices may ultimately increase the liquidity and profitability of the bank, since more investors will come back and reinvest their funds if they perceive that adequate information is provided. Also, the authority supervisor can and does require information that is not publicly disclosed, in order to be able to assess the bank's risk profile. Having accurate information in regulatory reports may reduce the incentive of the supervisory authority to impose additional restrictions on banks or alternatively ease them. In the presence of effective market discipline, high-quality disclosure arguably helps the supervisor, as the market will exercise a certain amount of supervision. However, effective market discipline in the (emerging market) countries where IBs operate may not exist.

2.10 The Issue of Transparency

Given the nature of IBs' capital structure and the business model in which they mobilise funds, their use of *Musharakah Sukuk* and *Mudarabah* should encourage IBs to be more transparent. In particular, reporting on how the fund is being mobilised requires disclosing the rate of return and risk associated with these types of sources of funds. According to Archer *et al.* (1998), the *Mudarabah* contract currently used by IBs raises several moral hazard issues in terms of the nature of the governance structure applicable to UIAHs, which leaves the management of the IBs with a great degree of discretion concerning the funds provided by UIAHs. Ariffin *et al.* (2009) pointed out that IBs should, in principle, be more transparent than conventional banks because of the characteristics involved in mobilising their funds. This is especially true when it comes to reporting their risks, which can help

UIAHs to monitor their investment properly and assist them to better understand their risk exposure as well as protecting their interests.

2.10.1 Transparency and Protection of UIAHs

The IFSB has issued a number of standards addressing the protection of UIAHs. As mentioned earlier, in terms of disclosure of information in IFSB-4 (2007), the IFSB has issued *Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services* which was intended *inter alia* to address the issue of transparency to UIAHs and to set recommendations to be followed by IFIs when making disclosures. The standard was designed to set a principle and to act as a guideline to IFIs, including Islamic windows to achieve transparency and promote market discipline as well as to address the supervisory authorities with different recommendations to set up the necessary policy to be implemented in terms of a bank's disclosure and risk profile. In addition, the IFSB standard helps with the role of the supervisory authority to encourage IBs to publish simplified and easy-to-understand information for normal investors who are looking for a safe return as an alternative to conventional deposits. Also, the IFSB standard provides the supervisory authority with a guideline to apply to IBs with regard to their reporting the return and risks in respect of UIAHs and to motivate them to produce a comprehensive but not technical report (IFSB-4, 2007).

The standard was based on the guidelines in international standards, such as those issued by BCBS Basel II (Pillar 3) and the International Accounting Standards Board (IASB), International Financial Reporting Standards (IFRS 7) in relation to bank transparency and governance with reference to disclosure[22]. These guidelines then reflect the specific information needed by UIAHs and shareholders, which arise from the unique risk and characteristics of IFIs that may not be properly addressed by the IFRS alone. The ability to

[22] For more information, see IFSB-4 – "Disclosures to Promote Transparency and Market Discipline or Institutions offering Islamic Financial Services", published in December 2007.

have effective market discipline in IBs is reduced by inadequate disclosure, which may increase the banks' tendency to adopt a risk appetite (having shareholders' risk-return preferences in mind) greater than that of the risk-averse UIAHs (Archer and Karim, 2013).

The importance of the IFSB standard comes from the fact that UIAHs have no representation on the BOD or the *Shari'ah* Supervisory Board. The position taken by the standard is that it is essential to have adequate disclosure since UIAHs have a right to expect accountability and transparency concerning investments made on their behalf. One of the objectives of the IFSB standard is to enable the market participants, especially UIAHs, to have access to relevant and reliable information wherever possible, thereby enhancing their monitoring capacity. According to Van Greuning and Iqbal (2008), although IBs have made several efforts to improve and enhance their level of transparency, there are still some areas that need to be developed. For example, IBs do not have uniform reporting standards that organise the financial reports. Moreover, different jurisdictions impose different levels of disclosure requirements on IBs in addition to other international regulation standards in order to achieve the desired level of disclosure needed. For instance, before the establishment of the AAOIFI, IBs rarely disclosed adequate information, and therefore information revealed on UIAHs funds, such as the smoothing percentage of the returns of UIAHs, was insufficient. Moreover, some IBs reported PSIA funds as liabilities on their balance sheets, while others treated them as equity, and yet others treated them as "off balance sheet" funds under management (Archer and Karim, 2007d). This lack of transparency created information asymmetry between UIAHs and management of IBs, which prevented UIAHs from accessing proper information to manage and best protect their investments, while giving management the freedom to act in favour of shareholders at the expense of UIAHs. Although the AAOIFI and the IFSB have created awareness of CG issues and transparency, very few regulations have been issued by national authorities where IBs operate with respect to CG issues in terms of equity investors, and some financial supervisors have approached UIAHs regulations from the deposit protection perspective. In addition, only a few countries have adopted the standards of the AAOIFI, and the adoption of IFSB standards varies between countries and is rarely complete. However, no protection

yet exists that fully covers the rights of UIAHs, and no country has deposit protection schemes that are fully applicable to UIAHs.

Chapter Three: Literature Review

3.1 Introduction

The following chapter will present the literature review, including the implications of CG for unrestricted profit-sharing investment accounts (UPSIAs), and it will discuss a general definition of CG and its background, extended to incorporate the perspective of CG in Islamic finance. It will also illustrate the IBs' business model and the dilemma of the UPSIA. Finally, this chapter will define the contribution of the research. As James D. Woldfensohn (1999), president of the World Bank, states, 'the proper governance of companies will become as crucial to the world economy as the proper governing of countries'.

3.2 Corporate Governance in General

To understand CG, it is important to state a general definition, together with the aim of CG, then focus on specific definitions including the Islamic viewpoint. Several international organisations have formulated best practices for CG and there are a number of definitions of CG. For example, in 1999 the Organization for Economic Co-operation and Development (OECD) issued its first set of CG principles, which then became an international benchmark for policy makers, investors, corporations and other stakeholders worldwide (OECD, 1999). Then in 2004, the CG principles was revised to increase its suitability for the economic environment around the rest of the world. CG is 'a set of policies, processes, and laws, which affect the way a corporation is managed'.[23] The last publication of G20/OECD principles of CG was conducted in 2015, which contains the results of second review of principles of CG (OECD, 2015). As the OECD has described it, 'Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other

[23] Principles of corporate governance available at http://www.oecd.org

stakeholders'. CG also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring (OECD, 2015).[24] The OECD has stated the aims of CG as follows: 'The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets' (OECD, 2015, p. 14). Similarly Cadbury Committee (1992) as the first UK CG Code, define CG as 'the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting'.

From the banking industry viewpoint, the Basel Committee on Banking Supervision (BCBS) points out that CG is concerned with allocating authority and responsibility. For example, the practice of how the bank's board of directors (BOD) and management lead the bank, including setting the bank's strategy and objectives, determining the bank's risk tolerance, protecting the interests of depositors, and meeting the shareholders' obligations, as well as protecting the interests of stakeholders. Sound CG practices are essential in the banking system to achieve public trust and confidence. On the other hand, poor CG practices can lead to a failure in the banking industry, which will in turn affect the public sector due to their potential impact on the deposit system; this could then have macroeconomic implications such as impact on payment systems (BCBS, 2010). In addition, BCBS notes that

[24] It should be noted that CG is also relevant to non-commercial corporate bodies such as universities.

poor CG could lead the markets to lose confidence in the banking system's capacity to manage assets and liabilities, including deposits, which may create a liquidity issue.

From the perspective of investors, Metrick and Ishii (2002) define CG as 'both the promise to repay a fair return on capital invested and the commitment to operate a firm, efficiently given investment'. Claessens (2006) emphasises that the definitions of CG fall into two sets of categories. The first set is concerned with the behavioural patterns of corporations, in terms of measuring performance, efficiency, financial structure, growth and treatment of stakeholders. For example, this type of definition considers how BOD operate. The other set involves the normative framework, such as the rules that firms operate under, for example, the legal system or the judicial system.

Choudhury and Hoque (2006) highlight the fact that CG deals with the legal and organisational structures that look after the internal integrity of a firm. They describe CG as a bundle of contracts and rules that firms work under, enacted by the legal tenets of government. The objective of CG is to identify and set the criteria by understanding the relationships between the variables in corporations.

CG explains the relationships inside the business environment, and defines the way that a corporation should be directed and controlled and its relationships with its other stakeholders. Therefore, for the purpose of this thesis the approach of the OECD on CG will lead us to consider the legal rights and the relationship between UIAHs and IBs because it also focuses on stakeholders. The OECD points out that CG is a set of relationships between a company's management, its board, its shareholders and stakeholders. We also take into consideration the viewpoint of BCBS on the CG of the banking industry, regarding allocation of authority and responsibility, such as the way that the BOD and management run the business.

3.3 The Perspective of Corporate Governance

Since the collapse of major companies like the Enron Corporation and MCI Inc. there has been a greatly increased interest in the CG practices of corporations. However, CG had been

discussed long before, and the general view of CG was recognised in the classical agency theory problem in the 1930s by Berle and Means (1932), who point out that CG issues arise from the separation of ownership and management in the modern corporation. They suggest that concentration of ownership would have a positive impact on firm value because it would reduce the conflict of interest between owners and managers. Most corporations in the 19th century belonged to a small number of wealthy shareholders, who had control of them, whereas 20th and 21st century corporations are different: there is a much wider range of shareholders in large firms in certain countries, notably the UK and the USA. Typically, shareholders do not have any control, and, due to the asymmetry of information and dispersion, shareholders could not impose a policy of maximising their interests. As described by Shleifer and Vishny (1986), this may have led to corporate assets being deployed to benefit managers instead of shareholders. Nevertheless, dispersed ownership still holds in the 21st century and shareholders only have control through the BOD. These factors led to the initial development of agency theory, which highlights the implications of the separation of ownership and control, and the conflict of interest between management and shareholders. However, the discussion of principal and agency in the corporate context originated earlier, in *The Wealth of Nations* by Adam Smith (1776), who highlighted the fact that 'the directors of joint stock companies are managers of other people's money more than of their own, and [it] cannot be expected that the managers' action would be taken in the same vigilance as the owner of the company'.

Coase (1937) presented transactions cost theory in terms of the nature of the firm, explaining why individuals want to establish a partnership or a firm, while trying to avoid and reduce some of the transactions costs. By creating a firm that serves as an intermediary between consumers and suppliers, transactions costs can be reduced, such as contracting, coordinating, enforcing and discharging rights and obligations under contracts (Cornell and Shapiro, 1987).

Alchian and Demsetz (1972) refine the view of the firm by focusing on the principal's cost of monitoring the agent, believing that the firm's management should continue the process

of negotiating contracts. They consider that contractual structure arises to enhance organisational efficiency in the factors of production. Jensen and Meckling (1976) develop the theory of the ownership structure of the firm, presenting the concept of agency costs and their relationship to separation and control issues, which may affect the value of the firm, as a contract where the principal (shareholders) – one or more persons – can engage with the agent (managers) – another person – to perform some service on their behalf that may involve delegating decision-making authority to the agent, with the objective of maximising the principal's value. Crucially, however, the agent or manager might not maximise value for the principal but might instead focus more on maximising the managers' own personal wealth. These divisions of interest create agency costs, although principals may limit such failure to maximise their interests by imposing monitoring such as having a BOD act on the principal's behalf to monitor and control the agent's activities and limit the issue of asymmetry of information to ensure the maximisation of shareholders' value. Also, principals may create appropriate incentives for the agent by contracting them to undertake actions in the interest of the principal or to avoid certain actions that conflict with the principal's interest. For example, the agent's activities may be restricted by commitment to contractual obligations to stay with the firm even if the firm is acquired by another firm, in a process called bonding costs. In addition, residual loss may be incurred as agency costs from the principal's and agent's interests, independent of the use of monitoring and bonding costs, which is the costs of providing incentives to the agent to act in the principal's interests. Fama and Jensen (1983b) indicate that the agency problem is a result of conducting a costless contract that is not enforced; however, these could be mitigated by developing a controlling process that ensures that the decisions taken by the management are to the benefit of shareholders. Therefore, the implication and development of agency theory led to the shareholder theory of CG.

In addition to the traditional principal–agency conflicts, there is the principal–principal model. Villalonga and Amit (2006) distinguish between the type I agency problem and type II: the issue in the type II agency problem is not between shareholders and managers but between different types of shareholders. For example, in a family firm, one concentrated

owner can take advantage of the company to their private benefit, while the other minority owners do not receive very much, because of the nature of ownership. This model of CG deals with the conflicts of interests between concentrated shareholders who have power and minority ones who have weak or no legal protection (Dharwadkar *et al.*, 2000). Williamson (1996) argues that equity investors normally have governance rights that involve them in transactions costs of governance, namely, costs of monitoring as a result of agency issues, via various mechanisms including a BOD that is answerable to them and periodic financial reports. Williamson also points out that creditors, who do not need to perform monitoring as equity investors do, typically have certain governance rights in the event of default.

3.4 Two Schools of Thought on CG

The CG perspective recognises that there are at least two classes of stakeholders. The 'shareholder theory' recognises only shareholders as stakeholders, whereas the 'stakeholder theory' recognises several. The original idea of CG emphasises the management and shareholder relationship; for example, Jensen and Meckling (1976) highlight the separation of ownership and control, and the potential conflict of interest, where the problem could be mitigated by governance structures. However, in the second half of the 20th century, the notion of stakeholders was extended and there emerged two views of stakeholders: one which continues to focus on shareholders, and one that is a more extended body of modern CG theory with a developed notion of the stakeholder.

Franks *et al.* (2006) point out that governance of Anglo-American firms reflects shareholder theory whereas the governance of German corporations reflects stakeholder theory. For example, British and American firms have some dispersed shareholders, whereas German corporations tend to have more concentrated ownership. Yunis (2007) also highlights the difference in the CG objectives, especially in the Anglo-American model (neoliberal) and the

Franco-German or Continental European model (societal).[25] Both models treat stakeholders differently, for example the Anglo-American model, which exists mainly in the UK and the USA, concentrates on maximising shareholders' value, emphasising the fact that management should take decisions in the interest of shareholders. On the other hand, the Franco-German model, in addition to shareholders' interest, also concentrates on the interest of other stakeholders, which include groups other than shareholders that are affected by organisational activities and decisions. The Franco-German model considers corporations as being in industrial partnerships that are more like long-term relationships, and therefore posits that the interests of employees, groups and other communities should not be subordinated to those of shareholders.

3.4.1 Shareholder View

The contracts and relationships between shareholders and managers, which the CG structure focuses on, are often referred to shareholders' model. The Anglo-American model argues that the agency theory conflict occurs between dispersed shareholders and managers, who have several governance mechanisms to reduce the conflict of interests between them, such as the BOD (internal mechanism), and the managerial labour market (external mechanism) (Fama and Jensen, 1983b). For example, the BOD can encourage the managers to make a project profitable by paying them well; since profit increases the shareholders' value, this will align the interests of the managers and shareholders (Padgett, 2012).

Shareholder theory is concerned only with maximising the shareholders' interest, where shareholders have control and the board have a fiduciary duty towards shareholders. The emphasis on the shareholders, since they are regarded as the guardian of the interest of other stakeholders, for example, in 'vicarious monitoring' hypothesis, holders of voting

[25] As further explained by Archer and Karim (2013a), the continental European approach is called neo-statist in France and neo-corporatist in Germany.

shares monitor on behalf of holders of non-voting shares. However, an alternative perspective, the stakeholders' view, rejects this and argues that shareholders cannot be relied upon to safeguard the interests of other stakeholders; the latter should be more involved in the structure. For example, the continental European view (or neo-corporatist) includes in their supervisory board (in listed companies), representatives of the workforce and local government in decision-making. This is a typical German model; a representative of the Land (local state) typically sits on the Supervisory Board of German stock corporations, as does a representative of the workforce. They have adopted a view of CG that takes a wide view of who the stakeholders are. Customers and suppliers are also stakeholders but are not represented on the board.

3.4.2 Stakeholder View

Stakeholder theory developed in response to the agency problem occurring between the agent and a larger set of stakeholders. As a result of shareholders' awareness of their rights, and apart from the agency theory perspectives on CG, which tend to focus on shareholders, much of the discussion has questioned different issues of CG (Ahmed and Chapra, 2002). For example, many arguments in the CG literature focus on whether CG should be concentrated on protecting shareholders' interests and maximising their value, or whether it should also include the protection of other stakeholders'[26] interests (Archer and Karim, 2007d). Stakeholder theory has a different view of the principal–agent relationship, where the optimal responsibility is to stakeholders rather than only to shareholders. Freeman (1984) offers a broad organisational definition of 'stakeholders' as any individual or group who can affect or is affected by the achievement of the organisation's objectives. This includes the relationships defining stakeholder involvement and the goals for which the

[26] Stakeholders were defined in the first stage by the Stanford Research Institute (1963) as 'those groups without [whose] support the organization would cease to exist'. Then the theory was later developed by Freeman (1984), who refers to a person, group or organisation that has interest in an enterprise or project, which can be affected by the organisation's actions, objectives and policies, such as employees, creditors, directors, owners as shareholders, suppliers, and even government, unions and the community from which the business draws its resources.

corporation is governed. The stakeholders are thus not only the shareholders, but also employees, customers, creditors, suppliers and the community at large. Phillips *et al.* (2003) note that, in stakeholder theory, the focus of management is more than just maximising shareholder wealth. Therefore, stakeholder theorists argue that managers in any organisation should have a network of relationships to serve that includes employees, suppliers and business partners (Abdullah and Valentine, 2009). Freeman *et al.* (2004) point out that stakeholder theory is managerial and that it reflects and directs how management operates rather than just addressing management theorists or economists. Pouloudi and Whitley (1997) suggest extending the definition of stakeholder theory, as opposed to neoclassical shareholder theory, by looking at inter-organisational information systems in which all individuals, groups or even organisations whose actions can effect or be influenced by the development and the use of the information system,[27] whether directly or indirectly, should be considered as stakeholders. These interested parties, or stakeholders, have important roles to play for the initiation and the continuation of inter-organisational systems. The theory of stakeholders, which emerged to address the issue of agency problem between management and a wide range of stakeholders, has received wide acceptance in business practice in relation to CG and corporate social responsibility.

3.5 Corporate Governance Mechanisms

According to Deakin and Hughes (1997), CG focuses on the relationship between the internal governance mechanisms of firms and society's view of corporate accountability. CG structure, including the BOD, plays a very important role in the effectiveness of CG. However, the BOD cannot perform its important role without proper qualifications, such as awareness of business risk and the complexities of the banking industries (Ahmed and Chapra, 2002). Also, in the case of banks, the BOD should have moral integrity and have full

[27] The development of information systems requires the participation of a number of interested parties and the effectiveness of their participation would influence the success of the system.

control over the affairs of the bank, clearly specifying the strategic objective, and setting up the code of conduct for senior management and staff. The roles of non-executive directors, CEO-chair duality[28], remuneration, audit and nominating committees have also been discussed in the context of effective CG (Mayer, 1997).

3.5.1 Importance of Structure of the Board

One of the important principles of CG is the election by shareholders of the BOD, which in turn selects top management. The BOD has two completely separate functions, one of which is to be the ultimate decision making body of the firm as a strategic function, and the other one is monitoring device, whereas the BOD carries out the monitoring function on behalf of shareholders. Therefore, according to John and Senbet (1998) the effectiveness of the BOD in its monitoring function is determined by the size of the board, its independence, and its composition. On one hand, the UK CG Code (previously known as the UK Combined Code published by the Financial Reporting Council) views duality in the composition of the board as unfavourable since it give one person too much power over the decision-making function (McKnight and Weir, 2009). Alternatively, empirical evidence from Donaldson and Davis (1991) shows that return on equity (ROE) ratio tend to be superior when there is CEO-chair duality. They argue that stewardship theory, concerning leadership by a CEO-chair, better explains maximisation of shareholders' interests than agency theory. In contrast, agency theory argues that CG is weaker when the bank has the same person as its chair (having an overseeing function over the CEO) and as its CEO, which is an executive role. For example, according to agency theory, the board of KFH-Kuwait had a weaker form of CG from 2003 to 2010 than when these roles were separated from 2011. The argument is that the chair is overseeing himself or herself as CEO and this is a form of weak CG. However, stewardship theory views the combination of CEO and chair as indicative of power and higher profit potential. The main difference between the two

[28] CEO-chair duality is where the roles of CEO and chair are held simultaneously (Dalton and Kesner, 1987).

theories remains in the method of operation, though, in both cases, management is assumed to be self-seeking, which is not the same as profit maximising in the shareholders' interest.[29] The key difference is that in stewardship theory management is assumed to believe that the best way to get on and be paid more is by doing what the shareholders want (Padgett, 2012), and there is considerable evidence that shows firms attain better financial performance with a single CEO-chair than with separate CEO and chair. From this perspective combining the chair and CEO is unproblematic. In contrast, in agency theory management is assumed to pursue its own interest by creating benefits for itself at the expense of shareholders, for example by giving itself generous perquisites or by shirking (Jensen and Meckling, 1976).

Also, empirical studies show that board size has its own influence on the ability of the board to control, monitor, disclose (Akhtaruddin *et al.*, 2009) and to perform other tasks of the company directors (Fama and Jensen, 1983b). For example, a small board is believed to encourage faster information processing and may enhance communications among the company's top management and senior executives (Zahra *et al.*, 2000). However, Zahra *et al.* (2000) also suggest that a larger board brings its own benefits, such as increasing company value by providing the expertise and knowledge of members on board. Additionally the size of the board has an effect on the level of voluntary disclosure; for example, Chen and Jaggi (2001) argue that a larger board size may reduce information asymmetry, which may increase company value. Birnbaum (1984) suggests that a larger board reduces uncertainty and lack of information. The effect of CG in reducing the agency problem between shareholders and management is thus assumed to be influenced by the BOD structure, generally composed of both insiders and external members.

On the other hand, several studies have tested the financial performance of IBs using various financial ratios including return on assets (ROA). For example, Hanif *et al.* (2012)

[29] Agency theory assumes that management is seeking to maximise its own objective function rather than just profit for shareholders.

examine the performance of Islamic and conventional banks in Pakistan during the five-year period from 2005 to 2009, in terms of internal and external banking factors. The internal factors include a measurement of profitability using ROA, liquidity, credit risk and solvency. Nine financial ratios are used in their empirical study to measure the differences in the internal factors as well as a model known as Bank-o-meter to gauge solvency. The external factors indicator includes customer behaviour and perceptions of both Islamic and conventional banks. Their study finds that the conventional banks' performance was better in terms of profitability and liquidity than that of the IBs. However, the performance of IBs in terms of credit risk and solvency was better than that of conventional banks. There are other dimensions of performance from bank customers' point of view. Hanif *et al.* (2012) include a customer survey on a sample group of mostly Pakistani males between the ages of 20 and 29 years old. The majority of the sample customers have five years of experience with their bank, which shows that customers' choice of bank is influenced by factors including *Shari'ah*-based banking, friendliness of personnel, facilities provided by the bank, image of the bank, effectiveness in handling problems, cost-effectiveness, and others. Results show 36% would tend to choose an Islamic bank over a conventional bank based on *Shari'ah* compliance when opening an account in a bank, whereas 30% would choose a conventional bank over an Islamic bank based on the facilities provided by the bank. There is some evidence that Muslim customers are willing to make a trade-off between quality of service and value for money on the one hand, and *Shari'ah* compliance on the other hand, especially in *Takaful* (Islamic insurance). Conversely, with the increasing number of IBs globally and the fact that Muslim customers are ordinary investors, they are looking for quality of service and value for money.

Alternatively, a different perspective on Islamic and conventional banks based on various financial ratios is provided by Ika and Abdullah (2011), who examine Indonesian banks to

compare financial performance with consumer choice.[30] The study makes a comparison analysis of profitability, liquidity, risk and solvency, and efficiency. The study finds that there is no significant difference between IBs and conventional banks in their financial performance using ROA; but in the case of liquidity ratios there is a difference, with IBs shown to be more liquid than conventional banks.

3.6 Corporate of Governance in IIFS

CG of institutions offering Islamic financial services (IIFS) has also gained attention lately because of the steady growth of Islamic finance and investment. Even though the Islamic financial industry is still in its initial development stage, and despite its small share of the global financial system, IIFIs remain essential to the financial market, especially in the Muslim world. In addition, conventional banks now offer Islamic windows to customers who are seeking *Shari'ah* compliance.

Much research has been conducted on viability, design and operations of profit sharing in IBs (Greuning and Iqbal, 2007); however, it is clear that insufficient research has been completed on the CG issue from an Islamic perspective (Hasan, 2009), particularly on governance structures and the potential conflict of interest between UIAHs and shareholders (Yunis, 2007). Some studies, such as those by Siddiqi (1981); Haneef (1995), looking at contemporary literature on Islamic economic thought, highlight the lack of references to and discussion on matters concerning CG from an Islamic perspective. Mannan (1984) also notes the absence of specific research on *Shari'ah* governance. Research carried out by Ahmed and Chapra (2002) addresses Islamic corporate governance, specifically focusing on the issue of the governance framework of IBs. These studies cover CG only from the viewpoints of accounting, auditing and the general framework in IBs.

[30] The study was conducted before and after the enactment of Indonesia's Islamic Banking Act No. 21/2008, which 'aims to strengthen the regulatory environment for further growth of Indonesia's market Islamic finance. The data was based on selected financial statements of Islamic commercial banks in Indonesia from year 2000 to 2007' (Ika and Abdullah, 2011).

According to El-Hawary *et al.* (2004), to be consistent with core principles and current practice, there is a need to contrast the risks and regulations in IBs. Furthermore, Rosly and Zaini (2008) add that there is an absence, in the theoretical studies in the literature, of consideration of risk–return relationships in Islamic capital markets. This may have impeded consideration of the important CG issue of possible conflicts of interest between shareholders and UIAHs in IBs and the implications of the lack of governance rights of the latter.

To remain successful and continue steady growth, and to promote financial stability in the Islamic financial sector and more widely, it is arguably important that IBs should have a robust CG framework (IFSB-3, 2006). However, any rigid rule-based approach adopted with the intention of strengthening the CG of IBs may threaten their potential and healthy growth (IFSB-3, 2006). Furthermore, there is no quick fix to apply to implement a good governance culture in IBs, but given a suitable environment in which they are given an adequate timeline, encouragement and incentives, one may expect that a good CG culture will continue to develop within the Islamic financial services industry.[31] However, so far as the legal and institutional environment is concerned, most countries in which IBs operate fall into the 'emerging market' category, which implies weaknesses from the standpoint of developing robust CG (IFSB-Report, 2015; IFSB-3, 2006).

3.7 Ideological Context of Islamic Banks

3.7.1 Shareholder Theory Perspective Related to UPSIAs

Considering the contractual relationship between UPSIAs and the IBs from an agency theory perspective, the bank, as the *Mudarib* (agent), has a fiduciary duty to act in the best interests of the UIAHs as principals (as well as the best interests of shareholders). However, the UIAHs are generally unable to monitor the activities of the *Mudarib*, because they lack

[31] CG problems of Islamic banks are linked to wider CG and regulatory problems in emerging markets.

the governance rights that would enable them to do so. We may observe some characteristics of the agency problem (Iqbal and Llewellyn, 2002), especially in the *Mudarabah* contract, where information asymmetry may exist. Therefore, risk and profit sharing contracted in the agency theory framework relate to two parties: one (in this case, the *Mudarib*) has no funding but has knowledge about a risky profitable investment, and the other (UIAHs) has the funding but not the knowledge (Khalil *et al.*, 2002). The problem of asymmetric information in this characterisation is very clear.

Another example is a principal–agent problem between the bank as agent and the UIAHs as principal, which indicates a need for governance mechanisms or rights to help safeguard the interests of UIAHs. Moreover, it should be noted that shareholders and UIAHs face the same investment risk in their portfolio when the funds of both parties are commingled and invested in the same asset pool, as is normally the case; yet the interests of shareholders and UIAHs may be in conflict, regarding both the sharing of profits and risk appetite. Hence, in addition to the potential 'principal–agent' issue, CG issues in IBs with respect to UIAHs can also be considered to include a 'principal–principal' agency problem (Archer *et al.*, 1998). UIAHs might in principle be able to count on shareholders to perform monitoring on their behalf, since shareholders need UIAHs to provide them with the *Mudarib*'s share of profits, which is an important part of their profits from the bank. However, this may be somewhat implausible because of a misalignment of incentive in terms of risk–return preferences, as pointed out in the Islamic Financial Services Board's (IFSB) guiding principles for CG of IFIs. According to IFSB-3 (2006), UIAHs are generally risk-averse and seek to avoid losses and to receive stable returns, whereas shareholders are more aggressive in terms of risk appetite, seeking an investment strategy aimed at higher but riskier returns. Tektas *et al.* (2005) explain that risk-takers are willing to bear higher risk for higher returns, where on the opposite side the risk-averse accept low returns to avoid risk. Likewise, Taktak (2011) states that the two categories of stakeholders (UIAHs and shareholders) have different desires regarding risk: UIAHs are considered to be defensive, seeking moderate and steady levels of *Shari'ah*-compliant returns, while the shareholders are more aggressive and desire riskier activities, which lead to a higher level of returns. Similarly, Archer *et al.* (2010)

mention that there is a potential conflict of interest between shareholders and UIAHs due to the different appetites for risk and the preferred risk–return trade-off for each category of stakeholders, hence UIAHs tend more towards risk aversion and shareholders are less risk averse. Thus, the difference in the levels of appetite for risk and return may lead to a conflict of interests. Therefore, when IBs commingle the funds of these two stakeholders into one asset pool, either to invest the funds in different projects for profit or to use them at their discretion, sound CG would require them to take into consideration and to balance the differences in risk appetite between these two types of stakeholders. However, the governance structures of IBs give shareholders the governance rights of equity investors (as residual claimants), such as the right to participate in general meetings and to appoint and remove members of the board of directors, while UIAHs have no such rights. Hence, management is likely to pursue policies that accord with shareholders' preferences, rather than those of UIAHs (Archer and Karim, 2007b; IFSB-3, 2006). This problem is mitigated to some extent by the desire of shareholders and management to maintain a given level of UPSIAs as a source of income from the *Mudarib*'s share of profits from investment of UPSIA funds, since UIAHs may 'vote with their feet' by withdrawing their funds (Archer and Karim, 2006). However, as the research for this thesis has indicated (see chapters 4, 5, and 7 below), UIAHs are typically very passive and appear to be content with modest levels of profit payout.

It may be argued that, although UIAHs, being profit-sharing and loss-bearing, are residual claimants with respect to cash flows from operations, as *Rabb Almaal* they have a right to recover the net asset value (NAV) of the assets financed by their funds in the event of the liquidation of the Islamic bank., i.e. they have a right similar to that of secured creditors. However, it is by no means certain that the insolvency regimes of various jurisdictions would uphold this right, which exists in *Shari'ah* law but not necessarily in secular law.

Be that as it may, even if UIAHs have as sole control right that of 'voting with their feet', it would seem reasonable that the CG regime should give them 'information rights', i.e. a right to accountability and transparency on investments made on their behalf. As mentioned

earlier in section 3.3, Williamson (1996) analyses the respective governance rights of debt and equity, where equity investors generally have governance rights that involve them in transaction costs of governance, namely, costs of monitoring via various mechanisms including the BOD. As Archer *et al.* (1998) argue, UPSIAs raise many issues regarding the relationship between them and the bank from different perspectives, such as agency theory and transaction cost economics. IBs have made some efforts to improve and enhance the level of transparency, for example in Bahrain, where the Central Bank of Bahrain has required the adoption of the standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). However, there are still some areas of transparency that need to be developed. IFIs do not have uniform reporting standards that organise the financial reports for IBs, or even comprehensive regulations to govern them (Greuning and Iqbal, 2007). Therefore, information asymmetry and the separation of ownership and control give rise to numerous instances of the agency problem.

In particular, the assumption of 'vicarious monitoring'[32] raised by (Archer *et al.*, 1998), where UIAHs can rely on shareholders to safeguard their own interest on their behalf, cannot be relied on because of a misalignment of incentive in terms of risk–return preferences. Both shareholders and UIAHs experience the same level of investment risk in their portfolio, since the funds of both parties are commingled and invested in the same pool. The hypothesis that the CG problems of IBs with respect to UIAHs can be considered to cause a 'principal–principal' agency problem makes the assumption of 'vicarious monitoring' unreliable, as both investors have different appetites for risk. Even though Siddiqi (1991) argues that the *Mudarabah* contract, with its sharing of risk and returns, reflects the core of Islamic banking, Ahmed (2002) points out that the agency and transactions cost problems with *Mudarabah* financing by IBs have led to the use of other financial instruments to provide financing to customers, such as *Murabahah* (mark-up-based financing), which have become the main method of financing in IBs. Iqbal *et al.* (1998)

[32] For more information on vicarious monitoring, see (Archer *et al.*, 1998).

supports the view that using *Mudarabah* in profit-sharing methods of financing entails moral hazard, i.e. the agency problem.

As a result, there is a potential principal–agent problem concerning the relationship between UIAHs as principals and management as agents. There is, also, as Archer *et al.* (1998) identify, a 'principal–principal problem' with respect to the relationship between the UIAHs and the shareholders as two sets of principals whose interests may not necessarily correspond. The agency theory literature does not specifically consider principals such as UIAHs, who are a form of stakeholder specific to IBs, but it does consider conflicts of interest between different economic actors including shareholders and management of the firm. However, according to Hart (1989), a firm is viewed as a relationship of contracts including creditors, employees, suppliers, customers and others which are essential part of the firm who usually face different problems and observe asymmetries of information.

3.7.2 Stakeholder Theory Perspective Related to UPSIAs

'Stakeholder theory' in the CG literature refers to theory which gives importance to other stakeholders in the corporation together with the shareholders (Al-Sadah, 2008). The stakeholder theory of CG provides a clear place for UIAHs as stakeholders, whereas shareholder theory fails to do so. Heath and Norman (2004) point out that stakeholder theory is about the fundamental nature of corporations, where a firm serves stakeholders' interests. For example, stakeholders provide capital to firms (as is the case with UIAHs) in exchange for returns on their investment, where firms have a fiduciary duty to maximise stakeholders' value (Hill and Jones, 1992).

The Basel Committee on Banking Supervision (BCBS) adds that, in addition to the banks' responsibilities to shareholders, banks have other duties to their depositors and to other relevant stakeholders (BCBS, 2010). This implies that stakeholder theory is particularly relevant in banking industries, including (and perhaps especially) IBs. Furthermore, IBs are expected to act with social responsibility, engaging in activities for the public good as part of the business establishment. As part of the community, they can thus play an important

role in the local environment, without forgetting that IBs are profit-seeking business entities, not charities. The issue is thus one of finding an acceptable trade-off between profit seeking and socially responsible business conduct.

Agency theory originally focused on the relationship between shareholders and managers, and this perspective is still pervasive in much of the CG literature. However, the later developments in agency theory examine principal–principal issues and other issues involving stakeholders other than shareholders. Hence, the perspective of stakeholder theory seems more appropriate for this research, especially in the area of potential conflicts of interest between UIAHs and shareholders. The key concern is how the management of Islamic enterprises balances the interests of UIAHs and shareholders, with particular reference to profit-sharing practices and the provision of relevant information to UIAHs.

According to Iqbal and Mirakhor (2004), the increased attention to CG and to finding an appropriate governance structure is due to multiple factors, including a shift from focusing only on the traditional shareholder value to focusing on a wider circle of stakeholders in the governance structure.[33] Baums *et al.* (1993) state that the neo-institutional economists' theory relies on agency theory to define the firm as a 'nexus of contracts'; they also point out that the neo-institutional economists argue that firms' claimants are a broader set than just shareholders and should include other stakeholders with whom the firm has explicit and implicit contractual interactions, such as customers, employees, creditors and others. As indicated earlier, the firm exists as a substitute for the costly forms of transactions (Coase, 1937), whereby the transactional costs of negotiating, contracting and other activities such as enforcing or discharging contracts can be reduced by the formation of the firm. As Jensen and Meckling (1976) claim, contractual designs emerge to reduce the transactional costs between factors of production. Thus, the formulation of the agency

[33] In addition to other factors that include the growth of institutional investors such as pension and mutual funds, plus the global trend of deregulation of financial sectors.

problem suggests that creating an effective monitoring structure can reduce adverse selection and moral hazard problems.

Nevertheless, the original formulation of the CG problem is based on the relationship between investors and managers and focuses on the protection of shareholders' interests only. On the other hand, business ethicists have considered this exclusion of other non-shareholder groups to be ethically unjustified and unacceptable. Iqbal and Mirakhor (2004) also indicate that stakeholder theorists reject the characteristics of the 'shareholder' model, which states that the fiduciary duty[34] of firm managers should serve and maximise shareholders' wealth only and that control should be in the shareholders' hands alone. Stakeholder theorists argue that other stakeholders should have a say in firms' decision-making that affects them, and managers should also include in their fiduciary duty all stakeholders' interests, not just those of shareholders, and hence the firm should promote the interests of all stakeholders as well. Iqbal and Mirakhor (2004) furthermore state that the Islamic economic system provides a strong basis for a stakeholder theory of CG, because Islam recognises the right of all forms of life in society, not just those of certain individuals. Therefore, the Islamic economic system refers to property rights and contracts to govern the economic and social behaviour of all forms of life in society including individuals, society and state. As *Shari'ah* provides a comprehensive protection of rights to every individual, community, society, and state, their property rights should not have conflicts of interest with one another. At the same time, Islam clearly defined stakeholders to have decision-making and accountability of an economics agent's activities, as well to protect their rights since the Islamic economic system is based on the rules of *Shari'ah*, where the goal is to maintain social justices.

[34] Fiduciary duty occurs when one party controls another party's assets, having discretion in decision-making but with care and loyalty, in order to benefit and maximise profits on the assets for the other party (Padgett, 2012).

On the other hand, Islam expects the managers of a firm to uphold social justice and not to be any different from the behavioural of any member in the society (Iqbal and Mirakhor, 2004). It is the fiduciary duty of the managers of the firm to have economic and moral behaviour toward all stakeholders not just the owners of the firms. This is why we might in principle have expected a better treatment of UIAHs in receiving their returns, and because Islamic economic system insures the compliance with the rules ensure effective governance system to have social justice among all members. However, IBs have been influenced by the juristic theories of *Fiqh* as *Muamalat*, notably the Nominate Contracts, rather than by Islamic economics, which is the main reason why IBs don't follow the precepts of Islamic economics in their operations. Their *Shari'ah* Boards accept this and don't seek to enforce Islamic economics.

3.8 UPSIA Rights and Risks

Equity investors typically have governance rights, as claimed by Williamson (1996) and, following this logic, all equity investors including UIAHs would be entitled to such mechanisms of governance (Archer *et al.*, 1998). For example, shareholders have the right to information (such as an annual report) and can participate in voting to elect the board of directors; however, UIAHs have no such rights. Subsequently, UIAHs have no voice in the investment strategy for their invested funds – in particular, regarding asset allocation and risk exposures. UPSIAs are a major funding source for IBs; for example, UPSIA-funded assets constituted on average about 62% of total assets for a sample of IBs in 12 countries in the Middle East and South East Asia (Sundararajan, 2008). Also Rosly and Zaini (2008) indicate that UPSIAs constitute the bulk of total deposits in Malaysia. With this significant source of funds in IBs, one would expect appropriate account to be taken of risks that are relevant to UPSIAs since their funds are likely to be combined with other sources of funds such as shareholders' and current account funds (Archer and Karim, 2006).

3.9 Corporate Governance Issues concerning UPSIA

IBs offer different customer accounts that are *Shari'ah* compliant, including current accounts, and both restricted and unrestricted investment accounts[35]. However, while other types of deposit account may raise CG or *Shari'ah* issues, those raised by UPSIA are the most challenging and involve a potential conflict of interest with shareholders (Grais and Pellegrini, 2006). According to Archer and Karim (2012), the issue of CG with UPSIA raises serious concerns. Normally, shareholders and UIAHs are entitled to a return from this combination of funds when bank investments turn a profit, except that UIAHs have no right to a share of income from assets financed by shareholders' funds and current accounts. UIAHs as *Rabb Almaal* have no right to interfere in managing the funds. This issue raises a potential conflict of interest in terms of investment strategy and asset allocation. Comparing the characteristics of UPSIA and shareholders with regard to governance rights reveals enormous differences between them. For example, the board of directors does in fact answer to shareholders in general meetings. Shareholders have the right to vote and can elect members of the BOD. In practice, through their control of the BOD, shareholders may enforce a point or dismiss senior management. By contrast, UPSIA have no governance rights either as investors or as creditors, and in cases of conflicts of interest with shareholders, the shareholders will always prevail (Archer *et al.*, 2010). Even the mechanisms that IBs establish to smooth the payouts to the UPSIA are in favour of shareholders; for example, the use of Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR) to cover possible losses on assets funded by UPSIA (Sundararajan, 2008; Farook *et al.*, 2012). The disclosure of such reserves to UIAHs is limited or non-existent and they have no rights to influence the use of these reserves (Greuning and Iqbal, 2007). UIAHs

[35] It is worth mentioning that Islamic banks have different names for investment accounts; for example, according to its annual report of 2012, the Kuwait Finance House generally invests 100% of investment deposits for an unlimited period for "Khumasia", and about 90% of investment deposits for an unlimited period for "Mustamera", as well as 70% of investment deposits for an unlimited period for "Sedra" and 60% of investment savings accounts for "Tawfeer" (see chapter 6 section 6.3 for more information).

lack transparency rights as investors and have poor information, not only about PER and IRR but also about the rate of return and associated risk. IBs have limited disclosure in their annual report concerning the fund allocation and risk that is associated with UIAHs (of course this may vary across jurisdictions), with those that apply AAOIFI standards having a better quality of disclosure. Banks generally disclose the rate of return on UPSIA but they do not disclose risk or losses to UIAHs.

3.10 The Dilemma of UPSIAs as Investment or Deposits Account

IBs in general are characterised by ambiguity on the nature of UPSIA attributes or status (Archer *et al.*, 2010), depending on the regulations and capital requirements of the countries that IBs operate in. For example, a few jurisdictions treat UPSIAs as a type of deposit account, the principal amount invested being protected with 'capital certainty' and the bank being liable for the amount of the deposit plus any accrued return. Hence, the 'capital' is 'certain' provided the bank is solvent.[36] However, this attribution of UPSIAs to being a deposit-like product does not seem to be in accordance with *Shari'ah* compliance, or at least compliant with the conditions of *Mudarabah*, where losses should be borne by the capital provider, except in cases of negligence and misconduct of the *Mudarib* (Archer and Karim, 2012; Ahmed, 2002).

A somewhat extreme example of regulatory interference in Islamic banking practices is provided by the case of a UK Islamic bank, the Islamic Bank of Britain (IBB) (IBB has changed its name to Al Rayan Bank). IBB offers a 'deposit' product (a type of UPSIA) for which the returns are based on profit sharing, as in a *Mudarabah*, but the regulator (at the time, the Financial Services Authority (FSA), now replaced by the Financial Conduct Authority (FCA)) requires IBB to offer the UIAHs 'capital certainty' in line with UK banking regulations.

[36] Solvency refers to the ability to service liabilities.

However, to make the product *Shari'ah* compliant for depositors who insist that the *Shari'ah* rules of *Mudarabah* be applied, in the case of a loss such depositors may inform the bank of their willingness to absorb the applicable share of that loss (Archer and Karim, 2012).

As noted by Archer and Karim (2007b), some jurisdictions provide UIAHs with a deposit guarantee, but this is not *Shari'ah* compliant unless it is arranged on the basis of *Takaful*[37] or provided by the central bank free of charge. Deposit guarantees of conventional deposits give rise to moral hazard, since they induce banks to take excessive risks in the knowledge that losses will be covered by the guarantee. This increases the need for regulation of capital adequacy. In principle, if UPSIAs are considered a type of collective investment scheme (CIS), the deposit guarantees might lead to regulatory arbitrage since UPSIAs would enjoy a protection denied to investors in other collective investment schemes, which are typically regulated by the capital markets regulator. However, UPSIAs, being designed as a *Shari'ah*-compliant alternative to conventional deposits, are not normally thought of as being a type of CIS, although restricted profit-sharing investment accounts (RPSIAs) might be so considered. Consequently, while extending deposit guarantees to RPSIAs (which seems very unlikely) would be problematic, the same would probably not apply to UPSIAs.

In jurisdictions where capital certainty is not required by the regulator of IBs, the latter typically treat UPSIAs as a type of deposit account but without any capital certainty. However, apart from the fact that the returns are dependent on the income from the underlying investments, such accounts are a far-from-perfect substitute for conventional deposits, due to the lack of capital certainty and the fact that returns are entirely dependent not just upon the performance of the underlying investments but also on the discretion of management as a result of various "smoothing" techniques as described below. In contrast, some jurisdictions treat UPSIAs as a type of investment account, although they are based

[37] This is a type of Islamic insurance, where the money is funded by members who contribute to a pooling system to guarantee each other against losses or damages, which is based on *Shari'ah*.

on conventional banking regulations. In this case, the central bank may not have specific regulations for IBs that take the characteristics of UPSIAs (such as the rules of *Mudarabah*) and principles into account, and in particular the appropriate levels of disclosure and transparency are not required. Hence, UIAHs are not treated as 'normal' investors in investment schemes, because they are subject to a lack of information about the riskiness and performance of their investments.

Some other regulators apparently allow IBs to offer UPSIAs based on *Mudarabah* while nevertheless insisting that losses should not be passed on to the UIAHs, as well as requiring the use of profit equalisation reserves (PERs) and investment risk reserves (IRRs) to 'smooth' the payouts to them.[38] IBs have developed these two types of reserves to smooth the profit returns to UIAHs (Farook *et al.*, 2012).

The ambiguity as to whether an UPSIA is a deposit-like account or a type of investment presents a challenge to the regulatory and supervisory authorities of IBs in assessing the actual risk exposures of shareholders and the implications for capital adequacy. In particular, the practice of 'smoothing' the returns to the UIAHs gives rise to displaced commercial risk (DCR).[39] For example, an IB may invest the UPSIA funds in long-maturity assets that yield a lower rate of return compared to the current market expectations, leading to 'withdrawal risk' in respect of UPSIA funds. 'Smoothing' may be achieved by reducing the bank's *Mudarib* share of the profits, or even 'donating' a part of the bank's share of profit from other funds, which increases the variability (i.e. the riskiness) of returns to shareholders (Sundararajan, 2008; IFSB-GN3, 2010). This additional riskiness has been termed DCR because it results in displacing part of the credit and market risks of UPSIAs

[38] This used to be the policy of the Bank Negara Malaysia, but this policy was abandoned when the Malaysian Islamic Financial Services Act 2013 was passed. UIAHs in Malaysia are now treated strictly as *Rabb Almaal* in a *Mudarabah*.

[39] DCR rises when an IB risks having to forgo part or all of its *Mudarib* share of profits, or even of the profits on investments funded by its own capital and current accounts, in order to 'smooth' upwards the rate of profit payout to UPSIA holders and so to mitigate the risk of withdrawals of funds by the UIAHs.

onto the shareholders. From a capital adequacy standpoint, this implies a need for the IB to hold capital to cover DCR (Archer and Karim, 2006).[40] PERs and IRRs are intended to mitigate this DCR.

3.11 The Implication of UPSIAs in Adding Risks to Islamic Banking

As noted above, an Islamic bank's capital structure is typically based on the funds of shareholders and UPSIAs,[41] which (unlike RPSIAs) are normally recognised on the balance sheet, where they take the place of deposits (although according to the AAOIFI they are classified not as liabilities but as a separate item: 'equity of unrestricted investment account holders').[42] In addition, IBs have current accounts, which are liabilities and in some cases constitute a very important source of funds. Recently, there has been an increased use of term deposits based on Reverse Commodity *Murabahah* transactions (CMT), in which the bank purchases a commodity on credit using a *Murabahah* contract and sells it immediately to raise cash. In many cases, UPSIAs are the major source of funding, and these *Mudarabah* assets, which the bank manages as the *Mudarib*, are usually commingled with other assets on the bank's balance sheet in a pool. The bank therefore has the right to the profits from these other assets as well as a *Mudarib* share (which may well exceed 50%) of the profits from the *Mudarabah* assets. In this situation, the bank's rate of return on equity is typically an order of magnitude greater than the rate of return on the UPSIA, even though the latter are exposed to the same credit and market risks as the bank on the pooled assets, with the exception of DCR, as previously explained.

[40] It should be noted that such 'smoothing' does not include the covering by the IB of overall losses on the investment funded by UPSIA, but only of *lack of profits* due to poor asset performance resulting from credit and/or market risks.

[41] CMT-based term deposits tend to be short-term. A source of longer-term funds is that of credits based on syndicated *Murabahah* (i.e. CMT), which may be securitised to facilitate the syndication. Islamic banks have also started to issue *Sukuk* as Basel-III-compatible capital instruments.

[42] As previously noted, according to IAS 32, UPSIAs fall into the category of 'puttable instruments', which are recognised by the International Financial Reporting Standards (IFRS) as a type of liability.

Haron and Hock (2007); Archer and Haron (2007) point out that DCR and *Shari'ah* noncompliance risk are unique types of risk to which IBs are exposed,[43] together with other risks that are common to both Islamic and conventional banks, such as credit and market risk. However, risks may affect each type of bank differently because of the *Shari'ah* restrictions on the risk mitigation available to IBs. For example, IBs are very restricted in how to manage liquidity risk, and although the risk is the same as that of conventional banks, the mitigations available to IBs are not the same.

3.11.1 Risks Specific to IFIs

DCR raises an issue of capital adequacy for IBs, since it implies a need for a bank to hold capital against the proportion of assets financed by UPSIAs. According to IFSB-15 (2013), this proportion is designated 'alpha'. As pointed out by (Archer *et al.*, 2010), the capital adequacy ratio (CAR) of an IB is very sensitive to any changes in the value of 'alpha'. For example, if an IB calculates its CAR without using a realistic value of alpha,[44] then the calculated CAR will not provide an accurate measure of the IB's capital adequacy. Therefore, the value of alpha depends on IB policies towards returns paid to UIAHs in relation to unsmoothed returns of UPSIAs, which result in DCR, subject to mitigation through use of a PER.

The estimation of the value of alpha requires historical data on returns to be measured accurately, and it is necessary to make the relevant data available to the banking supervisor, with public disclosure in the annual report, especially of UPSIAs concerning PERs and IRRs, to the relevant stakeholders to come up with the best realistic value of alpha, as these reflect a CG issue at IBs (Farooq and Vivek, 2012). There may be a need for a good level of disclosure about DCR, how it arises and how it is managed, in the notes to the annual financial statements, in addition to full disclosure to the supervisor. Consequently, the IFSB

[43] *Shari'ah* noncompliance risk is the risk to an IB of failing to comply with *Shari'ah* rules and principles.
[44] The IFSB Capital Adequacy Standard refers to the proportion of risk-weighted assets financed by UIAHs' funds that need to be included in the denominator of the CAR as 'alpha'.

Capital Adequacy standard (IFSB-15, 2013) proposes two forms of CAR for IBs. For example, if the UPSIAs are treated as pure *Mudarabah* investment accounts, where the UIAHs absorb all market and credit risk, then the formula excludes from the denominator of the CAR the risk-weighted assets (RWA) in respect of credit and market risk funded by UPSIAs, so that there is no capital requirement for risk arising from these assets (except for operational risk). However, if UPSIAs are treated as deposit accounts for which, owing to regulation or market pressures, UIAHs do not fully absorb the credit and market risks, then the Islamic bank has to hold regulatory capital to absorb the DCR 'displaced' from the UIAHs, and the IFSB standard requires that a proportion ('alpha')[45] of RWA for credit and market risks funded by UPSIAs be included in the denominator of the CAR. The determination of 'alpha', which is intended to reflect the bank's level of exposure to DCR, is a matter of supervisory discretion (Archer and Karim, 2012). The IFSB has published a Guidance Note on the estimation of alpha for a range of IBs (IFSB-GN4, 2011).

In fact, according to a strict interpretation of the *Mudarabah* contract, the only risk that an IB, as the *Mudarib*, should face in dealing with UPSIAs is operational risk, including the fiduciary risk,[46] which arises when an IB breaches the contract, for example by not complying with the *Shari'ah* requirements. This may represent a reputational risk, such that depositors may lose confidence in the bank and possibly withdraw their money. Also, a low rate of return compared to the market may raise a potential issue of fiduciary risk, if

[45] In practice, there are two views of PSIA characteristic of Islamic banks, depending on the jurisdiction; some may view them as deposit-type accounts that carry no risk of losses provided the bank is solvent, and other jurisdictions may view them as pure investment accounts, which bear the risk of losses on the underlying investments. The IFSB Capital Adequacy Standard recommends the fraction of alpha to be included in the denominators of the UIAHs' funds, called the capital adequacy ratio (CAR) formula, used according to supervisory discretion. For example, when Islamic banks determine alpha to be near zero, this indicates the PSIA to be an investment-type account, and alpha near one indicates a deposit-type account.

[46] Fiduciary risk (also called reputation risk) can be defined as the bank's risk of facing legal action if it violates its contract with its customers and fails in its' fiduciary responsibility to its depositors and shareholders. This risk may expose UIAHs and shareholders to economic losses, as they will lose the potential profit, since any profit accrued by the bank from non-*Shari'ah*-compliant activities will go to charity (El-Hawary *et al.*, 2004).

investors perceive that as breach of the investment contract by virtue of negligence or mismanagement of the funds by the bank (AAOIFI, 1999b).

However, for the reasons explained above, an IB may be obliged to absorb some of the profit variations (but not losses, which would not be *Shari'ah* compliant) that would otherwise be reflected in the profits attributable to the UIAHs.

3.12 Other Issues and Regulation of Islamic Banks

As indicated above, UIAHs are exposed to a potential conflict of interest on the part of the BOD and senior management of IBs, in so far as the latter may be inclined to pursue the interests of shareholders (who elect the members of the BOD) at the expense of the interests of UIAHs, who have no such governance rights. Furthermore, the members of the *Shari'ah* supervisory board are in most cases appointed by the BOD and the UIAHs have no say in this. UIAHs nevertheless have a right to expect accountability and transparency regarding the investments made on their behalf.

IBs do not have comprehensive financial reporting standards, since the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) fail to unambiguously address various issues such as the recognition of UPSIAs (on or off the balance sheet) or profit recognition in *Murabahah* contracts (on signing or on conclusion of the contract, or *pro rata temporis*), while the AAOIFI standards, which are clear on these points, are accepted only in a small minority of jurisdictions (Greuning and Iqbal, 2007; Van Greuning and Iqbal, 2008). It is fair to say that the IFSB's guidance on disclosure in IFSB-4, while it does not cover such issues as profit recognition, goes further than AAOIFI's as regards disclosure since it covers product disclosures other than purely financial ones[47].

[47] See IFSB-4 (2007) for more information.

3.13 The Gap in Empirical Research on the CG Issue of UPSIAs

The CG issues of UPSIAs have been discussed in the literature, but there is an absence of empirical work on the topic. One of the problems in doing empirical work on Islamic finance is the insufficiency of the primary and secondary data. Partly because Islamic finance only started in the 1970s and partly because there is not a very large number of such institutions around the world, this imposes quite severe methodological constraints. For example, to obtain enough observations to fit a regression model we have to use panel data, which means we cannot directly test the coefficient of variation but must use proxy measures. If similar research had been conducted for conventional finance, it would cover hundreds if not thousands of institutions and would have a much longer time series.

An examination is necessary to evaluate the CG and its role in IBs bearing in mind the potential conflicts of interest between UIAHs and shareholders and the governance rights held by the latter. The major issue is the effectiveness of the current CG practice in IBs of balancing the interests of UIAHs as a major stakeholder with those of shareholders, in protecting the rights of UIAHs to transparency and fair returns. With respect to the fairness of returns, one obvious way of doing this is to examine the risk-adjusted rates of return received by each category of stakeholder.

In principle, one would expect UIAHs as profit-sharing investors to earn a risk-adjusted rate of return on their capital not substantially inferior to that earned by shareholders. Therefore, the research tries to identify the implications for CG of UPSIAs from a practical point of view, and through certain theoretical issues, since CG is concentrated in four key principles: justice or integrity, responsibility, accountability and transparency (Hasan, 2009). According to *Shari'ah*, behaviour should be fair and equally balanced towards all stakeholders. Therefore, adopting a stakeholder model would be the best way to explain and represent the relationship of IFIs and UPSIAs. The CG practices of IFIs with respect to UPSIAs need to be investigated and it is necessary to utilise different approaches by using both qualitative and quantitative research methods to deal with the unique relationship between IFIs and UPSIAs.

3.13.1 Specific Corporate Governance Motivation

While some problems are common to financial institutions, IBs raise specific CG issues, in particular with respect to asset allocation, risk appetite, transparency in financial reporting, and potential conflicts of interest between shareholders and UIAHs. The funds of shareholders and UIAHs face the same underlying asset risk in so far as their funds are commingled with those of current accounts[48] to finance the same pool of assets, and so they raise some concerns regarding governance rights. Therefore, the motivation for this research is concern about the practices of IBs in these areas, which raise specific CG issues that cannot be mitigated within the current regulations. The research also casts light on some severe anomalies in the treatment of UIAHs, which call for urgent reform of the CG of IBs. This implies that IBs have unique CG requirements that fit their business model and that function effectively to address the issues concerning UIAHs.

This research will examine the CG issues in IBs from the perspective of stakeholder theory, especially the potential conflicts of interest between UIAHs and shareholders, by studying how effectively (or ineffectively) the current practice of CG in IBs protects the interests of UIAHs as a major stakeholder. The research will further evaluate current practices of CG in IBs in accordance with principles set out in IFSB standards and guidelines. In particular, there will be an examination of the fairness (or otherwise) of the treatment of UIAHs with respect to the percentage returns on their funds, comparing returns and risk with those of shareholders. Since information about IFIs is still limited, it is necessary to expand the scope from focusing purely on a single country to include a number of countries, including Gulf Cooperation Council (GCC) countries such as Bahrain, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates (UAE),[49] and other Islamic countries adopting Islamic financial services, such as Malaysia.

[48] The bank (i.e. the shareholders) receives the returns on assets funded by current accounts.
[49] Oman will not be included in the sample, since that country only recently opened Islamic banks and would not have sufficient data for comparison.

As indicated in the introduction, a comparison between shareholders' and UIAHs' returns will be made in chapter 4 to illustrate the decisions made by IBs, using the coefficient of variation analysis for a comparison of risk-adjusted returns. However, IBs are relatively new, hence comparison is challenging. Therefore, in chapter 5, panel data analysis is undertaken to illuminate the effect of CG on the CV difference between shareholders and UIAHs, by including several CG variables and non-CG variables that may influence the difference in return.

The inaccessibility of some information may mean that certain research methods using secondary data are difficult or impossible to apply. Therefore, research will utilise an embedded case study approach in chapter 6, with comparative analysis between KFH-Kuwait and its subsidiaries, including other IBs in Kuwait. Subsequently, chapter 7 will focus on dividend yields as a cash payout for shareholders comparable to the UIAHs' payout.

Chapter Four: Risk and Return in Unrestricted Profit-Sharing Investment Accounts

4.1 Introduction

This chapter is written from the perspective that UIAHs are remunerated on a 'profit-sharing' basis, and it aims to analyse the returns to UIAHs compared to the shareholders' returns in terms of profit sharing. The focus in this and the following chapter is on accounting returns rather than, in the case of shareholders, stock market returns. There are two reasons for this focus. First, the concept and practice of 'profit sharing' place the emphasis on accounting measures of profit. Second, the shares of the banks in this sample are not listed on exchanges in efficient stock markets. Some are unlisted, while the majority are listed on exchanges in markets that are not even weak-form efficient (Jamaani and Roca, 2015). The coefficient of variation (CV) of the annual rate of return is used to provide a risk-adjusted measure of the returns.

4.2 Overview of the Research

IBs have been in the spotlight and receiving significant attention concerning CG as an outcome of the unique characteristics of IBs' transactions, which have to be *Shari'ah* compliant (Islamic law). As mentioned in chapter 3, the use of profit-sharing contracts as an alternative to conventional deposits raises certain governance issues, especially when IBs mobilise funds through *Mudarabah* and *Wakalah* contracts, which involve the agency problem. For example, the bank's management acts as agent for the shareholders, and at the same time the bank also acts as agent (*Mudarib*) to UIAHs, which raises a potential conflict of interest for the management of IBs, due to the fact that both shareholders and UIAHs have different strategies and different levels of risk tolerance. Indeed, UIAHs may not be aware of the risk to their investment and may therefore be satisfied with a rate of return that is equivalent to the market rate of return on deposits (Nienhaus, 2007).

This situation would give the management of IBs the advantage of keeping for their shareholders the extra profit that should be paid to the UIAHs to compensate them for their investment risk exposure. In addition, the UIAHs may be aware of the risk of their investment; however, they may not have an alternative, such as the option to place their funds into a different *Shari'ah*-compliant account (for instance when KFH was the only IB in Kuwait from 1977-2005) and therefore they may be obliged to keep their funds in IBs regardless of the risks and returns. Alternative options would include the withdrawal of the funds to deposit them into other Islamic institutions, such as Islamic funds or collective investment schemes. On the other hand, it is better for depositors such as UIAHs to place their funds in investment accounts rather than just holding cash, since, according to Muslim law (as one of the five pillars of Islam), Muslims are required to pay *zakat*[50] of 2.5% annually on unused money. Therefore, it is more beneficial to place the fund into an investment account and get a return to reduce the 2.5%, or offset the percentage of *zakat* if the return is more than 2.5%.

4.3 Research Aims and Objectives

The aim in this chapter is to analyse the rates of return to UIAHs compared to the shareholders' rates of return, in terms of profit sharing, concentrating on accounting returns rather than stock market returns. Although UIAHs are major stakeholders and investors who, since they absorb the loss on the *Mudarabah* investment, bear financial risk, they nevertheless do not have any board representation or other governance rights like those of shareholders. There is no clear model that represents the specific relationship of UIAHs and IBs, since both UIAHs and shareholders are considered equity holders but with different governance rights. Archer and Karim (2007d) best described the relationship as a 'principal–principal' agency problem, which could serve as a starting point to explain the

[50] Profit share or transfer of ownership.

type of relationship between IBs and UIAHs. According to *Shari'ah* concepts of fairness imply that UIAH should have their rights as stakeholders properly acknowledged by IBs.

The objective of this research is to examine the consequences of the absence of governance rights, where UIAHs lack governance rights and may suffer from a conflict of interest with the shareholders of IBs as the BOD and management are subject to the shareholders' governance rights. UIAHs and shareholders share the same risks in the commingled fund, and in principle both should get similar rates of return relative to the level of risk, while making allowance for the bank's remuneration as asset manager. Therefore, the aim is to evaluate CG practice by examining the exercise of profit distribution between two stakeholders (shareholders and UIAHs), since both are considered equity holders. It is worth mentioning that not all IBs practise 100% commingling, which is visible from their annual reports, or have different types of accounts that use different proportions of commingling. For example, KFH-Kuwait generally invests approximately 100% of investment deposits for an unlimited period in a *Khumasia* investment account, 90% of investment deposits for an unlimited period in a *Mustamera* account, 70% of investment deposits for an unlimited period in a *Sedra* account, and 60% of investment savings accounts in a *Tawfeer* account. In another bank (Al Salam, based in Bahrain), as stated in their annual report of 2012,[51] the UIAHs' funds are commingled with the bank's own funds. Al Salam Bank then utilises the funds to invest in Islamic modes of finance as previously agreed by the terms of acceptance of the unrestricted investment accounts. Of the UIAHs' funds, 100% is employed and invested, taking into consideration the relevant weightage, and the *Mudarib* share of profit ranges between 40% and 50%. However, Al Baraka Bank, also based in Bahrain, does not mention the percentage of commingled funds in its annual report, but, as *Mudarib*, took 70% of the profits of UIAHs as the bank's share in 2012 and, similarly, up to 70% in 2011.[52]

[51] Al Salam Bank annual report 2012.
[52] Al Baraka Bank annual report 2012.

4.4 Different Levels of Risk Appetite

As equity holders, shareholders and UIAHs, have different levels of risk appetite; by nature, UIAHs are more risk-averse, even though some of the literature sees some shareholders as being risk-averse. However, even the more risk-averse shareholders are less so than either conventional depositors or UIAHs. According to Sundararajan (2008), shareholders are compared with the naive UIAHs, who are in general more risk-averse. Even though from a common sense perspective, when UIAHs receive much lower risk-adjusted returns (i.e. risk premia) which may be because of the lower degree of financial sophistication of UIAHs or because they are more constrained in the array of financial options available to them. However, since UIAHs are not profit maximisers, and are defensive investors, they cannot complain if they get much lower returns if at the same time they are facing much lower risk than shareholders, but the problem is that in a significant proportion of cases UIAHs have a higher risk-adjusted returns than shareholders, meaning that they have higher CV. It needs to be borne in mind that even when compensating for the respective levels of risk, shareholders are likely to get a "better deal" than UIAHs, because the governance structure works in favour of shareholders and does not work for UIAHs. The UIAHs do not have voice in the governance structure; all they can do is "vote with their feet" by withdrawing their funds (Archer and Karim, 2013a), although they lack the information to make a well-informed decision about doing so. Therefore, given that lower returns for UIAHs may be justifiable if at the same time they are facing lower risk than shareholders, arguably UIAHs should not complain about their returns (although they may justifiably do so about the lack of transparency).

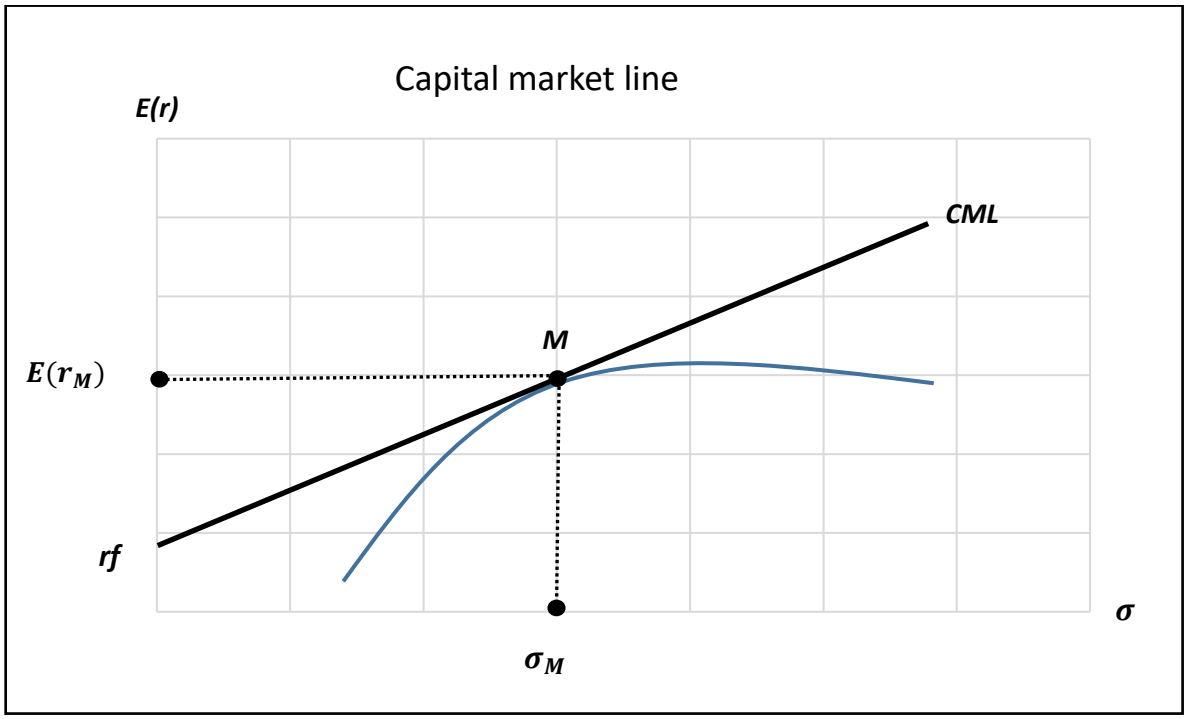
Investors who are characterised as risk-averse are typically willing to invest funds in the market at low risk and usually prefer investments that have a low risk premium (Bodie *et al.*, 2011). Generally speaking, there is a trade-off between return and risk for investors, which could be measured by the utility value that investors receive from holding the portfolio. The higher utility value is given to a portfolio with higher expected return and lower risk. For example, the capital market line (CML) was developed to show that an

efficient portfolio could be constructed by combining risky assets with a riskless asset. The slope of the CML reflects the increase in risk as a greater proportion of risky assets is included. By using a combination of risky and riskless assets, we get a straight line, which represents the efficient frontier. In fact, the CML becomes the new efficient frontier.

It is true that in their asset portfolios IBs can include some very low-risk assets, such as the Islamic Development Bank's (IDB's) *Sukuk* (AAA-rated Islamic security). The bank could use CML-type logic in constructing the portfolio; shareholders, being more aggressive, want to be more toward the market portfolio or to the right-hand side of the CML line (see figure 4-1) and UIAHs want to be further to the left-hand side toward the risk-free assets. UIAHs want to have less risk and accept less return, while shareholders tend to be more diverse and are prepared to take a risk on individual investments in expectation of a greater return. Therefore, we have two different investment mentalities, and by looking at the CML graph we can see the issue of the conflict of interest, in that the management would usually go with what the shareholders desire.

According to the CML, the management of a bank may develop its strategy based on risk aversion in their investment, which may position the management of the bank in a conflict of interest with shareholders, since shareholders desire more profit and usually desire a more aggressive investment strategy. On the other hand, if the management chooses a management strategy that is based on greater risk-taking, which in this case takes no account of the UIAHs' low risk appetite and desire for an investment strategy that is more risk-averse, this again puts the management into a conflict of interest with UIAHs. UIAHs are usually looking for a safe place to put their money and for moderate return on their money, keeping in mind that Muslim people have to pay 2.5% as *zakat* on their money if it goes untouched or unused for a whole year. This situation may create what is known in agency theory as a 'principal–principal' issue of conflict of interest, and, so far as UIAHs and management are concerned, a 'principal–agent' issue, since management tends to act more in the interest of shareholders, who have governance rights over them while UIAHs do not.

Figure 4-1: The capital market line



The capital market line (CML) shows the trade-off between risk and return of risk-free assets and market portfolios for investors – for example, an increase in the expected return with each increase of standard deviation (SD); in other words, as risk increases, the expected return would increase with it. From UIAHs' point of view they would go for a less risky portfolio towards the left-hand side of the graph toward the risk-free, while the shareholders tend to go further to the right-hand side of the CML.

M = Market portfolio

r_f = Risk-free rate

$E(r_M)$- r_f = Market risk premium

$\left[\frac{E(r_m)-r_f}{\sigma_m}\right]$ = Market price of risk

σ = Market standard deviation

4.4.1 The Rationale of Using the Coefficient of Variation

The CV and the Sharpe ratio are close in theory.

CV = SD of rate of return/(mean rate of return) – see equation 4-2 below

and the Sharpe ratio is the risk premium in the return divided by the SD:

$$Sharpe\ ratio\ =\ \frac{r_x - R_f}{SDr_x} \qquad \textbf{Equation 4-1}$$

x = Investment

r_x = Mean average rate of return of x

R_f = Best available rate of return of a risk-free security

SDr_x = Standard deviation of rate of return of x

Using the Sharpe ratio in Islamic finance is problematic; theoretically every transaction should have or should involve some risk. The closest thing to the risk-free transaction in Islamic finance would be the bank current account, which is considered *Qard Hasan* and has no return or risk to it.[53] Therefore, there is no true risk-free rate to make a comparison with in Islamic finance. However, there are AAA-rated Islamic securities (*Sukuk*), which might be used as proxies, although data for *Sukuk* is still not widely available and *Sukuk* are still traded in the over-the-counter market. This problem does not arise if the CV is used.

4.5 Research Question

Despite the fact that UIAHs may contribute the majority of the commingled fund, and they may bear the losses, except in cases of misconduct or negligence, shareholders still typically get a substantially higher accounting rate of return on their investment regardless of the risk exposure. In theory, both types of investor should at least get a rate of return relative to their risk; however, shareholders invest a relatively small portion into the funds and generally get a large share of the returns. Therefore, it is necessary to examine what drives the rate of return spread between shareholders and UIAHs, and how risk exposure motivates profit distribution to both types of investor. What explains the difference in the

[53] Empirically, there is no 'riskless asset' that produces a return. Conventionally, US 90-day Treasury bills are used as a proxy for the riskless asset.

accounting rates of return for these investors, and what influences those differences in a way that produces a significant spread between them? This chapter will attempt to answer the following question:

1. ***Does the current practice of corporate governance in Islamic banks as reflected in profit sharing show fairness of treatment of UIAHs in terms of risk-adjusted returns?***
    - ***Are the differences between the ROE to shareholders and the rates of return to UIAHs compensated for by differences in the levels of risk (volatility) of the returns, taking account of the bank's right to some remuneration as asset manager?***

Of course, there are other ways of considering and comparing rates of return, for example based on cash payouts, which are examined later in this thesis, but given the strong emphasis on 'profit sharing' in Islamic banking it seems reasonable to commence the comparison on the basis of (accounting) profits. Moreover, as regards stock market returns, another possible reason is that the relevant stock markets are ineffective. According to Sultan *et al.* (2013), the GCC stock markets are not even weak-form efficient and so do not provide a satisfactory basis for comparison.

4.6 Research Methodology

There are different methods of measuring risk within the theoretical work of portfolio theory, including variance and standard deviation (SD), which are widely used as dispersion measures (Curto and Pinto, 2009). The SD is used to measure risk (i.e. variability) in an investment that has the same expected rate of return and is the absolute measure of dispersion of returns. For example, when comparing variation between two different datasets, SD can be used only if the two compared variables have the same unit of scale and have relatively similar means. However, if the two variables have different units or different means then SD would not make sense and could be misleading; in this case, coefficient of variation (CV) would be a better test. The CV is calculated as the ratio or a percentage of the standard deviation from the sample mean and determines how much risk or volatility

is assumed in comparison to the amount of return expected from investment. The CV is used to compare risk relative to return between two or more investments if there are major differences in the expected rates of return (Chikobvu *et al.*, 2010). Indeed, unadjusted variance may give an incorrect result. For this reason, when there are two or more investments with a different mean then it is necessary to use the measure of relative variability to indicate risk per unit of expected return. In fact, CV is widely used among researchers in different fields such as engineering, medicine, agricultural economics, archaeology and financial management (Weber *et al.*, 2004). A lower ratio of standard deviation to mean return leads to a better risk–return trade-off. A larger value of the coefficient indicates greater risk (dispersion) relative to the mean rate of return. Therefore, CV can measure the risk that is associated with the expected return.

$$\textbf{Coefficient of variation} = \frac{Standard\ deviation}{Mean} * 100 \qquad \textbf{Equation 4-2}$$

In addition, SD is an absolute measure of risk, whereas CV is a relative measure and could be more useful when used in the context of more than one investment; in any investment, someone expects some percentage of profit as an expected return and most expected returns are different from actual returns. Those differences, either a loss or a gain of returns, are accompanied by risk, where the difference in return on an investment or the spread between the actual and the expected return is a measure of risk (Spaulding, 2013).

Since the percentage return for shareholders is generally much larger than that for UIAHs, it would be appropriate to use the CV to overcome this problem by adjusting for the scale of units in the population. The CV is useful because it allows for meaningful comparison between two or more magnitudes of variation, even if they have different means or different scales of measurement.

For example, if we look at KFH-Kuwait's results and use only the SD to measure the dispersion, the result shows that shareholders have more variability than UIAHs, when in

fact there is more relative variability in UIAHs' returns (as measured by the CVs) than in shareholders' returns in KFH-Kuwait from 2003 to 2012 (see table 4-1). CV may suggest that there is more relative variability in the two (percentage return to shareholders and percentage return to UIAHs), even if SD is much smaller.

Table 4-1: Mean return for KFH-Kuwait

KFH - Kuwait	*% Return to Shareholders*	*% Return to UIAHs*
Mean	16.42%	3.53%
SD	8.62%	1.97%
CV	52.49%	55.80%

Source: KFH annual report 2003–2012. CV = coefficient of variation, SD = standard deviation. Calculation of SD and CV using ROE and UIAHs' returns. Observing the SD, we can see more variation in the shareholders' returns, but, calculating the relative variation using the CV, it is clear that the UIAHs have higher variation.

4.6.1 Measuring Risk Using Coefficient of Variation Ratio

Calculating the relative risk attributed to UIAHs and shareholders as investors by using CV allows us to examine whether the rates of return paid to both types of investors in IBs accord with their exposure to risk. Our empirical data will be based on secondary data by selecting a sample of at least 28 IBs' annual reports from different jurisdictions (different countries) over the past 12 years. We are only considering retail IBs that provide UPSIAs; for example, in Kuwait there are five IBs, and we are using four of them, since Warba Bank has only recently been established and would not have sufficient data for comparison. Therefore, the four IBs represent 100% of listed IBs in the Kuwait Stock Exchange (KSE), since Warba Bank was not listed in the KSE until 2013.

In addition, four Saudi banks in Appendix A of chapter 4 are examined separately due to the fact that Saudi banks use a type of restricted investment account instead of unrestricted accounts and therefore need to be separated, even though in practice both types of accounts involve the same profit sharing, albeit without commingling of funds for risk. The different countries examined include most GCC countries, Bahrain, Kuwait, Qatar, the UAE

and Saudi Arabia in a separate section,[54] as well as Malaysia. Our data will be unbalanced since some of the IBs do not have 12 years of annual reports: some are relatively new. However, choosing a period of 12 years will be beneficial in averaging out the effects of good and bad years' performances and obtaining valid observations in order to conduct a meaningful hypothesis test.

4.6.2 Return on Equity and UIAHs' Returns

The comparison of the differences between the shareholders' return on equity (ROE) and the UIAHs' rates of return on investment is necessary to get a view of the fairness of returns. For example, testing the relationship between percentage returns to shareholders and to UIAHs in terms of risk, using profits attributable to shareholders and returns to UIAHs from the sample bank's annual reports, will give a good indication of the difference in rates of return (dividends to shareholders and cash payouts to UIAHs will be considered in chapter 7). In the case of shareholders, the ROE (see Equation 4-3) is a commonly used measure of profitability for shareholders, where the amount of net income is calculated as a percentage of shareholders' book equity, which can be compared with UIAHs' rates of return. Returns to UIAHs are ultimately (notwithstanding 'smoothing') based on the performance of management in managing its funds, and therefore the evaluation of IBs' performance is also important to the UIAHs. Measuring management performance by analysing ROE[55] would give a rational measurement of IBs' performance and management efficiency from the shareholders' point of view. A higher ROE would indicate a higher level of managerial efficiency.

[54] Oman is also one of the GCC countries; however, it is not included because Oman has only just adopted Islamic banking and will not have sufficient data for comparison.

[55] A more objective measure of management performance would be return on assets, which will be tested in the next chapter.

$$\boldsymbol{ROE} = \frac{Net\ profit\ attributable\ to\ common\ shareholders\ of\ the\ bank}{Stockholder's\ equity\ attributable\ to\ the\ common\ shareholders\ of\ the\ bank} \qquad \textbf{Equation 4-3}$$

In banks, ROE measures the efficiency of making profits from every unit of shareholders' equity/bank capital (Gul *et al.*, 2011). The relative riskiness of percentage rates of return to shareholders and UIAHs, i.e. the standard deviations, will also be measured, testing whether there is a relationship between the standard deviations and the means (or the CVs) of the percentage rates of return. In principle, one would expect higher percentage returns paid to the shareholders to be accompanied by higher volatilities of the shareholders' rates of return.

There are different ways of measuring the shareholders' returns:

1. Stock market return. In any stock market, the total shareholder returns are calculated using ending share price minus opening share price plus dividends over the beginning of the share price (the return that investors get for holding the share). However, when companies are not listed in the stock market or are listed on an inefficient stock market, using the share price change as an indicator of the shareholder returns is very questionable. In a thin or inefficient market, there is a great deal of noise in the market (this is typical for the IBs), and looking at the shareholders' rates of return in these conditions would not be informative. It is also worth mentioning that, in our sample, not all IBs are listed on the stock market and some have just recently converted to Islamic banking. Even if the bank is listed, it may not have a long history of paid dividends. Therefore, we will use the accounting measure of ROE, namely, the profit attributable to shareholders divided by shareholders' equity on the balance sheet.
2. Accounting ROE. In an efficient market, we would expect retained earnings to be reflected in the share price. The retained profits increase shareholders' equity and they normally represent a return to shareholders in terms of an increase in the share value. Retained profits increase a bank's regulatory capital and enable

it to expand its balance sheet with additional assets, which in turn would be expected to increase its future profits and hence value for shareholders. The equity belongs to shareholders but the issue is to what extent retained earnings add or create value for shareholders.

3. Dividend yield. This is the annual dividend divided by the opening share price for the year. This is used in chapter 7.

The interest here is in how UIAHs' and shareholders' rates of return vary with respect to their level of risk-adjusted rates of return, not only the different levels of the rates of return. The easiest way to measure the level of risk adjustment is by using the CV, which is the SD divided by the mean.

4.6.3 The Hypothesis

The hypothesis of the study is based on the argument that, according to the OECD definition of CG, the practice of CG should result in mitigating the conflict of interest (namely, that between UIAHs and shareholders, with the management privileging the interests of the latter) to which UIAHs may be exposed in IBs. Therefore, with respect to the risk exposure, we are assuming that if UIAHs are getting reasonable or justifiable rates of return, they should be paid according to the risk they are exposed to. Thus, the CV of UIAHs' rates of return should be no higher than that of shareholders' rates of return. Thus, a low level of the rate of return of UIAHs would be compensated for the higher stability of the returns. Hence, if UIAHs are getting a lower return on investment, and if they are also getting a more stable return on investment compared to shareholders, then the bank is treating UIAHs 'fairly': because shareholders are absorbing a higher proportion of risk, they are getting a higher return as well. In another word, if shareholders' CVs are significantly greater than UIAHs' CVs, then UIAHs are getting a better risk-adjusted return than shareholders (less risk in relation to their rates of return, which is fair on a bank-by-bank basis). Therefore, there is a sort of justice because the lower return of the UIAHs is being compensated for by lower variability.

- $\boldsymbol{H_0}$: ***Coefficients of variation are not significantly different*** between shareholder and UIAHs relating to individual banks, and if there is a difference the CV of UIAH is lower. The level of the rate of return is compensated for the relative stability of the rate of return. CV UIAHs ≤ CV shareholders; this implies fairness to UIAHs.
- $\boldsymbol{H_1}$***: Coefficients of variation are significantly different*** between shareholder and UIAHs relating to individual banks, and those of UIAH are higher. CV UIAHs > CV shareholders: 'unfairness to UIAHs'.

It is worth mentioning, however, that underlying profit attributable to UIAHs may be higher or more variable than the payout, if UIAHs do not receive the actual profit, which could be subject to 'smoothing' practices such as transfers to or from PER or IRR accounts. Underlying profits attributable to UIAHs may not be disclosed, and in any case they are not accessible to the UIAHs.

Thus, we are examining whether the risk-adjusted rates of return of UIAHs (as measured by the CV) are at least equal to or less than the risk-adjusted rates of return of shareholders, i.e. CV UIAHs ≤ CV shareholders. In other words, are UIAHs getting the level of risk that is compensated for by lower returns (or *vice versa*)? UIAHs should be paid according to the risk to which they are exposed, as the null hypothesis states, as with any normal investment where investors are willing to bear higher risk for higher returns. Therefore, if the UIAHs' rates of return are lower than those of shareholders, they should have a lower risk (standard deviation) than shareholders, resulting in a CV that is not greater. If the UIAHs were being unfairly treated as regards profit sharing, a sign of this would be that they had a greater CV of rates of return than shareholders. In addition, we use the statistical test (t-test) on the CV of the two investors to determine if there is a significant difference between the risk-adjusted rates of return on a bank-by-bank basis.

4.6.4 Test Strategy

By taking a cross-sectional approach only, we are addressing the variability between banks rather than the variability for the same bank over time. Therefore, a cross-sectional

approach will not answer our question without time-series analysis. We are interested in a time-series analysis of a given bank to find out how much in percentage terms shareholders' and UIAHs' rates of return vary with respect to their level of risk – for example, whether UIAHs are getting rates of return that are compensated by lower risk (or *vice versa*) compared to shareholders.

In terms of accounting ROE, the non-distributed or retained profit element is worth mentioning, and in chapter 7 another calculation will be made using the dividend yield (distributed profit as a percentage of market value of shares) in the numerator for the shareholders, to make rates of return comparable in cash terms. The dividend stream is generally more stable than the income stream; this is true of companies in general, which tend to maintain a level dividend payout even if their profit number is going down, trying to avoid a negative signal to the market. Since a lower dividend may send such a negative signal, the management wants to assure the market that the drop in profit does not signal any longer-term loss of profitability.

As mentioned earlier, using accounting numbers instead of the stock market returns would give more reliable results, because the stock markets are not efficient in the GCC (Hassan *et al.*, 2003; Jamaani and Roca, 2015), and in any case not all IBs are listed in the stock exchange. Furthermore, some of the listed IBs lack a sufficient history of paid dividends that can be used as empirical data. The bulk of these banks' shares are in the hands of wealthy shareholders or another Islamic or conventional bank, which do not usually trade them. In addition, some governments hold a big portion of IBs' shares and rarely if ever trade them, such as the case of KFH-Kuwait. The shares of these banks are thus not traded often and a large transaction may have a disproportionally large effect on the price. Furthermore, UIAHs' returns are not reported in the stock market, so we need to refer to the bank's notes in its annual report.

Apart from the fact that the bank is entitled to some remuneration for its work as asset manager (*Mudarib*), the higher returns that shareholders get are justified by their being

exposed to greater risks than UIAHs, partly because of 'smoothing' or DCR,[56] which has the effect of transferring variability of returns from UIAHs to shareholders. However, UIAHs are not profit maximisers as they are typically people operating savings accounts who are more interested in having safe returns than in maximising returns (somewhat like conventional deposit accounts). Even though PERs and IRRs mitigate the DCR (in effect, at the expense of UIAHs, who in profitable years are denied payouts that they otherwise would have received), the use of PERs and IRRs also serve to stabilise UIAHs' rates of return. On the other hand, shareholders are typically wealthy investors who are profit maximisers and are willing to take greater risks for higher returns. Therefore, what we are looking at is the extent to which these shareholders do in fact take on additional risk relative to their rates of return, as measured by the CV, thus justifying substantially higher rates of return. If this is not the case, it implies that the lower rates of return received by UIAHs are not a fair return in relation to the level of risk, and in fact they may be being exploited.

4.7 The Coefficient of Variation Test

The research is conducted based on samples collected from 32 IBs in six different countries (Bahrain, Kuwait, Qatar, Malaysia, Saudi Arabia and the UAE). Of the banks, 28 use UPSIAs and four Saudi banks (in Appendix A at end of chapter 4) use a type of restricted profit-sharing investment accounts (RPSIAs), since RPSIAs[57] operate on a different basis with no commingling. In total, there are more than 250 observations. We make our own computation of the returns by calculating the ROE and the rates of return to UIAHs from the banks' annual reports, unless the UIAHs' rates of return are given in the annual report. Our sample consists of banks in the five GCC countries and Malaysia, which in fact represents a significant percentage of the total global Islamic banking institutions, especially in the GCC area, which represents about 70% of the Islamic banking industry's assets (Ernst & Young, 2016). Our sample banks consist of the major players in their own countries, these

[56] For more on DCR, see Archer and Karim (2013a).
[57] RPSIAs are exposed to less risk due to the nature of the account type.

being among the first banks to have offered Islamic finance. For example, we include the largest IBs, such as KFH-Kuwait, and Al Rajhi, based in Saudi Arabia. The latter is believed to be the largest Islamic bank globally, as mentioned by the International Islamic Financial Market (IIFM)[58] Al Rajhi Bank has maintained its top ranking based on assets of over US$82 billion, followed by KFH-Kuwait with US$56.8 billion.

4.7.1 Calculating ROE and UIAHs' Returns

To calculate ROE, it is generally considered by analysts to be more appropriate to take the average of equity for the year, rather than taking the equity at the beginning or end of the year. For example, if we take the shareholders' equity at the beginning of the year and there is a big entry during the year, then we are overestimating the return. On the other hand, if we take shareholders' equity only at the end of the year and there is a big entry during the year then we may underestimate the return. Analysts have different ways of calculating the return on average equity (ROAE). The best approach to calculating ROAE seems to be to take the average of the beginning and the ending balances in the time series. Most of the IBs are required by the different accounting standards and the supervisory authority to report the beginning and ending balance of the years; therefore, taking the average of the beginning and the ending of the corresponding year would be the best way to calculate the ROAE of the year.

$$\boldsymbol{ROAE} = \frac{Net\ profit\ attributable\ to\ equity\ holders\ of\ the\ bank}{Average\ stockholder's\ equity\ attributable\ to\ the\ equity\ holders\ of\ the\ bank} \qquad \textbf{Equation 4-4}$$

The tables in Appendix H at the end of this research show the calculations of all the ROAE and the UIAHs' returns for 28 IBs following the CVs for both types of investors, plus four Saudi IBs in a separate section at the end of Appendix A to chapter 4. All numbers are taken

[58]Source: International Islamic Financial Market: 'Al Rajhi remains world's largest Islamic bank'. Retrieved 06 March 2016 from https://www.islamicfinance.com/2015/07/al-rajhi-worlds-largest-islamic-bank/

directly from the annual report of the corresponding bank for each year. One needs to bear in mind that not all IBs have a history of 12 years and therefore the calculations of the ROE and the UIAHs' returns are based on the availability of the online annual reports by the bank. Also, if the UIAHs' returns are not published in the annual report then the UIAHs' return equation *4-5* is used to calculate the returns. UIAHs' returns are based on the payout, which includes all types of investment accounts plus savings accounts, but not current or non-investment accounts.

$$\boldsymbol{UIAH\ returns} = \frac{Profit\ distributed\ to\ depositors}{Average^{59}\ value\ of\ UIAH\ depositors'\ accounts} \qquad \textbf{Equation 4-5}$$

- $\boldsymbol{UIAH\ depositors'\ account}$ = Customer deposits (less current accounts and margin)
- ***UIAHs' returns*** = profit distributed to depositors (less *Sukuk* and other irrelevant accounts)/the average of depositors' accounts of UIAHs including other investment accounts such as *Wakalah*, savings accounts (excluding current accounts).

4.7.2 Estimation Method for Calculating UIAHs' Returns

UIAHs' returns are published in the annual report; however, some banks do not disclose the percentage of the return and only have the figure for payouts to UIAHs. For the purpose of this and subsequent chapters, it is necessary to have the percentage return to calculate the CVs (this chapter) and the differences between the percentage returns of shareholders and UIAHs (chapter 5). Different methods are used by IBs to calculate the return to UIAHs. Some banks include the payout to *Sukuk*, and others include the amount of profit transferred to the 'smoothing' reserves PERs and IRRs. Therefore, it is necessary to apply a standardised method to define the percentage return. For example, banks' accountants have different

[59] The average of beginning and ending balances for the year.

ways to calculate UIAHs' returns, which are based on payouts that include all types of investment accounts plus savings accounts, but not current or non-investment accounts. The following method illustrates the methods used by different banks and, for the purposes of this research, method 1 (which takes as the UIAHs' returns the amount of profit available to UIAHs for the financial year)[60] is used to standardise our dataset to calculate the UIAHs' returns, but only if UIAHs' percentage returns are not disclosed in the annual report.[61] For example: Dubai Islamic Bank's annual report for 2011–2012 does not disclose the percentage return to UIAHs (during the time frame in the sample) and only discloses the amount available to UIAHs (this is not the actual cash payout, which appears in method 2 in Appendix B); therefore, the following methods could be used:

Table 4-2: Customer' deposit

Description	*2012*	*2011*
Current accounts	17,831,454	17,784,560
Saving accounts	11,271,332	10,848,614
Investment deposits	37,350,634	35,912,221
Margin accounts	169,007	192,765
Depositors' share of profit payable (note 18(d)) – account profit share	113,676	158,522
Depositors' investment risk reserve (note 18 (c))-not getting paid out	64,749	33,157
Total of Customers deposits	66,800,852	64,929,839

Source: annual report of Dubai Islamic Bank 2012, in AED '000s.

[60] There is another method (method 2), which uses the actual amount paid out during the financial year, which typically consists of a second instalment in respect of the previous year's entitlement plus a first instalment of the current year's entitlement (payouts being made in two instalments).

[61] For the full calculations, including other methods, see Appendix B at the end of chapter 4.

Table 4-3: Depositors' and Sukuk holders' share of profit

Description	*2012*	*2011*
Investment and savings deposits from customers (note 18 (d))	612,542	699,941
Wakalah *and other investment deposits from banks (note 22(a))*	521,624	560,788
Profit accrued on Sukuk *financing instruments (note 22(a))*	182,039	126,079
Total depositors' and Sukuk holders share of profit	1,316,205	1,386,808

Source: annual report of Dubai Islamic Bank 2012, in AED '000s. For more information, see note 43 in Dubai Islamic Bank annual report 2012.

4.7.2.1 UIAHs Method 1 for Dubai Islamic Bank 2012

Customers' profit-sharing deposits = total customer deposit – current account – margin – any other irrelevant accounts + profit equalisation provision or account

Profit distributed to UIAHs = total profit distribution – *Wakalah* and other investment deposits from banks – profit accrued on *Sukuk* financing instruments

UIAHs' return = profit to UIAHs/average of beginning and ending balances of customer accounts

Customers' deposits: (2011): 64,929,839 - 17,784,560 - 192,765 = 46,952,514

(2012): 66,800,852 - 17,831,454 - 169,007 = 48,800,391

Profit distributed to UIAHs = 1,316,205 – 521,624 (from *Wakalah*) – 182,039 (profit from *Sukuk*) = 612,542

UIAHs' return = 612,542/47,876,453 (47,876,453 = average of 48,800,391 and 46,952,514)[62] = 1.279%

Due to the nature of the accounting policy for each bank, and the different methods used to calculate the profit of UIAHs in each year (for example, some profit may not be distributed but kept until next year as a reserve instead), as stated earlier, method 1 will be

[62] Average of beginning and ending balances of customer accounts – in this case, 2011 and 2012.

used for the UIAHs' annual profit for the purposes of this research; method 1 includes total profit distributed and the amounts appropriated to PERs/IRRs and excludes amounts released from these reserves. Shifting between methods will affect the calculation adversely and will produce the wrong individual figures for each bank, which will not allow standardisation of the UIAHs' returns.[63]

4.7.3 Mean Return Between Shareholders and UIAHs

It is relevant to know whether the returns of the two classes of stakeholders are significantly different or not. By looking solely at the mean returns between the shareholders and UIAHs we can observe the vast difference in levels of return, without even considering the risk shared between them. For example, if we look at mean returns for 2002–2012 for the entire sample, we notice the spread difference in the returns for the shareholders compared to UIAHs. The results of a t-test to see whether the difference in the mean returns is statistically significant is shown in table 4-4, although the size of the difference is clear from visual inspection.

[63] Even though method 1 is the safest and most straightforward method used to calculate UIAHs' returns, it may not produce the amount actually paid out, since some banks do not disclose all the relevant information about IRR and PER activities. This may overstate the amount actually paid to UIAHs, because at least we know what it is – the UIAHs' share of profit for the year before transfers to and from PER/IRR.

Table 4-4: Shareholders and UIAHs' returns 2002–2013

t-Test: unadjusted ROE	*Shareholders*	*UIAHs*
Mean	0.08	0.03
Variance	0.01	0.00
Banks	28	28
Level of Significance	0.05	
t Stat	2.28	
P-Value	0.03**	
Standard Deviation	0.11	0.01
Coefficient of Variation	1.39	0.20

Note: the shareholders' negative returns (outliers) were not replaced with zeros, which affects the CV calculation in the next table. **The p-value is smaller than the significance level of α of 5% and the test statistic is high, both of which indicate that there is a significant difference in mean returns between shareholders and UIAHs.

However, our interest is in how UIAHs' and shareholders' returns vary with respect to their level of risk-adjusted rates of return, rather than the differences in the levels of the returns. Therefore, we need to look at the CVs to measure the levels on a risk-adjusted basis. It is worth mentioning that some IBs have existed for more than 10 years, although they only make certain annual reports available online.

Table 4-5: Coefficients of variation with unadjusted ROAE

Bank according to Jurisdiction	*Coefficient of Variation*		*Observations*
Bahrain	**Shareholders**	**UIAHs**	
Albaraka Islamic Bank	-284.36%	33.65%	6
AlSalam Bank	69.62%	85.02%	8
Bahrain Islamic Bank	-1558.03%	18.71%	12
Ithmaar Bank	14770.45%	17.95%	10
Khaleeji Commercial	217.03%	20.74%	9
KFHB	92.43%	37.56%	12
Kuwait	**Shareholders**	**UIAHs**	
Ahli United	8.17%	26.46%	4
Boubyan	13996.42%	56.27%	9
KFH	52.49%	55.80%	12
KIB	81.35%	44.27%	8
Qatar	**Shareholders**	**UIAHs**	
Masraf Al Rayan	14.25%	59.44%	7
Qatar Islamic Bank	36.47%	42.12%	12
UAE	**Shareholders**	**UIAHs**	
Abu Dhabi Islamic	45.54%	77.51%	10
Dubai Islamic Bank	45.62%	48.01%	12
Emirates Islamic Bank	165.65%	47.39%	10
Sharjah Islamic Bank	33.40%	31.88%	9
Malaysia	**Shareholders**	**UIAHs**	
Affin Islamic Bank Berhad	33.71%	22.08%	7
Alliance Islamic Bank Berhad	56.04%	26.88%	7
Bank Islam Malaysia Berhad	-468.85%	37.18%	12
Bank Muamalat Malaysia Berhad	86.56%	15.98%	12
CIMB Islamic Bank Berhad	122.67%	39.75%	9
Hong Leong Islamic Bank Berhad	29.16%	18.35%	8
KFHM	-649.62%	44.38%	9
Maybank Islamic Berhad	41.10%	45.84%	6
OCBC Al-Amin Bank Berhad	74.32%	45.35%	6
Public Islamic Bank Berhad	36.09%	50.11%	6
RHB Islamic Bank Berhad	33.52%	17.49%	9
Standard Chartered Saadiq Berhad	53.00%	39.28%	6

Note that there must be a positive result for CV for a meaningful comparison to be possible; however, there are some outliers in the ROE that affect the CV calculation, which need to be adjusted. CV outliers shown in red result from negative ROAE, and higher UIAHs' CVs are shown in green. There are six outliers (red), four negative CVs, and two large positive results from a large negative ROAE. Looking at the CVs of UIAHs' rates of return, we can see nine cases where the CV of the UIAHs' returns is higher than that of shareholders' CV. In this case, UIAHs' low level of return is not compensated for by the higher stability of the returns. Hence, UIAHs are getting a lower return on investment, when in fact they are getting more variability in the return on investment compared to shareholders; therefore, they are not being treated fairly by the bank.

4.7.4 Rationale of adjusting Outliers

To be able to calculate the CV of returns for each bank, it is necessary in some cases to replace dataset extreme negative values for shareholders' returns with zeros in the time-series, following the same methodology as Diaw and Mbow (2011), if the result of these extreme values is to make the overall mean for the time series negative or extreme positive (outliers). By treating these extreme negative returns as outliers and replacing them with zeros, we are not aiming to underestimate the variation of shareholders' returns compared to UIAHs but to gain meaningful results. If we are looking at the income by itself, then we do not make any adjustment (as in table 4-4) because we do not want to lose the information in the negative return. On the other hand, there is the case of large positive outliers, where the extreme negative value for shareholders' returns in the time series result in a very small mean return. Therefore, it is more useful to treat all negative ROEs as outliers, not just those that result in negative CVs, for three reasons:

1. It is better to avoid huge positive CVs that are obtained when negative ROEs result in very small mean returns for some banks in the time series. These huge positive CVs are outliers that distort the data.

2. There are no negative returns for UPSIAs when the bank has negative return on investment, because even if there are underlying losses these are 'smoothed' by the use of IRRs. Hence, removing all negative ROEs makes the CVs of shareholders and UIAHs more comparable.

3. Negative CV cannot be interpreted.

In fact, even after adjusting all outliers, the results did not change the classification. For example, Boubyan Bank was adjusted in 2009 only; it has an outlier of negative 59% of ROE for the shareholders, due to recording large losses resulting from provisions against

delinquent customers and impairment of some portfolio components.[64] To have sufficient CV, we replaced the ROAE of Boubyan's negative return for 2009 of -46.51% with zero that year only. Yet on the basis of the adjusted numbers, Boubyan's shareholders still had a higher CV than UIAHs' CV, indicating that on that adjusted basis the shareholders' returns were shown to be more exposed to risk than those of UIAHs (see table 4-6). In Table 4-6, CVs of banks for which the ROE for a year was treated as an outlier and replaced with a zero are shown in red. CVs of UIAH rates of return for banks that are greater than the CVs of shareholders' ROE are shown in green.

[64] According to the Boubyan Bank 2009 annual report, such precautionary provisions caused the bank to record unrealised loss of KD 51.7 million for the year 2009. Provisions made by the bank to address the impact of the global financial crisis that started in 2008 amounted to KD 66.9 million, leading to unrealised losses of KD 51.7 million.

Table 4-6: Adjusted coefficient of variation

Bank according to Jurisdiction	*CVs of % returns*		*Observations*
Bahrain	**Shareholders**	**UIAHs**	
Albaraka Islamic Bank	111.65%	33.65%	6
AlSalam Bank	69.62%	85.02%	8
Bahrain Islamic Bank	91.64%	18.71%	12
Ithmaar Bank	142.94%	17.95%	10
Khaleeji Commercial	114.82%	20.74%	9
KFHB	92.43%	37.56%	12
Kuwait	**Shareholders**	**UIAHs**	
Ahli United	8.17%	26.46%	4
Boubyan	82.49%	56.27%	9
KFH	52.49%	55.80%	12
KIB	55.10%	44.27%	8
Qatar	**Shareholders**	**UIAHs**	
Masraf Al Rayan	14.25%	59.44%	7
Qatar Islamic Bank	36.47%	42.12%	12
UAE	**Shareholders**	**UIAHs**	
Abu Dhabi Islamic	45.54%	77.51%	10
Dubai Islamic Bank	45.62%	48.01%	12
Emirates Islamic Bank	106.39%	47.39%	10
Sharjah Islamic Bank	33.40%	31.88%	9
Malaysia	**Shareholders**	**UIAHs**	
Affin Islamic Bank Berhad	33.71%	22.08%	7
Alliance Islamic Bank Berhad	56.04%	26.88%	7
Bank Islam Malaysia Berhad	111.52%	37.18%	12
Bank Muamalat Malaysia Berhad	58.37%	15.98%	12
CIMB Islamic Bank Berhad	66.33%	39.75%	9
Hong Leong Islamic Bank Berhad	29.16%	18.35%	8
KFHM	104.05%	44.38%	9
Maybank Islamic Berhad	41.10%	45.84%	6
OCBC Al-Amin Bank Berhad	70.37%	45.35%	6
Public Islamic Bank Berhad	36.09%	50.11%	6
RHB Islamic Bank Berhad	33.52%	17.49%	9
Standard Chartered Saadiq Berhad	53.00%	39.28%	6

Coefficient of variation after adjusting the negative ROAE as outliers. However, there is no change to the classification of the CV results in the adjusted banks, as the shareholders still have higher CVs. Only 24 observations with negative returns were replaced with zero, out of 247 observations. Again, in nine cases the UIAHs have CVs higher than shareholders'. This indicates that UIAHs have a lower level of risk-adjusted rate of return. Hence, UIAHs are not being treated fairly in these nine cases.

Table 4-7: Shareholders' and UIAHs' adjusted rates of return 2002–2013

t-Test: adjusted Rates of Return	*Shareholders*	*UIAHs*
Mean	0.11	0.03
Variance	0.00	0.00
Banks	28	28
Level of Significance	0.05	
t Stat	8.34	
P-Value	0.00**	
Standard Deviation	0.05	0.01
Coefficient of Variation	0.45	0.20

Note: shareholders' negative ROEs were replaced with zeros (24 observations out of 247). P-value is smaller than the significance level of α of 5% and the test statistic is high, both of which indicate that there is a significant difference in mean rates of return between the two classes of stakeholders. We may note that the mean rate of return of shareholders on the adjusted basis in this table is 11%, as opposed to 8% without the adjustment in table 4-4.

Table 4-8: T-test for the difference in CV by bank 2002–2013

t-Test	*Shareholders*	*UIAHs*
Mean	0.64	0.39
Variance	0.12	0.03
Observations	28	28
Level of Significance	0.05	
t Stat	3.40	
P-Value	0.000	
Standard Deviation	0.34	0.18

Difference in the coefficient of variation between shareholders and UIAHs for returns 2002–2013 where the p-value is smaller than the significance level of α (5%), which indicates significant difference in risk-adjusted return.

According to the data calculations from the selected IBs, one third of UIAHs' returns have higher CVs, which indicates that the UIAHs received a bad deal on a risk-adjusted returns basis compared to shareholders. This is a noteworthy proportion, which raises some important governance issues, even though for two thirds of the banks the opposite was the case. However, we need to bear in mind that we are only looking at the volatility of the risk-adjusted returns and not at the risk of capital impairment (downside risk), since it is difficult to get that information. Nevertheless, historically capital impairment cases have been rare

in IBs, although the risk is still there. For example, Arcapita Islamic Bank,[65] based in Bahrain, suffered losses in 2012 (Kary and Sharif, 2012). Even where the CV of the shareholders' rates of return is higher than that of the UIAHs, this does not take account of the UIAHs' risk of capital impairment, so it does not necessarily follow that, all things considered, UIAHs are getting a 'fair deal' in such cases, and this remains a subject for further research.

The bank is expected to look after the shareholders' interests since shareholders are the owners of the organisations and are characterised as bearing the residual risk. Even though legally, UIAHs can also be characterised as bearing this equity risk, the status of the UIAHs in the event of a bankruptcy is unclear. In the case of bankruptcy, UIAHs may be disadvantaged relative to conventional depositors, who are deemed to be creditors of the bank (El-Gamal, 2006). From the *Shari'ah* point of view, the UIAHs are the owners of the assets financed by their funds, and are comparable to secured creditors, in the sense that they have a priority claim to those assets financed by their funds. Therefore, in bankruptcy, UIAHs would not be treated as residual claimants like shareholders, but as creditors secured by their underlying assets. However, when it comes to profit sharing on an ongoing basis, UIAHs are residual claimants who share any available profit, and have no contractual right to any return. There is no legal or ethical reason why shareholders' interests should override the interests of other stakeholders. Nevertheless, it tends to be the case that shareholders have more power (e.g. the right to vote directors off the board), while the BOD is formally accountable to shareholders in annual general meetings.

We have explained above the reasons for using an accounting-based measure of shareholders' rates of return. An alternative, which we adopt in chapter 7, would be to calculate the CV of shareholders' dividends rather than the CV of ROAE. The means of the

[65] Arcapita Islamic Bank, founded in 1996 as the first Islamic investment bank, is a leading investment bank based in Manama, Bahrain that manages *Shari'ah*-compliant investment. The bank provides global investment to institutions as well as individuals, operating mainly in the United States. On March 19 2012, Arcapita and several of its affiliates filed for bankruptcy in the United States under chapter 11 to protect their assets and investment from any legal challenge, which allowed the bank to continue talks with its lenders.

dividend yields would normally be lower than the means of the ROEs, and whether or not the standard deviation is different would be another matter since dividends tend to be less volatile than earnings, and sometimes firms pay dividends despite a loss to avoid sending a negative signal to the market. However, most IBs do not have a long history of paid dividends, which makes them a problematic basis for comparison. Nevertheless, such a comparison is made later in this thesis (in chapter 7) using the available data for a subset of 20 banks.

4.8 Findings

In general, ROE is more volatile in nature than the UIAHs' rates of return, but about one third of all the banks had a higher CV for UIAHs' rates of return than for shareholders' ROE, which implies that this substantial proportion of UIAHs might have been 'taken for a ride' as they were exposed to higher relative risk with lower returns. This indicates that in a significant proportion of cases UIAHs are not being properly compensated for the level of risk they face. According to the OECD: 'Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined' (OECD, 2015). This implies that the interests of UIAHs as significant stakeholders should be reflected in the way IBs are governed so that UIAHs are remunerated according to the risks they are exposed to. Thus, if the UIAHs' rates of return are lower than those of shareholders (subject to the bank's remuneration for fund management), their rates of return should have a correspondingly lower SD and a CV less than or equal to that of shareholders' ROE. However, in our sample there is a substantial percentage where UIAHs are not doing well in these terms. For example, at KFH-Kuwait, shareholders had a CV of 52.49% while UIAHs had a CV of 55.80%. Also, in some cases the shareholders' CV is slightly higher than the UIAHs' CV, such as in Sharjah Islamic Bank, CV for shareholders is 33.40% and the CV for UIAHs is 31.88%; still, the shareholders get a considerably higher rate of return than UIAHs (shareholders' mean return 7.85% and UIAHs'

3.79%). Therefore, UIAHs are experiencing a higher level of risk in relation to their level of return by comparison. Hence we can hardly say that the UIAHs are being treated equitably. The higher rates of return that shareholders get would need to be justified by their being exposed to a higher level of risk than UIAHs.

4.8.1 Results for the UIAHs and Shareholders Hypothesis

According to the calculations for both shareholders' and UIAHs' rates of return and the t-tests in table 4-7 and table 4-8, (p-value of 0.000, which in this case is much smaller than α; significance level of 5%), we can reject the null hypothesis that there is no difference between the CVs of the UIAHs' rates of return and those of the shareholders. The justification of the lower rates of return of the UIAHs being compensated for by lower variability does not exist in a significant number, i.e. one third, of the cases examined. Although in two thirds of the cases the CVs of the shareholders' rates of return are higher, the significant proportion of CVs of UIAHs' rates of return that are higher leads us not merely to reject the null hypothesis that there is no significant difference in the CV level between UIAHs and shareholders, but also to conclude that there is an absence of 'fairness' in balancing risk and return. Normally, one might expect to find that the rates of return to shareholders (ROE) would be higher, compared to those of the UIAHs. However, one might also expect that this would be balanced by a higher variation of the shareholders' rates of return because of "smoothing" using reserves such as PER and IRR. The UIAHs would thus be expected to have a lower risk or a less volatile income stream than shareholders; however, what is surprising is that in many cases (about 33%) this does not seem to be true, which indicates that those UIAHs are getting a 'bad deal'. Although the bank's *Mudarib* share, if not excessive, could justify some difference, it would seem that there is no real justification for paying such lower risk-adjusted rates of return to UIAHs. Consequently, this situation means that UIAHs tend to be more like depositors and not, as the banks claim, investors. However, conventional depositors' funds are capital-certain (and they have rights as creditors), while UIAHs are exposed to losses. Therefore, we have two classes of investors

whose money is commingled together and exposed to the same risk but rewarded differently.

4.9 Concluding Remarks

Although the *Mudarabah* contract is in principle a profit-sharing (and loss-bearing) contract, the actual return to UIAHs is subject to management discretion since the contractual *Mudarib* share is generally very high and is treated as a maximum, which leaves scope for considerable flexibility in allocating the *Mudarabah* profits; in addition to this, accounting techniques (PERs and IRRs) may be used to produce a 'managed' return for the UIAHs. Even though UIAHs are sharing the risk, the *Mudarib* share (effectively, the management fees) may easily reach 60% or more of the profit, according to the bank's annual report. For example, Al Baraka Bank's 2012 annual report mentions that the *Mudarib* share is 70% of the profits on equity of investment account holders (funding *Mudarabah* assets) as per the terms of the UIAHs agreements. This situation is considerably different from the standards used in the conventional management funds industry. Conventional investment funds do not remunerate the fund manager through profit sharing, but charge a flat percentage of the funds under management – fees which can sometimes be very high but which are known in advance, allowing investors to 'shop around'.

In fact, Diaw and Mbow (2011) found that the rate of return to UIAHs is correlated to the corresponding conventional interest rate. Their study includes a comparison of UIAHs' rates of return and local interest rates that shows that the means and standard deviations of these are similar. The impression is given that IBs are looking at the conventional bank interest rate and trying to match to it the rate of payout to the UIAHs, regardless of the profit they make. For example, if the bank makes a high profit for the year, it will allocate the maximum *Mudarib* share to its shareholders and possibly transfer part of the profit to reserves such as PERs or IRRs so as to match the market (interest) rate of payout. The reserves are used at the management's discretion to increase the UIAHs' payouts for the year with lower profits. This use of reserves will penalise UIAHs, who are denied the return they could have been paid in a year of high profits, unless they keep their account until

there is a year of poor results, when funds are released from the reserves to increase the amount available for UIAHs' payouts. Such practices, and the lack of transparency surrounding them, are problematic from a corporate governance perspective.

Another consideration is that an Islamic bank, having a very large *Mudarib* share, which could reach 70% while the UIAHs contribute the majority of the commingled fund, can use UIAHs' funds as a form of leverage but without the risk of conventional leverage (in a conventional bank, the shareholders take on the risk resulting from leverage). In effect, shareholders in IBs may be getting (in accounting terms) three to four times the return UIAHs are getting, whereas the underlying assets have the same level of risk. Thus, in a good year, management of IBs is able to allocate most if not all of the benefit to the shareholders.

By using smoothing devices such as PERs and IRRs that are largely (for IRR, wholly) created out of the UIAHs' funds, IBs are not genuinely making the UIAHs' risk go away. The risk to the assets is still there, and the bank, as *Mudarib*, is not liable for the losses (except in cases of demonstrable negligence or malpractice). Therefore, one way of explaining what is happening is to say that IBs' managements are trying to make the UIAHs' investment (i.e. the assets in the commingled fund) appear less risky by using the smoothing techniques but are in fact 'creaming off' the higher returns associated with the actual level of risk for the benefit of shareholders, while giving the UIAHs a return using the benchmark of the returns to conventional depositors (Sundararajan, 2011). Given that the *Mudarib* share is more than half of the profit, this gives them plenty of latitude during smoothing. Also, when IBs use the smoothing technique, they make the shareholders' returns more volatile and one would therefore expect the rates of return to shareholders to be more volatile than those of UIAHs; but, as we have seen, for a substantial proportion of IBs this is not the case. Therefore, to answer the questions for the research in respect of the lack of governance rights and the absence of control rights, the consequences is that in a significant proportion of cases UIAHs are not treated in a fair manner in terms of the rates of return. Also it is clear that IBs attempt to make UIAHs' rates of return behave similarly to conventional

deposits, in terms of stability of returns and protection against losses using the PER and IRR devices.

The practice of 'smoothing' the returns to UIAHs and the acceptance of DCR by IBs may perhaps be seen as an implicit recognition that the *Mudarabah* model with a very high *Mudarib* share is less than fair to the UIAHs, and as an attempt to make it fairer. Yet the use of reserves such as PERs and IRRs to mitigate DCR works in the opposite sense, as well as being at the expense of transparency. In the cases where the CV of the shareholders' rates of return is higher than that of the UIAHs', it can be argued that UIAHs are getting a 'fair deal', because, on a risk-adjusted basis, UIAHs are getting a better level of return than shareholders. That is why, although the CV of returns is a simplistic measure, it is a powerful one as regards fairness in the context of so-called 'profit sharing'.

The fact that appears here is that the business model of the Islamic bank is questionable, insofar as the Islamic bank is trying to offer a *Shari'ah*-compliant (as opposed to conventional) deposit account, and in doing so, has introduced a product that is deeply problematic. For example, Saudi Arabia's central bank does not allow IBs to deal with UPSIAs. Also, in Qatar, the central bank instructed the IBs not to pass losses to UIAHs, even though this is not consistent with the *Shari'ah* rules of *Mudarabah* (Archer and Karim, 2009). This used to be the case in Malaysia; however, the Malaysian parliament passed a new act, in accordance with which the central bank changed its position, not merely allowing losses to be passed to UIAHs but insisting that UPSIAs should be treated as a pure *Mudarabah* investment account product (Islamic Financial Services Act, 2013). In this case, there is a clear risk of capital impairment to UIAHs; whether they have understood it or not is another matter.

One may observe that there are moral hazards involved in a retail finance product such as this because the customers do not necessarily understand the product, and even the bank staff who are selling the product may not necessarily understand it, and may not explain it clearly either, as they may simply want to sell the product. Moral hazard is understandable in conventional finance, which is not based on ethical principles, but IBs are holding

themselves out as offering ethically principled products. The view is formed that UIAHs do not deserve more than the rate on conventional deposits. The whole model used in *Mudarabah* appears to be designed to pay a low return to UIAHs for the benefit of the shareholders.

Appendix A - Restricted Investment Accounts (Special Case)

A.1 Introduction

Restricted profit-sharing investment accounts (RPSIAs) have certain CG issues, resulting from the absence of a separate legal entity to hold their funds. Therefore, this section will discuss the CG issues concerning RPSIAs. Since it is just a sub-fund of the bank, there is no protection of the type conventional investors in collective investment schemes would expect to have. For example, there is no board of trustees to represent RPSIAs, and they are at the mercy of the management of the bank. However, there is no commingling of the funds, and in a sense it is a less complicated problem for CG than UPSIAs, and a less interesting issue in the literature.

A.2 Restricted Investment Accounts of Saudi Arabia

Saudi Arabia is a special case, since they only use restricted investment accounts even though they still use *Mudarabah* to mobilise the funds of the restricted investment account holders (RIAHs) and behave more like UIAHs. Therefore, it is more appropriate to separate the Saudi Arabian accounts from those of other countries, who use the UPSIAs. Restricted investment accounts offer a product that is low risk/low return compared to UPSIAs. While it is not mentioned in the annual report, the funds in an RPSIA are not commingled and it forms a restricted fund where asset allocation is conservative and defensive. For example, the fund is utilised in specific investments such as land, buildings and real estate. Usually, the level of funds dedicated to RPSIAs is small compared to the UPSIAs used in various countries by IBs. Most of the Saudi bank funds are from the current accounts. For instance, according to Al Rajhi Annual Report (2011), 95% of the bank's total accounts were in the form of demand deposits. (See the following table.)

Table 4-9: Customer deposits fund at Al Rajhi

Type of account	2011	2010
Demand deposits	164,817,558	130,902,994
Customer time investments	5,726,461	9,527,096
Other customer accounts	2,885,446	2,633,947
Total	173,429,465	143,064,037

Source: Al Rajhi annual report 2011; demand deposits represent a non-interest current account in SAR '000s, and customer time investment is the restricted investment account. The balance of the other customer accounts includes margins on letters of credit and guarantees, cheques under clearance and transfers.

As mentioned in the Al Rajhi Bank annual reports, the bank provides RPSIAs for customer deposits, although they still use *Mudarabah* transactions to mobilise funds on behalf of customers. The RPSIA is being treated by the bank as off balance sheet items. Other Saudi banks use *Musharakah* and *Wakalah*. Therefore, three methods are used in RPSIAs at Saudi banks:

1. *Mudarabah:* where depositors theoretically absorb all losses except in the case of misconduct and negligence, and the bank does not have any money in the product but does lose work and time. The bank shares the profit and may reach up to 70% of the profit according to some annual reports, which comes very close to a rip-off because the bank can get away with paying the minimum to depositors and pocketing the rest by using accounting tricks.
2. *Musharakah:* more like a conventional partnership, involving a sleeping or inactive partner. Both partners have to put money into the product. Therefore, both the bank and depositors are exposed to losses. The losses have to be proportional to the share of capital. The losses could be *pro rata* to capital.
3. *Wakalah:* a sort of agency, asset management contract where asset managers get a fee, which is normally a percentage of the assets, plus possibly a performance bonus. In a sense, *Wakalah* tends to operate like *Mudarabah* because the agent has no money in the product and the way the fee is calculated may take account of the profit being generated.

A.3 RPSIA Finding

Al Rajhi Bank offers a low-risk deposit type of product that is a restricted investment account and presumably cannot commingle the fund with other types of funds. The asset is off a balance sheet, making it more like a managed fund, but asset allocation is designed to produce a safe return. However, the returns on the restricted account tend to be more like those of UPSIAs in practice. The CV of UIAHs at Saudi banks that use RPSIA is still high compared to the shareholders' and acts in the same way as that of UPSIAs. For example, Al Rajhi Bank deals with *Mudarabah* and its CV for UIAHs is higher than shareholders. Aljazira Bank offers *Shari'ah*-compliant banking products (non-interest based) (Aljazira, 2011), which are approved by its *Shari'ah* supervisory board, such as *Murabahah*,[66] *Ijarah*,[67] *Musharakah* and *Tawarruq*[68] and have higher CV for relating to UIAHs than for shareholders. The other two banks use *Musharakah* or *Wakalah* and their CV for UIAHs is lower.

Table 4-10: CV for Saudi Arabian banks (RPSIA)

Bank according to Jurisdiction	Shareholders' CV	UIAHs CV	Observations
Albilad Bank	200.73%	94.07%	8
Alinma Bank	69.44%	18.39%	4
Aljazira Bank	97.18%	115.37%	6
Alrajhi Bank	33.10%	43.28%	8

Higher CVs for RIAHs are shown in green. 50% of RPSIAs have higher CV than shareholders, which indicates that the RIAHs received lower risk-adjusted returns compared to shareholders. This implies that RIAHs are exposed to higher relative risk with lower returns and that RIAHs are not well compensated for the degree of risk they expose with. This also raises some important governance issues.

[66] According to Aljazira Bank's (2011) annual report, *Murabahah* is an agreement whereby the bank sells to a customer a commodity or an asset, which the bank has purchased and acquired based on a promise received from the customer to buy. The selling price comprises the cost plus an agreed profit margin (Aljazira, 2011).
[67] *Ijarah* is an agreement whereby the bank, acting as a lessor, purchases or constructs an asset for lease according to the customer's (lessee's) request, based on his/her promise to lease the asset for an agreed rent and a specific period that could end by transfer of the ownership of the leased asset to the lessee.
[68] *Tawarruq* is a form of *Murabahah* transaction where the bank purchases a commodity and sells it to the customer. The customer sells the underlying commodity at spot price and uses the proceeds for his financing requirements.

The type of restricted investment account used by some Saudi banks is intended to be a *Shari'ah*-compliant alternative to a conventional deposit account offering low risk/low return. However, the numbers for the Saudi banks seem to work out rather similarly to those for UPSIAs. Even though the bank does not mention that there is commingling of the fund, theoretically it is possible for the bank to invest in the same fund. For example, a couple of the banks mentioned *Musharakah*, which indicates that the banks have invested in the same fund. Also, the fund is supposed to be raised for the purpose of investment and to make a profit that would later be shared. In addition, insufficient transparency has been noted in Saudi banks; for example, the annual report does not mention the *Mudarib* share and we cannot assume the level of the fees or how they are calculated.

The finding of the coefficient of variation of the Saudi banks indicates that Aljazira and Al Rajhi banks have a higher CV for RIAHs than for shareholders, which again indicates that RIAHs are not compensated for the level of risk they are exposed to. Al Rajhi Bank, which is a leading bank in Islamic finance, has a CV for RIAHs of 43.28% and CV for the shareholders of 33.10%. The depositors in these banks are getting low rates of return compared to the higher risk they are faced with, keeping in mind that RPSIA holders can still lose their money in the investment by the bank. Consequently, the results for the CV of RPSIAs were not distinct from the UIAHs' results. Both types of products seem to be unfair in paying low rates of return to UIAHs, who are exposed to a higher level of risk, which works against the theory of risk–return trade-off.

Appendix B - Methods to Calculate UIAHs' Returns

B.1 Other Methods to Calculate UIAHs Returns for Dubai Islamic Bank 2012

As mentioned in chapter 4 section 4.7.2 that there are other methods used by IBs to calculate UIAHs returns. Method 2 involves adjusting the payout figure by adding the amount that is allocated but not yet distributed for the current year and subtracting the amount allocated in the previous year but distributed in the current year.

UIAHs' return = 612,542/47,891,453 (= average of 48,800,391 and 46,982,514) = 1.279%

Profit distributed to depositors = investment and savings deposits from customers (note 18(d)) + depositors' share of profit payable for current year (note 18(d)) - depositors' share of profit payable for previous year (note 18(d))

Profit attributable to depositors = 612,542 + 113,676 – 158,522 = 567,778

UIAHs' return = 567,778/47,891,453 = 1.186%

B.2 UIAHs Method 3 for Dubai Islamic Bank 2012

This method involves using the amount of profit actually paid out after transfers to the IRR, which may not be very accurate, however for the illustration purposes we thought to include it.

Profit distributed to depositors = profit paid during the year - *Wakalah* and other investment deposits from banks and customers - profit accrued on *Sukuk* financing instruments

Table B-1: Movement of depositors' share of profit

Description	*2012*	*2011*
Depositors' share of profit for the year (note 43)	612,542	699,941
Net transfer to depositors' investment risk reserve IRR (note 18 (C))	(33,305)	(33,647)
Sub total	579,237	666,294
Less: Amount paid during the year	(465,561)	(507,772)
Balance at 31 December (note 18 (a))	113,676	158,522

Movement of depositors' share of profit payable during the years ending 31 December 2012 and 2011.

Profit distributed to depositors = 465,561 + 113,676 – 158,522 = 42,0715

UIAHs' return = 420,715/average 48,800,391 + 46,982,514 = 0.879%

B.3 Concerns with other Calculation Methods

If we take the profit paid during the year only, such as in method 3, and deduct the *Wakalah* and *Sukuk* amounts that contain the year's undistributed profit for *Wakalah* and *Sukuk* only, this will not give an accurate profit. See table below:

Table B-2: Another movement of depositors' share of profit

Description	*2010*	*2009*
Share for the year	1,435,631	1,739,197
Less: Pertaining to depositors' profit equalization provision (note 53)	(511)	(II ,636)
Transfer from depositors' profit equalization provision PER (note 53)	42,000	195,500
Total	1,477,120	1,923,061
Less: Paid during the year	(1,147,192)	(1,558,921)
Depositors' share of profit payable (note 25)	329,928	364,140
Investment and savings deposits from customers	996,491	1,176,329
Wakalah *and other investment deposits from banks and customers*	409,884	529,138
Profit accrued on Sukuk *financing instrument*	29,256	33,730
Total	1,435,631	1,739,197

Source: annual report of Dubai Islamic Bank 2012, in AED '000s. For more information, see note 43 in Dubai Islamic Bank's 2012 annual report.

Profit distributed to depositors 2010 = 1,147,192 - 409,884 – 29,256 = 708,052

UIAHs' return = 708,052/average of 48,800,391 and 46,982,514 = 1.443%

- Compared to 2010, UIAHs' return in method 1 of 2.03% includes only the individual customers and contains undistributed profit to individual UIAHs only.

On the other hand, if we take the profit payout for investment and savings deposits from customers plus depositors' share of profit payable for current year less depositors' share of profit payable for previous year,[69] this, again, will not give an accurate profit figure, since the depositors' share of the profit payable is already included in the denominator. (See table 4-2, customers' deposits.)

Customers' deposits: 66,800,852 - 17,831,454 - 169,007 = 48,800,391

[69] The numbers for payout are adjusted to take account of the part of this year's profit that is distributed next year, minus the part of last year's profit that is distributed this year.

Chapter Five: The Impact of CG on Return Difference

5.1 Introduction

This chapter will examine the extent to which some CG and financial variables explain the difference in rates of return between shareholders and UIAHs, using panel data analysis. The benefit of using the panel data regression is that it has the dimension of both time-series and cross-sectional data, which increases the sample size considerably, with less collinearity among variables, while increasing the degrees of freedom (Wooldridge, 2010). Time-series data is collected over time on one or more variables; cross-sectional data involves one or more variables collected at a single point in time (Brooks, 2008). Therefore, the use of panel data would increase the number of observations that fit the model. For example, if we use time-series data, we have only 12 observations, which would be insufficient and would not allow sufficient degrees of freedom to run a regression. On the other hand, if we use cross-sectional data we only have 28 observations; this is because, to calculate for each bank the coefficient of variation (CV), which is standard deviation (SD) over the mean, we need to calculate each year's average return and its corresponding SD. Therefore, neither time series nor cross section would provide results that might fit a model. Through using panel data, we will obtain about 250 observations;[70] however, in order to do that we need a proxy for the CV. As indicated below, the difference in the rates of return between shareholders and UIAHs would be a good proxy since there is a strong correlation between the CV and the difference in the rates of return; in addition, the denominator of the CV is the average return of the entire period for each bank.

[70] Only cover retail banks that deal with UPSIAs, not including any investment banks, Islamic windows, or non-retail banks in GCC and Malaysia. For example, Kuwait has about 18 IFIs, and among them are only five Islamic banks that deal with UPSIAs (one just recently emerged). We use all the retail banks except the most recent since it does not have data for comparison.

Furthermore, panel data regression has the benefit of taking heterogeneity into account (since panel regression relates to individuals over time) by explicitly allowing individual specific variables (Gujarati, 2012). It is more effective to measure the effects between variables and enrich empirical analysis, which cannot usually be done using time series or cross-sectional analysis by themselves. Another good reason to use panel data regression (especially in Islamic finance, where most IBs are relatively new or recently converted to Islamic banking) is that such banks may not have sufficient data for comparison, and therefore it would be advisable to use the panel data approach to reduce the effect of the small number of observations. Since not all banks in our sample have existed for 12 years, our data will be unbalanced.[71] Using panel data regressions will be a better estimator with the type of data observed than just time series or cross-sectional analysis as a single regression, to compare the difference in rates of return between shareholders and UIAHs as a dependent variable. For example, using a fixed effects model in the panel regressions would differentiate the intercept associated with each bank (such as bank jurisdiction or management policy), providing a better estimator of the returns in different IBs. Similarly, rates of return may depend on the profitability of the bank in different geographical markets and on the CG practices used in each bank, which also could be included in the panel data model as independent variables that may affect the dependent variable, namely, the difference in the rates of return between shareholders and UIAHs.

5.2 Specific Research Aims and Objectives of this Chapter

Investors usually invest some of their wealth for expected return in the future, bearing the risk associated with investments. Even though there is a difference between the expected return and the actual return received, the higher risk assets typically offer higher expected return (Bodie *et al.*, 2011). Finance theory (risk–return trade-off) suggests an increase in risk is usually accompanied by an increase in returns, i.e. a positive risk–return relationship.

[71] Because we do not have the same number of time-series observations (number of years observed) for each cross-sectional element (number of banks), there are fewer observations for some banks than for others.

Therefore, by examining this trade-off to compare the return to both shareholders and UIAHs (since they both share the same risk in the commingled funds) we can examine the risk-adjusted returns in our model. Therefore, the aim here is to conduct an empirical study applying a panel data model to test certain relevant CG variables which could have influenced the difference in rates of return that was tested in chapter 4.

By applying panel data, we can ascertain if any control variables influence the proxy measures for spread in CVs. What we are seeking here via the proxies is explanations of why the CV of the UIAHs is greater than the CV of shareholders in a number of cases, since this is an issue for CG. If we take the CV of return to equity holders and deduct the CV of the return to UIAHs, we would expect to find a difference that is positive or zero. Since the denominator of the CV is the mean return, we use as proxy measures the differences in the rates of return between shareholders and UIAHs.

One issue is that if we look at the mean percentage payouts to UIAHs, they are all very low. For example, if we look at the way the CV is calculated (SD/mean) and if the bank is paying a return of only 2% to UIAHs, which is a low mean, then it does not take much SD to produce a big CV. Thus, what drives the higher CV for UIAHs is the much lower payout to UIAHs, and the shareholders receive substantially bigger payouts that can absorb more variability, in the sense that, as the payout is bigger, the denominator can absorb a bigger SD. Given the role of the low rates of return to UIAHs in driving a higher CV for UIAHs, this raises the question of why the rates of return are low. To answer this question, it is perhaps better to compare the rates of return on conventional deposits offered by the conventional banks in various countries with the rates of return for the UIAHs. In fact, according to a study by Diaw and Mbow (2011), some of the IBs match what the conventional banks are paying, which might be considered normal from a competitive standpoint. However, considering the difference in the level of risk taken by the depositors in both type of banks, we would expect that IBs would pay significantly higher returns to UIAHs on average, although there would be variation in returns between years.

Since we are testing the actual payout to UIAHs then we have to consider the negative returns (outliers) to shareholders because the minimum payout to UIAHs cannot be less than zero (although an underlying loss might have occurred).[72] This may lead to the question of whether the real variability of returns is actually greater. This may be the case but, if so, what exactly happened to the UIAHs' returns? There could be losses which reduce UIAHs' capital but these losses are not disclosed because of the way returns to UIAHs are calculated and the use of smoothing techniques (including IRRs and PERs) by IBs. We cannot actually see if there have been any losses since it is not visible information to the public. For example, the 2009 annual report of Al Baraka Bank, based in Bahrain, showed a loss of US$26,463,032; however, the bank still paid out a 5.62% share of profit to UIAHs after its *Mudarib* fee and transfer from reserves. Therefore, although a loss may occur at a particular bank in a specific year, because of the pooling effect, which entails a loss for the shareholders but not for UIAHs, at Al Baraka bank, the UIAHs showed a positive result because of smoothing.

Even if we keep the negative returns in ROE, there would be differences in returns, and shareholders would mostly have higher returns (see table 4-4, p. 87). On average, shareholders would have 8% and UIAHs would have 3%, but for comparability we will substitute the negative outliers of ROE (for shareholders) with zero as we did for the calculation of the CVs (see chapter 4), in order to be consistent and gain a meaningful result, as explained in more depth later.[73] On this basis, the average rate of return to shareholders is 11%. Thus, the key question is:

1. ***To what extent would CG and non-CG variables explain the differences in rates of return between shareholders and UIAHs?***

[72] See methods to calculate ROE in Appendix C to chapter 5.
[73] It is true that UIAHs' actual payout cannot be negative (although there may be a loss) but for shareholders there can be a negative ROE. Likewise, stock market returns can be negative.

For example, country could be a non-CG factor because regulators (central banks) in different countries may have different policies. Country as an external factor would be imposed rather than being chosen. Bahrain, for instance, does have a special law for Islamic finance. However, Saudi Arabia does not yet have one, and the UAE only recently issued a law dedicated to IBs. On the other hand, anything that deals with the BOD contains an element of choice. For example, in the sample countries, as per central bank regulations and IFSB-3 (2006) recommendations, there is the question of whether the BOD sets up a governance committee attached to itself, which could be addressed by analysing the annual report. Another characteristic of the BOD is the proportion of the non-executive directors, board size and CEO-chair duality as elements of independent variable. In contrast, *Shari'ah* boards of IBs deal with the *Shari'ah* compliance of products (KFH-Bahrain, 2011); these activities of the IBs are mentioned in their annual reports.[74]

Since the BOD has the fiduciary responsibility and is expected (with the senior management which is answerable to it) to create value for shareholders, as well as protecting the interests and rights of other stakeholders such as UIAHs (IFSB-3, 2006), this research focuses on some CG vehicles such as leadership structure (CEO-chair duality and proportion of non-executive directors). In terms of Islamic banking, one reason why central banks' regulations exist is because regulatory and supervisory authorities are responsible for making sure an adequate CG framework is in place to protect the interests of other stakeholders, such as the rights of UIAHs. Therefore, the regressions may show whether the control variables

[74] KFH-Bahrain mentioned in their 2011 annual report that 'The *Shari'ah Fatwa* & Supervisory Board is responsible for ensuring that all the products, services, investments and related policies and agreements of the Bank are in compliance with *Shari'ah* rules and principles (including AAOIFI standards). Before launching any new products or services, the related policies and agreements shall be verified by the *Shari'ah Fatwa* & Supervisory Board in coordination with the senior management. It is the responsibility of the *Shari'ah Fatwa* & Supervisory Board to provide guidelines, formulate policies and conduct annual *Shari'ah* audits in order to ensure the Bank's compliance with all *Shari'ah* principles. Brief responsibilities of the *Shari'ah Fatwa* & Supervisory Board are outlined in the Articles of Association'.

have any explanatory power for the differences in the rates of return[75]. IBs have a fiduciary duty towards UIAHs no less than to shareholders, as mentioned in IFSB-3 and other IFSB standards (IFSB-3, 2006).

5.3 Correlation Coefficient Analysis

The correlation coefficient can show that there is a relationship between two variables, and the value of the correlation coefficient lies in the range $-1 \leq r \leq +1$ (Mann, 2011), measuring the degree of linear association between the two variables (Brooks, 2008). As noted above, the difference in mean levels of return between the banks is a main driver of the differences in CVs. Thus, we show in Figure 5-1 on page 118 that there is a high correlation (nearly 60%) between the two variables, which allows us to use the difference in returns as a proxy to capture the variability in CV and see whether any CG variables help to explain a high level of CV in the UIAHs.[76]

5.3.1 Rationale for Adjusting ROE Outliers

The results of the CV calculations remain the same as in the previous chapter, as in a few cases a negative ROE return for shareholders was replaced with zero (adjusting the losses to zero), for two reasons. First, if we end up with a mean result of less than zero for a bank for the time series, then we cannot calculate a meaningful CV of the returns for that bank, since a negative CV cannot be interpreted. Hence, we have to adjust some large losses

[75] The differences of the level of returns were used as a proxy for the differences in CVs, because of the way CV is calculated, which gives one CV for each bank in the entire period. While neither time series nor cross section would provide results that might fit a model, by applying panel data, we get about 250 observations. The difference in the returns between shareholders and UIAHs would be a good proxy while there is a strong correlation between the CV and the difference in the return.

[76] Correlation between the difference in returns and the difference in CV, as shown in the tables at the end of chapter 5 in Appendix D, where the results of the correlation coefficient between column 8 (difference in CV between shareholders and UIAHs) and column 9 (difference in returns between shareholders and UIAHs) equal -59.2%, representing a relatively strong negative relationship. For example, when the difference in UIAHs' CV tends toward negative, the difference in returns tends toward positive.

(outliers) to avoid having a negative CV or huge positive CV. Second, the way that UIAHs' return is calculated eliminates any negative results, because even if there are losses (impairment of capital) these are not visible as we simply look at the actual payout rather than the impact on the UIAHs' capital. For example, when the bank uses PERs, IRRs and all the smoothing devices, any losses would not be recognised or disclosed, even though the IFSB has recommended the disclosure of the smoothing techniques used by IBs (IFSB-GN3, 2010). In other words, the time-series returns to UIAHs are to a significant degree the results of management decisions on accounting treatment, by virtue of which no negative returns are reported. Therefore, to achieve comparability it is preferable to do the same thing to the time series of accounting returns to shareholders. In addition, both the CV mean and returns mean for shareholders were adjusted (where a loss is converted to a zero result), which makes the data in this chapter consistent with each other[77] and with those in chapter 4.

5.3.2 Treatment of ROE Outliers

A total of 24 losses out of 247 ROE observations are adjusted,[78] where all shareholders' losses are converted to zero. It might be argued that the semi-adjusted ROE (removing losses only if they are outliers and producing negative CV) would be more appropriate, as removing all the losses, including the normal losses, may take information out of the data. However, when there is a loss to the bank, given the argument about the profit sharing, there should also be a loss to the UIAHs; yet this loss is covered up by the use of reserves. As the losses to the UIAHs are being covered up, then arguably it is reasonable to remove

[77] The results of the unadjusted ROE would be in chapter 5's Appendix C, Table 5-14, where ROA is still the main player, and R^2 = 85%, even with a high number of outliers in the negative ROE. For example, in 2006, the bank Islam Malaysia Berhad had a negative ROE for more than %573 to shareholders, which produced a big outlier. Therefore, for better comparability to UIAHs, we prefer to use adjusted accounting ROE due to the reasons already mentioned. Also if there is no profit to shareholders then there will be no profit to UIAHs either, but because of smoothing devices such as PERs and IRRs.

[78] See Appendix C at the end of chapter 5 for more detailed calculations.

the losses to shareholders (negative ROEs) to increase the comparability. A more valid comparison, if available, would be actual losses to the UIAHs, but these cannot be accessed due to the lack of transparency of the UIAHs' data and due to losses having been covered up by the use of reserves.

In addition, if we do not fully adjust the ROE for losses and simply remove the negative outliers, we still get some outliers in the CVs, because some banks would have a positive CV with a very small mean return, which produces an enormous positive CV.[79] For example, Boubyan Bank had a negative ROE in 2009 of -49%, and if we calculate the mean ROE and the CV by including the 2009 ROE, it would give a CV of 13996.42%, which is again an outlier but on the positive side. Therefore, this is a further reason for using fully adjusted ROE rather than semi-adjusted ROE and, for a reasonable comparison to UIAHs' CV, these outliers should also be adjusted to avoid extreme positive ROEs.

On the other hand, some might argue that adjusted ROE does not give a true picture when we look at the shareholders' rates of return, as this understates the variability of the shareholders' returns by taking out all the losses. We have two different situations: the comparison with rates of payout to UIAHs, since it is the only information available from the annual report, and the comparison with accounting rates of return, which are not the same thing as the rates of payout. Thus, as noted above, since the UIAHs' returns that are reported exclude any losses (using the IRR where necessary), for the sake of comparability it is logical to likewise adjust the shareholders' returns to exclude losses. Thus, the ROE of the shareholders and the return to the UIAHs are both accounting returns, although the accounting for the UIAHs is subject to smoothing and corresponds to actual payouts.

[79] See Table 5-15, Appendix C.

However, the other approaches (unadjusted and semi-adjusted ROE test) appear in Appendix C to chapter 5. The objective is to show both methods of treating ROE and the results of using each method. These do not affect the conclusions.

Table 5-1: Adjusted accounting returns to shareholders as percentages

Bank	2002	2003	2004	2005	200	2007	2008	2009	2010	2011	2012	2013	Bank ROE Ave
BARK	NA	NA	NA	NA	NA	NA	0.014	0.000	0.031	0.011	0.000	0.006	1.04%
SALM	NA	NA	NA	NA	0.1	0.156	0.154	0.075	0.036	0.002	0.051	0.056	8.13%
BAHN	0.058	0.063	0.080	0.118	0.1	0.191	0.126	0.000	0.000	0.000	0.000	0.083	7.47%
ITHM	NA	NA	0.160	0.158	0.3	0.111	0.022	0.000	0.000	0.000	0.000	0.000	7.86%
KHAJ	NA	NA	NA	0.121	0.2	0.235	0.200	0.023	0.000	0.004	0.006	0.000	8.88%
KFHB	0.068	0.087	0.238	0.261	0.2	0.258	0.150	0.009	0.021	0.019	0.026	0.015	11.81%
AHLI	NA	NA	NA	NA	NA	NA	NA	NA	0.120	0.124	0.141	0.139	13.10%
BOU	NA	NA	NA	0.064	0.0	0.145	0.014	0.000	0.038	0.033	0.040	0.051	5.30%
KFH	0.208	0.213	0.244	0.256	0.2	0.288	0.128	0.096	0.084	0.062	0.067	0.076	16.42%
KIB	NA	NA	NA	NA	0.0	0.120	0.123	0.000	0.091	0.054	0.062	0.060	7.19%
MASF	NA	NA	NA	NA	NA	0.231	0.169	0.151	0.185	0.180	0.166	0.177	18.00%
QATR	0.239	0.301	0.288	0.285	0.3	0.283	0.279	0.164	0.147	0.134	0.109	0.114	22.19%
DHABI	NA	NA	0.082	0.196	0.2	0.188	0.154	0.014	0.154	0.139	0.113	0.113	13.92%
DUBAI	0.102	0.143	0.197	0.317	0.2	0.264	0.162	0.136	0.060	0.109	0.123	0.135	16.69%
EMIT	NA	NA	0.024	0.061	0.1	0.208	0.275	0.060	0.022	0.000	0.032	0.041	8.51%
SHAJ	NA	NA	NA	0.088	0.0	0.139	0.073	0.062	0.062	0.057	0.061	0.068	7.85%
AFFN	NA	NA	NA	NA	NA	0.182	0.112	0.099	0.063	0.109	0.130	0.087	11.19%
ALLN	NA	NA	NA	NA	NA	0.046	0.046	0.223	0.127	0.143	0.098	0.090	11.04%
ISLM	0.033	0.073	0.066	0.000	0.0	0.631	0.331	0.114	0.204	0.141	0.146	0.153	15.76%
MUAT	0.028	0.010	0.000	0.063	0.1	0.066	0.044	0.082	0.074	0.100	0.060	0.060	5.88%
CIMB	NA	NA	NA	0.000	0.0	0.102	0.103	0.153	0.273	0.206	0.188	0.146	13.19%
HONG	NA	NA	NA	NA	0.0	0.100	0.101	0.106	0.108	0.079	0.110	0.180	10.79%
KFHM	NA	NA	NA	0.001	0.0	0.047	0.045	0.000	0.000	0.000	0.041	0.063	2.41%
MAY	NA	NA	NA	NA	NA	NA	0.069	0.168	0.096	0.100	0.205	0.191	13.83%
OCBC	NA	NA	NA	NA	NA	NA	0.000	0.085	0.094	0.065	0.117	0.202	9.38%
PUBC	NA	NA	NA	NA	NA	NA	0.085	0.278	0.238	0.232	0.187	0.146	19.45%
RHB	NA	NA	NA	0.073	0.1	0.170	0.109	0.073	0.072	0.084	0.103	0.089	10.17%
STAD	NA	NA	NA	NA	NA	NA	0.015	0.050	0.125	0.120	0.132	0.092	8.89%

Note: for a suitable comparison to UIAHs' rates of return, we prefer to substitute all the negative ROEs with zero as described above (24 observations out of 247). However, the unadjusted and semi-adjusted calculation results are presented in Appendix C to chapter 5. The table shows the percentage return on equity for the shareholders in each tested bank.

Table 5-1 above shows the annual rates of return to shareholders (ROE) for each bank, which are used to calculate the mean rates of return to shareholders, for comparison with the UIAHs' returns in table 5-2. Correspondingly, in table 5-2, below, when UIAHs have a higher CV (UIAHs are not 'treated well' in returns), the difference in CV between shareholders and UIAHs is negative. Also, when the CV difference is negative, the difference

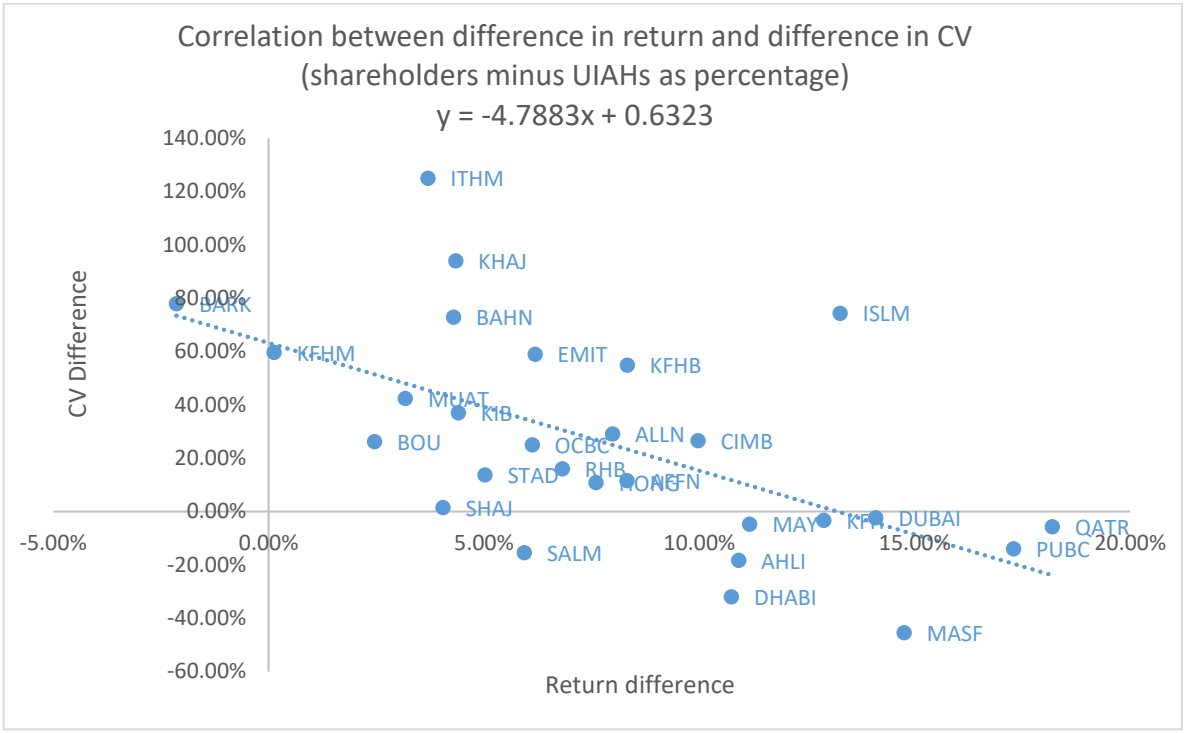
in rates of return would be high, meaning shareholders enjoy a larger rate of return compared to a lower rate of return to UIAHs; this will result in a strong negative relationship between CV and returns. Therefore, a high CV for UIAHs also accompanies a low rate of return to them. As already noted, a low rate of return produces a small denominator for the CV, which cannot absorb much variance without producing a large CV.

Table 5-2: Rates of return and coefficients of variation for shareholders and UIAHs

2002-2013	Shareholders			UIAHs			Differences (shareholders – UIAH)	
IBs	**Mean**	**SD**	**CV**	**Mean**	**SD**	**CV**	**Mean diff**	**CV diff**
BARK	1.04%	1.16%	111.65%	3.18%	1.07%	33.65%	-2.14%	78.00%
SALM	8.13%	5.66%	69.62%	2.19%	1.87%	85.02%	5.94%	-15.40%
BAHN	7.47%	6.84%	91.64%	3.18%	0.59%	18.71%	4.29%	72.93%
ITHM	7.86%	11.23%	142.94%	4.15%	0.75%	17.95%	3.70%	124.99%
KHAJ	8.88%	10.92%	114.82%	4.53%	0.94%	20.74%	4.34%	94.08%
KFHB	11.81%	10.92%	92.43%	3.48%	1.31%	37.56%	8.33%	54.87%
AHLI	13.10%	1.07%	8.17%	2.19%	0.58%	26.46%	10.91%	-18.29%
BOU	5.30%	4.37%	82.49%	2.83%	1.59%	56.27%	2.46%	26.21%
KFH	16.42%	8.62%	52.49%	3.53%	1.97%	55.80%	12.89%	-3.31%
KIB	7.19%	3.96%	81.35%	2.79%	1.23%	44.27%	4.41%	37.08%
MASF	18.00%	2.52%	13.98%	3.24%	1.93%	59.44%	14.75%	-45.46%
QATR	22.19%	8.09%	36.47%	3.99%	1.68%	42.12%	18.20%	-5.66%
DHABI	13.92%	6.34%	45.54%	3.17%	2.46%	77.51%	10.75%	-31.97%
DUBAI	16.69%	7.61%	45.62%	2.60%	1.25%	48.01%	14.09%	-2.38%
EMIT	8.51%	9.06%	106.39%	2.32%	1.10%	47.39%	6.19%	59.01%
SHAJ	7.85%	2.62%	33.40%	3.79%	1.21%	31.88%	4.05%	1.52%
AFFN	11.19%	3.77%	33.71%	2.86%	0.63%	22.08%	8.32%	11.63%
ALLN	11.04%	6.19%	56.04%	3.06%	0.82%	26.88%	7.99%	29.16%
ISLM	15.76%	17.57%	111.52%	2.48%	0.92%	37.18%	13.27%	74.35%
MUAT	5.88%	3.43%	58.37%	2.71%	0.43%	15.98%	3.17%	42.39%
CIMB	13.19%	8.75%	66.33%	3.22%	1.28%	39.75%	9.97%	26.58%
HONG	10.79%	3.15%	29.16%	3.19%	0.59%	18.35%	7.60%	10.81%
KFHM	2.41%	2.50%	104.05%	2.28%	1.01%	44.38%	0.12%	59.67%
MAY	13.83%	5.68%	41.10%	2.66%	1.22%	45.84%	11.17%	-4.74%
OCBC	9.38%	6.60%	70.37%	3.26%	1.48%	45.35%	6.12%	25.02%
PUBC	19.45%	7.02%	36.09%	2.16%	1.08%	50.11%	17.29%	-14.02%
RHB	10.17%	3.41%	33.52%	3.35%	0.59%	17.49%	6.82%	16.03%
STAD	8.89%	4.71%	53.00%	3.87%	1.52%	39.28%	5.02%	13.72%

Note: CV = standard deviation over the mean rate of return as a statistical tool to measure risk-adjusted rates of return. There are nine negative (in red) differences between shareholders' and UIAHs' CVs, which indicates that UIAHs are not treated fairly in rates of return. Shareholders ROE are adjusted to be comparable with UIAHs' rates of return (shareholders' negative annual returns adjusted to zero).

Figure 5-1: Correlation between the differences in CV and the differences in returns



The graph shows the correlation between the differences in the coefficient of variation (shareholders' CV – UIAHs' CV), and differences in rates of return (shareholders' rates of return – UIAHs' rates of return). The dataset is scattered where relationship across time and across banks is indirect. The slope of the line is negative, indicating a fairly strong linear correlation where (r) is -59.2%. The point here is to show that the dependent variable 'Return difference' is a good proxy for the CV difference.

According to the rule of thumb used by statisticians such as Mann (2011), the strength of relationship is considered high if it is more than 50%, since in the real world we do not usually encounter perfect positive or perfect negative correlation. In our case we have nearly -60%, which indicates that we have a relatively strong negative relationship between differences in rates of return as proxy and the differences in CVs that we want to test. A smaller difference in CVs (such that the CV of UIAHs is close to, or even greater than, the CV of shareholders) is associated with a higher rate of return difference. Thus, when UIAHs have a higher CV they will also tend to have a lower rate of return compared to shareholders.

5.3.3 The Differences in Returns for Both Stakeholders

The t-test can show that there is a significant difference in the rates of return between shareholders and UIAHs. This difference in rates of return can be used as a proxy to examine the differences in the CV between shareholders and UIAHs, using panel data analysis, since there is a fairly strong correlation between them, as mentioned earlier. For example, table 5-3 shows time-series observations, the average yearly rates of return for each individual bank observation (28 banks) and the means averaged across the 12 years from 2002 to 2013.

Table 5-3: T-test for the difference in returns by bank sample 2002–2013

Difference between shareholders and UIAHs returns for the entire sample			
Time series mean returns by bank			
	Shareholders		*UIAHs*
Mean	0.11		0. 03
Variance	0.0025		0.0000
Observations	28		28
Significance level	5%		
t-statistic	8.3353		
One-tail	0.0000		
t-critical one-tail	1.7011		
Two-tail	0.0000	**	
t-critical two-tail	2.0484		
Standard deviation	0.0495		0.0062
Coefficient of variation	0.4525		0.2026

**The p-value is much smaller than α at the level of 5%, which indicates that there is a significant difference between shareholders' and UIAHs' returns for the entire sample of banks. It can be seen that there is a large difference between shareholders' mean returns of nearly 11% versus UIAHs' mean returns of 3%.

The interesting part of the result is that the shareholders' rates of return are significantly higher compared to UIAHs' rates of return, even though the risk is similar in many aspects (Diaw and Mbow, 2011). Also, as can be seen from table 5-4 below, the larger the difference between shareholders' ROE and UIAHs' rate of return, the more likely it is that UIAHs' CV will exceed the CV for shareholders. With the exception of two banks, ISLM and SALM, all the banks with the larger differences between the ROE and the UIAH rate of return also have the UIAHs' CV exceeding that of the shareholders.

Table 5-4: CV and return differences

Islamic banks	Shareholders CV	UIAHs CV	CV differences	Shareholders return	UIAHs return	Return differences
PUBC	36.09%	50.11%	-14.02%	19.45%	2.16%	17.29%
QATR	36.47%	42.12%	-5.66%	20.38%	3.82%	16.56%
MASF	13.98%	59.44%	-45.46%	18.00%	3.24%	14.75%
DUBAI	45.62%	48.01%	-2.38%	16.69%	2.60%	14.09%
ISLM	111.52%	37.18%	74.35%	15.76%	2.48%	13.27%
KFH	52.49%	55.80%	-3.31%	16.42%	3.53%	12.89%
MAY	41.10%	45.84%	-4.74%	13.83%	2.66%	11.17%
AHLI	8.17%	26.46%	-18.29%	13.10%	2.19%	10.91%
DHABI	45.54%	77.51%	-31.97%	13.92%	3.17%	10.75%
CIMB	66.33%	39.75%	26.58%	13.19%	3.22%	9.97%
KFHB	92.43%	37.56%	54.87%	11.81%	3.48%	8.33%
AFFN	33.71%	22.08%	11.63%	11.19%	2.86%	8.32%
ALLN	56.04%	26.88%	29.16%	11.04%	3.06%	7.99%
HONG	29.16%	18.35%	10.81%	10.79%	3.19%	7.60%
RHB	33.52%	17.49%	16.03%	10.17%	3.35%	6.82%
EMIT	106.39%	47.39%	59.01%	8.51%	2.32%	6.19%
OCBC	70.37%	45.35%	25.02%	9.38%	3.26%	6.12%
SALM	69.62%	85.02%	-15.40%	8.13%	2.19%	5.94%
STAD	53.00%	39.28%	13.72%	8.89%	3.87%	5.02%
KIB	81.35%	44.27%	37.08%	7.19%	2.79%	4.41%
KHAJ	114.82%	20.74%	94.08%	8.88%	4.53%	4.34%
BAHN	91.64%	18.71%	72.93%	7.47%	3.18%	4.29%
SHAJ	33.40%	31.88%	1.52%	7.62%	3.79%	3.82%
ITHM	142.94%	17.95%	124.99%	7.86%	4.15%	3.70%
MUAT	58.37%	15.98%	42.39%	5.88%	2.71%	3.17%
BOU	82.49%	56.27%	26.21%	5.30%	2.83%	2.46%
KFHM	104.05%	44.38%	59.67%	2.41%	2.28%	0.12%
BARK	111.65%	33.65%	78.00%	1.04%	3.18%	-2.14%

Note: Islamic banks are sorted according to the largest difference in return. Higher return difference between shareholders and UIAHs tends to widen the difference in CV.

5.4 Methodology

Panel data analysis with a fixed effects approach is used in preference to a random effects model (see Appendix E to Chapter 5 for more details), to estimate a model to evaluate the spread in the rates of return between shareholders and UIAHs in a sample of IBs.[80] As previously noted, funds from both types of stakeholders typically get commingled in an asset pool by an Islamic bank, which means that both stakeholders face the same risk.

[80] Testing whether or not some of the control variables may influence the return spread between the two categories of stakeholders, taking account of the riskiness of the returns.

However, the rates of return are rather different, to say the least, although we are primarily interested in the differences in the rates of return as proxy measures for differences in CVs. As shown in the results of the preceding chapter, in one third of the sample banks, UIAHs were not receiving fair returns in terms of profit and risk sharing, the CVs of their rates of return being higher than those of the shareholders.

The sample in the panel data regression model includes 28 IBs,[81] representing different geographical markets such as the GCC and Malaysia over the past 12 years (2002–2013). However, our dataset will be unbalanced since not all the banks have 12 years of observations; some IBs are relatively new or have just converted to being an Islamic bank, and there is a minimum of four years and a maximum of 12 years per bank. Furthermore, the selection of this 12-year period allows us to include both good and bad years, the latter including the bad years following the 2008 global economic crisis, which may have a strong impact on the sample banks' overall mean rates of return, and to obtain a sufficient number of observations to be able to conduct a meaningful regression analysis.

In addition, we use ratios such as return on average assets (ROAA) and others such as total equity to total assets from the Bankscope and Bloomberg databases for the observed IBs, in order to be able to compare the banks' performance and profitability and to see if these had any effect on the spread of rates of return between shareholders and UIAHs. The model would be a short panel, where N = 28 cross-section identifiers, and T = 12 years. Fixed effects models were employed to allow the intercept in the regression model to differ across sections but not over time – for example, different α values for each bank and the same slope over time. The panel data model would be

[81] As mentioned in chapter 4, we are only considering retail Islamic banks that provide UPSIAs, and covering GCC and Malaysia, through which we cover the majority of the market; see concluding remarks in chapter 8 for EY statistics.

$$y_{it} = \alpha_i + \beta x_{it} + u_i + v_{it}$$ **Equation 5-1**

where the y_{it}, the dependent variable, is the difference in the annual rates of return between shareholders and UIAHs. βx_{it} is the slope for each of the independent variables that have fixed or non-stochastic values in the repeated sample, including corporate governance and non-CG variables that can explain the movement or the variations of y. u_{it}, an error term (random disturbance term), is divided into ($u_i + v_{it}$). Error term u_i captures individual specific effects and would affect the dependent variable cross-sectionally but not over time – for example, bank sector, or country where the bank is located (Brooks, 2008). Error term v_{it} is the remainder disturbance that varies over time and captures the rest of what is unexplained about y_{it} for the bank-specific coefficient.[82] The model would have two classes of stakeholders' rates of return to compare.[83] First are shareholders**,** using accounting return, i.e. ROE (for the reasons given in chapter 4). The second category of stakeholder is investment account holders, using the published annual returns from the banks' annual reports.[84]

Another model would be estimated by dividing the sample banks into two groups using the dummy variables; least squares dummy variables (LSDV) approach by adding the country dummy.

$$y_{it} = \beta x_{it} + u_1 D1_i + u_2 D2_i + \ldots + u_N DN_i + v_{it}$$ **Equation 5-2**

We expect that country would have an effect on the difference in rates of return, since Bahrain and Malaysia are better-regulated countries with more competition, and it would appear that UIAHs are treated better there than in other countries. The same independent

[82] GLS weight would also be imposed to treat heteroscedasticity in the error term.
[83] UIAHs are considered stakeholders because they are investors, as well as being depositors considered as investors.
[84] Returns to UIAHs are not published in the stock market.

variables would be examined again to see their effect on the difference in returns (dependent variable) by controlling country variable, such as the proportion of non-executive directors in the BOD, structure of the BOD, board size, CG committee, ROA, TETA, and TDTA as a mix of CG and non-CG variables to ascertain their explanatory power, if any. Group A would include Bahrain and Malaysia as a reference category, with the other countries being in group B. Also removed from the model in equation 5-2 is α (the intercept), to avoid multicollinearity between the dummy variables, which refers to the 'dummy variable trap'.[85]

5.4.1 Model 1: Panel Data – Fixed Effects Models

Individual fixed effects panel data regression will be conducted, assuming that there is a correlation between some features of each bank in the sample and the other explanatory variables. The benefit of using a fixed effects model for the spread of the returns is that it allows the heterogeneity among individual banks to be reflected in the intercept for each bank value (α_i) across sectional fixed effects (Gujarati, 2012). Hence, to differentiate between individual banks, since it is not common to have the same α (intercept) for all banks, for example, each bank has a different strategy on investment, a different policy for returns, a different level of competition among banks, a different set of regulations in each country, or even a different management style. Applying (α_i) suggests that banks may be different because of the special attributes of each individual bank and also captures the unobserved heterogeneity across individual banks that is correlated with the explanatory variables. Therefore, to avoid bias in the least squares estimation, it would be better to include the omitted or the unobserved variables, whereas the fixed effects approach is used to make up for those omitted variables using the dummy variable technique (Startz, 2015).

85 The dummy variable trap, as described by Gujarati (2012), is the situation of perfect collinearity or perfect multicollinearity, if there is more than one exact relationship among the variables.

$$\alpha_i = \alpha + \gamma z_i$$ **Equation 5-3**

where z would be the unobserved variable across banks but not through time, and therefore we can replace α_i in the original equation 5-1.

$$y_{it} = \alpha_i + \beta x_{it} + u_i + v_{it}$$ **Equation 5-4**

Also, it is assumed that the slope coefficient of the independent variables does not vary across banks or time. Applying an individual fixed effects model will show which variables influence the difference in rates of return between shareholders and UIAHs.

$$\begin{aligned}
&\boldsymbol{Return\ spread}_{\boldsymbol{it}} \begin{pmatrix} shareholders\text{' rate of } returns \\ minus\ UIAH \text{ rate of } returns \end{pmatrix} = \alpha_i \\
&+ \beta_1\ ratio\ of\ non_executive\ members\ in\ the\ BOD \\
&+ \beta_2\ leadership\ structure + \beta_3\ BOD\ size \\
&+ \beta_4\ existence\ of\ CG\ committee + \beta_5 ROA \\
&+ \beta_6 total\ equity\ to\ total\ assets \\
&+ \beta_7\ total\ deposits\ to\ total\ assets + u_{it}
\end{aligned}$$ **Equation 5-5**

5.4.2 Research Variables

The panel data model has been used before by different researchers, including Sundararajan (2011), who implemented panel data analysis for 14 IBs in 12 countries between (2003-2004) 3 years period, testing IAHs' returns (dependant) variable on Mudarabah profit in a regression equation, to estimate the implicit weight "w" attached to market rates by bank management. His research found that market rates receive a major

weight in the decisions on rates to be paid to IAH. As he realized that the estimation of "w" could proceed a good approximation to the appropriate α needed for capital adequacy calculations. Also in his previous research Sundararajan (2007), examined 14 IBs in 8 countries, for 2 time periods (28 observations), testing the relationship of the return on IAH and all return on ROA, ROE and the level of risks, using multiple regression analysis on return to IAH. He found that IAH return have a significant positive relation to market return on deposit. In addition, Sundararajan found that when ROA is high the IAH return is low, and with ROA is low return to IAH has increase, because of smoothing technics used by IBs. ROA is positively correlated with ROE as well and the reserves (PER and IRR) are contributing factors why returns on *Mudarabah* always lower than equity.

Rosly and Zaini (2008), tested 6 IBs in Malaysia and found that ROE is higher than return to *Mudarabah*, using the difference in return only (ROE – IAH return) for 2005 only. They found that IAHs returns are compatible with the rate in the conventional fixed deposit. (Diaw and Mbow, 2011), compared the ROE and IAH return for 9 IBs in 7 countries between the period (2005-2009). They confirm a gap between ROE and IAH returns, despite similarities between ROE and IAH in terms of risk. Their test considered the mean variance between ROE and return to IAH, using SD to measure risk. Diaw and Mbow also examined factors that may have explained the difference in return through the use of regression analysis for KFH case study, such as ROA to measure bank performance, TDTA and TETA for leverage effect. They have found that *Mudarabah* contract and equity share same profile in terms of risk but are different on how they are rewarded, for example, ROE tend to be at least 2 times higher than return to IAH. Also higher ROA affect ROE more than IAH, and IBs used local interest rate as the benchmark to determine the return rate.

As mentioned in the literature review, one of the research interests is to look at different CG elements as independent variables to test whether they have explanatory power for the rates of return differences between shareholders and UIAHs (the dependent variable). For example, we examine the structure of the board of directors (BOD), including CEO-chair duality, non-executive directors, board size and the existence of a CG committee. From an

agency theory perspective, one might expect duality to have adverse effects on firm performance. According to Core *et al.* (1999) duality would increase the level of control by top executives over determining of the amount and structure of managerial compensation. Their empirical test found that duality has a negative relationship with no significant effect to enhance corporate performance, reporting that firms with duality have a weaker form of CG which lowers the value and performance of firms. Ghosh and Sirmans (2003) found duality is significantly negatively associated with firm performance. Also Sanda *et al.* (2005) found a positive relationship between separating the function of leadership structure (CEO-Chair) and the corporate performance. However sometimes in the literature duality has been found to have positive effects. Donaldson and Davis (1991) found that for their sample ROE tended to be higher when there is duality.

Normally board size and the independent directors would have positive impact on firm performance but in fact some literature found a negative relationship or it does not seem to have any effect on performance. For example, Abdullah and Page (2009) found a negative relationship between ROA and board size. Also Kiel and Nicholson (2003) found that there is no relationship between corporate performance and the ratio of outside directors.

In addition, we consider other financial variables such as return on assets (ROA) which is a common measure of corporate performance widely used in the literature. Several studies show that there is a link between ROA and corporate performance, such as Adams and Mehran (2005); Coles *et al.* (2012) show that ROA as a significant accounting indicator for financial performance, in addition to corporate governance mechanisms. Similarly, total equity to total assets (TETA) as a leverage effect measurement, and total deposits to total assets (TDTA) as a *Mudarabah* ratio[86], are examined. Clearly, considering the earlier calculation of CV in the preceding chapter, we see that UIAHs in Bahrain and Malaysia are

[86] TDTA is analogous to the TDTA ratio in conventional banks.

doing better on this basis than in any other country, and in these countries UIAHs stand to benefit from a better-behaved (more competitive and better-regulated) market. Therefore, in the panel data analysis Bahrain and Malaysia will be used as a country dummy reference variable (group A).

Dependent Variable

The difference in rates of return between the shareholders and UIAHs is a variable of interest in its own right and also as a proxy for the difference between the CVs.

Return Spread	Represents the dependent variable that is random or stochastic and has a normal probability distribution, which is the rate of return difference between shareholders and UIAHs in different IBs for the past 12 years.

Independent Variables

NON_EX_D	Ratio of non-executive directors in the BOD. Proportion of non-executive members in the BOD; the data was collected from the banks' annual reports, by dividing the number of non-executive directors by the total number of BOD members.
LS	Leadership structure; a dummy variable that takes a value of one in each sample bank refer to the absence of a duality role, that has a separate CEO and chair, and zero otherwise (duality: same chair and CEO held simultaneously for the bank).
B Size	The size of the BOD; total number of members on the board.
CG COMM	Existence of a CG committee. As a central banks requirement, to adopt best practices in the area of CG, and to have CG committee attached to the

BOD, as a dummy variable. It takes a value of one in the model when the bank has a governance committee, and zero otherwise.

ROA Return on assets (net income/total asset) to measure the performance of the bank, which shows the profit earned per dollar of assets, reflecting the management's ability to make profits by utilising the bank's assets to achieve a good return. The data on ROA was taken from the Bankscope database.

TETA Equity ratio, which is ratio of total equity to total assets, to measure the leverage effect. The data was acquired from the banks' annual reports by dividing total equity by total assets.

TDTA Ratio of total deposits to total assets or the *Mudarabah* deposit ratio (UPSIA/total assets). If the bank is financed largely by profit-sharing deposits, we expect that this might generate a big difference in return. The bank may use this leverage to boost the return to shareholders at the expense of depositors. Even when the bank gets more depositors and pays more returns to them, shareholders still receive a better return.

Group B Country dummy variable, which takes a value of one for banks located in Bahrain and Malaysia, and zero otherwise. Having Bahrain and Malaysia as reference countries since both countries have the CG regulations in place (such as CG code) compare to the rest of the GCC countries, would supposedly cover all the aspect of around CG practice including CG code. The effect of the CG code is combine with the more competition and more regulation generally.

5.4.3 Model 2: Panel Data With Country Dummy

Model 2 includes a country dummy to see the effect of the jurisdiction on the difference in return. Bahrain and Malaysia would be the reference country in group A, assuming that they have better-regulated markets and more competition than the other countries in the sample, such as Kuwait, Qatar and the UAE in group B. One would expect a country to have influence in the model because of differences in regulatory environment and level of competition, as seen in the CV results between the two groups.

$$\begin{aligned}\boldsymbol{Return\ Spread}_{\boldsymbol{it}}\ (shareholders'\ \text{rate}\ returns\ minus\ UIAH\ \text{rate of}\ returns) \\ = \beta_1\ \ ratio\ of\ non\_executive\ members\ in\ the\ BOD \\ + \beta_2\ leadership\ structure + \beta_3\ BOD\ size \\ + \beta_4\ existence\ of\ CG\ committee + \beta_5 ROA \\ + \beta_6 total\ equity\ to\ total\ assets \\ + \beta_7\ \ total\ deposit\ to\ total\ asset\beta_5 + country\ dummy_k + u_{it}\end{aligned}$$

Equation 5-6

Since heteroscedasticity is common in the panel data approach, and it is assumed that the error variance is heteroscedastic, generalised least squares (GLS) cross-sectional weights will be used to maintain the fourth assumption where the variance of the error term should be constant (homoscedasticity). Even though heteroscedasticity does not result in biased parameter estimates, the fact is that ordinary least squares (OLS) estimates are no longer the best linear unbiased estimator (BLUE) (Brooks, 2008). Therefore, OLS does not measure the smallest variance and the significance tests could be too low or too high. As noted by Arellano (1987), 'the reason OLS is not optimal when heteroscedasticity is present is that it gives equal weight to all observations when, in fact, observations with larger disturbance variance contain less information than observations with smaller disturbance variance'.

5.4.4 Hypothesis Testing

If certain CG criteria have been met, the UIAHs might receive better treatment. For example, the existence of central bank regulations resulting in the presence of a governance committee of the BOD should be to the benefit of the UIAHs; as mentioned in IFSB-3 (2006),

IBs should form such a committee to stand up for UIAHs' rights in the BOD. The following table presents the hypothesis testing.

Table 5-5: Table of hypotheses

Variables	H_0	H_1
1. *Non-executive Directors' Ratio*	Majority of non-executive members on the BOD does not influence the rate of return spread between shareholders and UIAHs in Islamic banks	Majority of non-executive members on the BOD does influence the rate of return spread between shareholders and UIAHs in Islamic banks
2. *Leadership Structure (LS)*	Separate leadership structure is not associated with the rate of return spread	Separate leadership structure is associated with the rate of return spread
3. *Board Size*	Board size does not have impact on the rate of return spread	Board size does have impact on the rate of return spread
4. *Existing Central Bank Regulations*	Central bank regulations do not influence rate of return spread	Central bank regulations do influence return spread on investment
	Other non-governance issues	
5. *ROA*	ROA does not have impact on the rate of return spread	ROA does have impact on the rate of return spread
6. *TETA*	TETA does not have impact on the rate of return spread	TETA does have impact on the rate of return spread
7. *TDTA*	TDTA does not have impact on the rate of return spread	TDTA does have impact on the rate of return spread

These variables are the normal CG variables apart from the last three, as non-governance variables, which may also have an effect on the rate of return between shareholders and UIAHs.

5.5 Empirical Results

The following table shows the correlation among the explanatory variables that have been used in the regression model:

Table 5-6: Correlation between variables

Variables	*NON_EX_D*	*LS*	*B_SIZE*	*CG_COMM*	*ROA*	*TETA*	*TDTA*
NON_EX_D	1						
LS	0.171054	1					
B_SIZE	0.010969	-0.119087	1				
CG_COMM	-0.209365	0.063258	0.044993	1			
ROA	0.159385	-0.062645	0.026271	-0.072871	1		
TETA	0.014800	0.015874	0.007102	0.036326	0.555581	1	
TDTA	0.123522	0.053330	0.088444	-0.099471	-0.345796	-0.662399	1

The table shows the Pearson correlation coefficient between the explanatory variables. Note that TETA and TDTA are somewhat correlated since both denominators are the total assets.

Table 5-7: Simple statistics

Variables	*Mean*	*Median*	*Maximum*	*Minimum*	*SD*
NON_EX_D	0.8919	0.8889	1.0000	0.3333	0.1200
LS	0.9433	1.0000	1.0000	0.0000	0.2317
B_SIZE	8.2794	9.0000	13.0000	4.0000	1.6475
CG_COMM	0.1660	0.0000	1.0000	0.0000	0.3728
ROA	0.0143	0.0104	0.1139	-0.1192	0.0251
TETA	0.1660	0.1205	0.9992	-0.0190	0.1468
TDTA	0.6442	0.6811	1.1837	0.0000	0.2021

Descriptive statistics for regression variables.

The result tables below show that some variables have explanatory power on the difference in rates of return between the two classes of stakeholders. What is interesting in the CG variables is that LS and board size have different signs. On one hand, LS has a negative sign when there is a separate chair and CEO: the UIAHs appear to do better (i.e. the difference is smaller) than if the bank has CEO-chair duality (same person as CEO and chair). However, if we look at the historical payouts by KFH-Kuwait when they had the same chair-CEO, we see that the bank used to give higher rates of return to UIAHs (the bank had higher profit as well, and shareholders also received high ROE). But, rather than the actual rate of return to UIAHs, we are considering the rate of return to shareholders minus the rate of return to UIAHs, and the negative coefficient in LS, meaning the difference is smaller when there is a separate chair and CEO. This finding is in opposition to the theory of stewardship discussed earlier and the empirical study by Donaldson and Davis (1991), which shows that a single CEO-chair tends to be better, although in our case it is better for UIAHs to have separate CEO/chair; however, UIAHs cannot do anything to reward the management. In fact, as we discover later, it is mainly the ROA that is driving the results.

Table 5-8: Regression estimates using individual fixed effects

Panel (A): Individual fixed effects

Variable	Coefficient	Std. error	Prob.
Non-exe-Dirc.	0.0240	0.0333	0.4728
LS	-0.0412*	0.0104	0.0001
Board Size	0.0061*	0.0025	0.0158
CG Comm	-0.0124**	0.0067	0.0649
ROA	2.5539*	0.1333	0.0000
TETA	-0.1994*	0.0328	0.0000
TDTA	0.0885*	0.0202	0.0000
R-squared	83%		
Adjusted R-squared	80%		
F-statistic	29.7835		
Prob(F-statistic)	0.0000		
Mean dependent variable	*0.1149*		
S.D. dependent variable	*0.1349*		

Note: *denotes significance at the 5% level, and **denotes significance at the 10%, using GLS weights to control for heteroscedasticity. The table shows the panel regression for difference in returns, the dependent variable (shareholders' returns minus UIAHs' return) where all losses in ROE are converted to zero to be comparable with UIAHs' time series of no loss reported.[87] Sample period between 2002 and 2013; cross-sections include 28 banks with a total panel (unbalanced) of about 250 observations.

[87] See unadjusted results in the appendix C to chapter 5.

Table 5-9: Regression estimates using individual fixed effects with country effect

Panel (B): Country Dummy

Variable	Coefficient	Std. Error	Prob.
Non-exe-Dirc.	0.0398*	0.0199	0.0467
LS	-0.0356*	0.0094	0.0002
Board Size	-0.0011	0.0016	0.5071
CG Comm	-0.0149*	0.0065	0.0225
ROA	2.8485*	0.1443	0.0000
TETA	-0.3033*	0.0346	0.0000
TDTA	0.0441*	0.0196	0.0256
GroupB	0.0173*	0.0057	0.0026
R-squared	71%		
Adjusted R-squared	70%		
F-statistic	72.7514		
Prob(F-statistic)	0.0000		
Mean dependent variable	0.1085		
S.D. dependent variable	*0.1144*		

Note: *denotes significance at the 5% level, using GLS weights to control for heteroscedasticity. Group B contains Kuwait, Qatar and the UAE.

Table 5-8 and table 5-9 show the empirical findings of the panel data regression. Panel A shows the fixed effects approach of several independent variables on the difference in rates of return between the two stakeholders (dependent variable). The model has R^2 of 83%, and panel A has LS, board size, ROA, TETA and a TDTA p-value of less than 5% in the model, all of which are significant, with CG committee significant at 10%.

With the introduction of a country dummy in panel B, where the country dummy tends to capture the unobserved heterogeneity such as degree of competition and market efficiency, the model has a lower R^2 of 71%. Individual bank fixed effects were removed and only group country dummy (A and B) was used for reference. For example, group B, as a country dummy variable, has a value of zero for countries located outside Bahrain and Malaysia (these two countries form group A, where the UIAHs receive a 'better deal' than in other countries), and the expectation is that country would have an effect on the difference in returns. In fact, group B is significant and with a positive coefficient, as expected, compared to group A, which implies that the countries in group B will have an

increased difference in rates of return; that is a bad market for UIAHs' returns, and represents the impact of the country in influencing the difference in returns. The following table 5-10 shows the summary of the regression results:

Table 5-10: Summary of the panel data regression

Panel Data	*Variable*	*Significant @ 5%*	*Sign*	*Description*
Panel A *Panel B*	Non-Executive-D	Not Significant Significant	+ +	non-executive directors protect shareholders' interest. Increase the difference in return
Panel A *Panel B*	Leadership Structure Separate CEO-Chair	Significant	- -	CEO duality tends to increase the difference in return
Panel A *Panel B*	Board size	Significant Not significant	+ -	More board size, increases the difference in return
Panel A *Panel B*	CG Committee	Significant** Significant	- -	Existence of CG comm. reduces the difference in return
Panel A *Panel B*	ROA	Significant	+ +	the higher the ROA, the bigger the difference in % return between shareholders and IAH
Panel A *Panel B*	TETA	Significant	- -	More TETA reduce the difference. The smaller the amount of equity paid in by shareholders, the higher the % return they receive
Panel A *Panel B*	TDTA	Significant	+ +	Higher proportion of UPSIA leads to a bigger Mudarib share which increases the difference in returns
Panel B	Country	Significant	+	Group B tends to increase the difference in return

** significant at 10%, GLS weights were applied in cross section to control for heteroscedasticity. The positive sign (+) means that the difference in rates of return between shareholders and UIAHs is more, and the (-) sign means that the difference is less.

Also, the bigger the TETA, the smaller the proportion of UIAHs in the capital structure. Therefore, having a negative sign would be understood as indicating inverse proportionality of shareholders' equity and UIAHs, and we would expect this to drive the difference in rates of return as a form of leverage. Similarly, TDTA is significant and positive, which is in line with TETA; the more deposits the UIAHs put in, the more shareholders benefit, because they receive a bigger *Mudarib* share.

5.6 Economic Interpretations of the Independent Variables

The regression results for the sample of IBs show a significant ROA, (the size of the difference in rates of return is mainly driven by ROA with a positive sign), indicating that shareholders get a much higher rate of return when a bank has better performance. In other words, shareholders get the benefit of a higher ROA more than UIAHs do; the higher the ROA in the model, the bigger the difference in rates of return between shareholders and UIAHs, which is more beneficial for shareholders than for UIAHs. For example, if the ROA increases by one unit then the difference in the rates of return between shareholders and UIAHs increases by 2.55%, as in panel A, and 2.85%, as in panel B. This indicates that when ROA is high, the shareholders tend to 'pocket' the extra profit, simply paying the UIAHs more or less the rate of return associated with conventional deposit accounts. Of course, this might mean that the variability of rates of return for UIAHs would tend to be very low. In addition, the mean rate of return to UIAHs is low, which is why we see that the CV of the UIAHs in one third of the cases is higher than the CV of the shareholders, though not because the UIAHs' rates of return are more volatile (in fact, they are less volatile). The difference is that UIAHs' returns are very small, and that is what tends to drive the magnitude of the CV.

This result is consistent with the general observation that a higher rate of return on assets benefits shareholders more than UIAHs, even though it is supposed to be a profit-sharing contract and both parties are supposed to be compensated accordingly and proportionally. Yet what could explain the case when ROA is high and the difference in rates of return gets bigger is the fact that the *Mudarib* share specified in the *Mudarabah* contact can be very high. However, when the bank performance results in a lower return on investment, the bank can lower this *Mudarib* share to avoid giving UIAHs a reason to withdraw their money. On the other hand, when the bank performs well the shareholders will receive a full *Mudarib* share, which could reach 70%, (Albarak annual report, 2012). Therefore, when the shareholders put in about 10% of the profit-sharing capital and receive 70% of the UIAHs' return, this gives a powerful leverage effect. For example, if the UIAHs who contribute 60%

of the entire commingled fund are receiving 30% (100% - 70% *Mudarib* share) of the profit on the assets that they put in, and if the return on assets is 5% of the entire pool of funds, UIAHs will receive only 1.5%, which is low. On the other hand, shareholders will get 26% (without including the current account returns to the bank as the 30% bank share), when in fact shareholders contributed only 10% to the entire commingled fund and the remaining percentage came from the *Mudarib* share. The funds are usually invested in different projects for profit at the management's discretion. However, in all our sample banks (see table 5-3 on page 119), the average percentage return to shareholders was about 11%, whereas the percentage return average to UIAHs was 3%, despite the fact that risk to both types of stakeholder is similar in many respects.

Table 5-11 below shows the leverage effect in the hypothetical pool of funds used by some IBs, when the *Mudarib* share is 70% of profit, assuming the commingled fund is £10,000.

Table 5-11: The effect of commingled fund leverage at Islamic banks

Hypothetical Pool of funds	Proportion of fund	Share	Descriptions
Current accounts as bank share	30%	£3000	Share of bank and no return to current account depositors, secured capital
UPSIA	60%	£6000	Contributed by unrestricted profit sharing investment account, unsecured capital
Shareholders' Funds	10%	£1000	
Total of commingled fund	100	£10,000	
Mudarib share	70%		As stated in *Mudarabah* contract
If bank achieved 5% as investment return out of a total asset of £10,000	5% as ROA 5% x £10,000	£500	For theoretical purpose, we are assuming the 5% return.
UIAHs share of 5% ROA	5% x 30% x 60%	0.9%	Less than 1%
UPSIA ROI (£10,000)	0.9%*(£10,000)	£90	£500 - £90 = £410 goes to the bank, i.e. the shareholders
% return to UIAHs	£90/£6000	**1.5%**	Return goes to UIAHs as return when in fact UIAHs have contributed 60% of the total pooled fund.
Bank's share on current accounts	30% x £500	£150	1.5% as bank share from the 5% ROI on current account. UIAHs do not receive any return from this account.
Shareholder ROI share	10% x £500	£50	Shareholders take 0.5% plus the bank share of ROI
Bank from Mudarib share	70% x 60% x £500	£210	2.10% out of the 5% goes to the bank as *Mudarib* share
Shareholders share from 5%	0.5%+2.1%	2.6%	4.1% of the 5% ROI goes to the shareholders or the bank
Shareholders share of ROI after Mudarib share	£50 + £210	£260	£410 out of the £500 ROI when in fact shareholders contributed only 10% of the entire pool of fund
Total return that goes to the 10% of Shareholders share	£260/1000	**26%**	Return to Shareholders = 21% from *Mudarabah* and 5% from current accounts

Effect of leverage when the *Mudarib* share is 70% of profits, such as in Al Baraka Bank in 2011. If the return on investment is £500, then UIAHs get £90, and shareholders get (£50 + bank share on current account £150 + bank share from *Mudarib* share £210 = £410).

The above table shows the leverage effect of commingled pool funds used by IBs, where UIAHs contribute 60% of the entire pool and receive a rate of return of 1.5%, in other words the UIAHs put £6000 into the bank and only get a small rate of return as a *Rabb Almaal* share. Shareholders contribute 10% and their share of *Mudarabah* profits gives them a rate

of return of 21% on their £1,000 investment. In addition, they receive another 5% from the £150 return of out £500 contributed by the bank's current accounts, from which UIAHs do not receive any return. As the shareholders take the risk for the current accounts and the UIAHs do not, it is not controversial that UIAHs are getting no return from current accounts in the pooled funds. However, what is controversial is that the bank takes a very high *Mudarib* share, as much as 70%, receiving a rate of return of 21% from the *Mudarabah* as against 1.5% for the UIAH, i.e. 14 times the rate, and this is called "profit sharing". Profit sharing would lead us to expect that *Rabb Almaal* (UIAHs) would get a share of around 50%. As shown in Table 5-12 below, with a *Mudarib* share of 40% the bank would receive a rate of return from the *Mudarabah* that is 4 times that received by the UIAH (12% as against 3%). Of course, the bank as *Mudarib* has no funds invested in the *Mudarabah*, which is why the use of *Mudarabah* by IBs has a powerful leverage effect. On the other hand, when the profit for the year is low, IBs use a reserve or lower the *Mudarib* share to smooth the return to UIAHs. Table 5-12 below shows the outcome when the *Mudarib* share is reduced from 70% to 40%.

Table 5-12: The effect of commingled fund leverage at IBs when *Mudarib* share is reduced

Hypothetical Pool of funds	Proportion of fund	Share	Descriptions
Current accounts as bank share	30%	£3000	Share of bank and no return to current account depositors, secured capital
UPSIA	60%	£6000	Contributed by unrestricted profit sharing investment account, unsecured capital
Shareholders' Funds	10%	£1000	
Total of commingled fund	100	£10,000	
Mudarib share	40%		Assuming *Mudarib* share have been reduced
If bank achieved 5% as investment return out of a total asset of £10,000	5% as ROA 5% x £10,000	£500	For theoretical purpose, we are assuming the 5% return.
UIAHs share of 5% ROA	5% x 60% x 60%	1.8%	Nearly 2% out of the 5% ROA goes to UIAHs as return
UPSIA ROI (£10,000)	1.8%*(£10,000)	£180	£500 - £180 = £320 goes to the bank, i.e. the shareholders
% return to UIAHs	£180/£6000	**3%**	return to UIAHs
Bank's share on current account	30% x £500	£150	1.5% as bank share from the 5% ROI
Shareholder ROI share	10% x £500	£50	Shareholders take 0.5% plus the bank share of ROI
Bank from Mudarib share	40% x 60% x £500	£120	1.20% out of the 5% goes to the bank as *Mudarib* share
Shareholders share from 5%	0.5%+1.2%	1.7%	1.7% of the 5% ROI goes to the shareholders
Shareholders share of ROI after Mudarib share	£50 + £120	£170	£170 out of the £500 ROI when in fact shareholders contributed only 10% of the entire pool of fund
Total return that goes to the 10% of Shareholders share	£170/1000	**17%**	Return to Shareholders = 12% from *Mudarabah* + 5% from current account funds

It is common to see the *Mudarib* share reduced in Islamic banks, especially with the historically low global interest rate.

In reality, we see banks reduce their *Mudarib* share (such as in the table 5-12, which represents the effect of the reduction in the *Mudarib* share from 70% to 40%), in order to pay a more representative return to the UIAHs. However, where 3% is paid to UIAHs in a low-interest-rate environment, UIAHs face the risk of losing their capital (which is not a capital-certain account such as a conventional savings account). Shareholders, on the other hand, get 17%, which is still pretty high given the market's low-interest-rate return record.

In other words, this illustrates how an IB may use techniques so that the rate of return to UIAHs more or less corresponds to what customers get from conventional deposits.

At the same time, the coefficient on TETA is also significantly different from zero when the p-value is less than 5%, which indicates that the smaller the proportion of equity capital contributed by shareholders, the higher the return they receive from the bank. When the shareholders' equity is small, the bank uses other sources of funds such as UIAHs' funds to finance its assets, which produces a leverage effect. At the same time, a high TDTA means that the bank has a bigger *Mudarabah* fund from which to receive a *Mudarib* share, and therefore the difference in returns between the result for the shareholders and the result for the UIAHs would be greater, because of the *Mudarib* share. The 'ideal' bank (from the perspective of maximising the ROE) would run with the lowest proportion of shareholders' equity.[88] Therefore, TDTA should be significant with a positive sign, because the higher the TDTA, the higher the profit from the *Mudarib* share that leads to bigger shareholders' returns compared to UIAHs' returns.

Together with the non-CG variables, some CG variables give significant results in the panel data test, such as leadership structure (CEO-chair duality) and board size at 5%, and CG committee at 10%. However, when the country dummy was introduced in panel B, the CG committee variable became significant at the 5% level, but board size was no longer significant at this level. Also in panel B, the non-executive directors became significant. Therefore, when we impose the country dummy we are looking at the returns difference between countries and it is evident that there are some differences in the rates of return between shareholders and UIAHs that are affected by various explanatory variables. This indicates that there are differences between the two country groups that might be due to greater competition or a better-regulated market in certain countries.

[88] This explains why there are regulatory requirements for banks' capital adequacy and (in Basel III) a requirement of a minimum of 3% of equity to total exposures (the leverage ratio).

5.6.1 Hypothesis Testing Result

According to the findings (see table 5-8 and table 5-9) and to the variables that have some impact on the difference in returns (the dependent variable), we would reject the null hypothesis in panel A (assuming the tested variables have no impact on the rate of return spread) for LS, board size, ROA, TETA and TDTA, as well as rejecting it for the CG committee at 10%. The board size hypothesis would only be rejected in panel A with individual fixed effects; however, when the country dummy is imposed in panel B, the board size becomes insignificant. Then, in panel B, we would reject the null hypothesis for non-executive directors, LS, CG committee, ROA, TETA and TDTA. For example, we reject the null hypothesis on ROA in both panel A and B, since ROA has a significant effect on the rates of return spread.

Table 5-13: Hypothesis testing result: rejecting the null hypothesis

Variable	Panel A	Panel B
Non-exe.	Not reject	Reject
LS	Reject	Reject
Board	Reject	Not reject
CG	Reject**	Reject
ROA	Reject	Reject
TETA	Reject	Reject
TDTA	Reject	Reject

Note: **rejected at the 10% level of significance; the rest is at 5%.

5.7 Conclusion

This chapter aims to examine the CG issue with UPSIAs and the practice used in IBs, comparing the rates of return paid to shareholders with those paid to UIAH. It looks at the implications of the CG effect on the differences in rates of return between shareholders and UIAHs, and, hence, by proxy, the effect of the CG on the CV spread, by including different CG variables and non-CG variables together that impact differently on the difference in return. Moreover, the model uses dummy variables, examining the effect of the country dummy (for example, in panel B regression) Bahrain follows the AAIOFI financial reporting

standards as part of a better regulated market, to compare the IBs according to their jurisdiction as a well-regulated and more transparent market group as (group A), where the UIAHs have a better deal according to the CV results, with the less-regulated market (group B) where the UIAHs are not doing so well. The dummies as a group are significant and affect the significance pattern of other variables. For example, the presence of the country dummy makes CG committee variable become significant at the 5% level, which may indicate that countries' regulatory bodies have an effect on IBs in their jurisdiction; as mentioned in several IFSB standards, IBs should develop CG committees to represent UIAHs (IFSB-3, 2006) and be transparent to UIAHs with respect to smoothing practices (IFSB-GN3, 2010). The coefficient of the CG committee is negative and significant at the 5% level, which implies that having CG committees at IBs affects the difference in returns. Also, the expected negative sign makes the difference in return smaller, whereby the UIAHs get a return closer to that of shareholders, because [ROE returns - UIAHs' returns = difference in returns], which means that the presence of a CG committee improves the treatment of UIAHs.

The results concur with the IFSB's proposal to have a CG committee attached to the BOD to represent UIAHs. Moreover, with country dummies the non-executive director coefficient has the opposite sign to that of the CG committee, as it is positive and statistically significant. Indeed, this is a normal, expected result, since non-executive directors traditionally protect shareholders' interest rather than the interests of other stakeholders. The finding of this results is also in line with previous studies including Sundararajan (2007), Rosly and Zaini (2008), Diaw and Mbow (2011), Sundararajan (2011), but is in contradiction with the capital market theory of risk and return (i.e. higher risk is associated with higher expected return), which raises a serious issue about the fairness of the profit distribution policies.

The significance of the finding is that there is evidence that, when the banks achieve good results, this tends to benefit the shareholders where profit-sharing practice is a matter of contractual form rather than economic substance. The results show that profit sharing, as

normally understood, is not being practised because good results lead to a higher ROE to the shareholders with less benefit to UIAH. In an efficient market this would be reflected either in an increased dividend or an increase in the value of the share. In virtually no cases are good results passed through to the UIAHs. In a third of cases, the phenomena are extreme; it is not only the case that good results are not being passed to UIAHs – the variability of the rates of return is actually greater, as the CV for the UIAHs is greater than for shareholders. So there is no sense in which the lower return to the UIAHs reflects the lower riskiness of the returns or the lower degree of variability. This is simply a more extreme form of the practices of those banks, because wherever there is a higher profit flow (of course, we are using accounting returns) the higher reported accounting profits do not result in significantly higher payouts to UIAHs. One of the reasons why UIAHs' returns do not vary is that they are not being giving the benefit of higher profit. This again shows the implications that UIAHs' lack of information for monitoring the management would result in unfair of return treatment toward UIAHs.

However, for the other two thirds of UIAHs, whose CV is lower than shareholders', rates of payout to UIAH are less variable than the ROE to shareholders. One reason for this is that the higher returns are going to the shareholders and not to the UIAHs, so it is not simply because the profit is being smoothed in poorer years; it is being smoothed down back to PERs and IRRs in better years.

The implication for IBs in our finding is not so flattering. One third of IBs have a CV for UIAHs that is higher than the CV for shareholders, which makes them unfair towards UIAHs. It seems that IBs are taking on deposits that are exposed to losses and giving no reward for said exposure to losses; however, they are skimming off the excess returns when the banks have good years of profit, giving little or none of the benefit to UIAHs. Therefore, this dubious behaviour towards UIAHs means that profit sharing exists only in name in these banks. Even in some other banks where the CV for UIAHs is lower than the CV for shareholders, the treatment of UIAHs is also questionable, since the CVs are very close; for example, in the Sharjah Islamic Bank, the CV for shareholders is 33.40% and UIAHs' CV is

31.88%. From an economic point of view, IBs try to create a product that behaves like a conventional deposit account, but in legal (i.e. contractual) terms the *Shari'ah*-compliant deposit (UPSIA) can still incur losses, yet the depositors receive no reward for this downside risk. The use of the *Mudarabah* contract protects IBs from the risk to which the depositors are exposed, but given the way that so-called 'profit sharing' is practised the latter are not compensated for this. From a more general CG perspective, we can see from table 5-8 and table 5-9 that some 'conventional' CG variables are shown to have an influence on the banks' treatment of UIAHs. Nevertheless, the regression results are largely driven by financial variables: ROA, TETA and TDTA, which are associated with the banks' use of UPSIA to leverage their returns on equity.

Appendix C – Treatment of ROE Outliers

C.1 Methods Used to Adjust Return on Equity

Two methods may be used to adjust the ROE outliers (accounting returns for shareholders). Method 1 can be used to calculate the CV and only extreme outliers would be adjusted; this is the semi-adjusted method. Method 2 can be used to calculate the differences in the payout returns between shareholders and UIAHs and all losses would be removed since a loss in net profit to a bank that results in a negative payout in ROE should also be a loss to UIAHs. Method 2 can also be used as a proxy for differences in the CV. It is not the ROEs as such that matter for this research, but the comparison of variability in the payout returns.

C.2 Calculating Coefficient of Variation

The return on equity (ROE) is needed in order to calculate the coefficient of variation (CV - standard deviation over the mean return) for shareholders to compare it with the UIAHs' CV. However, CV must be positive in order to be valid for comparison (Abdi, 2010). CV must always be positive or null, and it takes a value between zero and $\sqrt{N-1}$, and N is a non-negative number with a real zero (Abdi, 2010). Hence, when the mean ROE for a bank over the time period is negative, it must be treated as an outlier and adjusted in order to compare the shareholders' and UIAHs' returns, since it is not possible to calculate the CV where the denominator (overall ROE mean) is negative. The following tables show the accounting return for shareholders (ROEs) for the sample size that covers 28 banks from different countries. The dataset was obtained from the banks' annual reports and the Bankscope database for the period 2002 to 2013. The dataset contains 247 total observations of ROEs, since not all banks have 12 years of observations.

Table 5-14: Unadjusted ROEs as a percentage

IB	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Mean ROE
BARK	NA	NA	NA	NA	NA	NA	0.01	0.15	0.03	0.01	-0.06	0.01	-2.39%
SALM	NA	NA	NA	NA	0.12	0.16	0.15	0.08	0.04	0.00	0.05	0.06	8.13%
BAHN	0.06	0.06	0.08	0.12	0.18	0.19	0.13	-0.13	-0.33	-0.17	-0.42	0.08	-1.27%
ITHM	NA	NA	0.16	0.16	0.33	0.11	0.02	-0.30	-0.22	-0.05	-0.05	-0.14	0.13%
KHAJ	NA	NA	NA	0.12	0.21	0.23	0.20	0.02	-0.05	0.00	0.01	-0.18	6.34%
KFHB	0.07	0.09	0.24	0.26	0.27	0.26	0.15	0.01	0.02	0.02	0.03	0.02	11.81%
AHLI	NA	NA	NA	NA	NA	NA	NA	NA	0.12	0.12	0.14	0.14	13.10%
BOU	NA	NA	NA	0.06	0.09	0.15	0.01	-0.47	0.04	0.03	0.04	0.05	0.13%
KFH	0.21	0.21	0.24	0.26	0.25	0.29	0.13	0.10	0.08	0.06	0.07	0.08	16.42%
KIB	NA	NA	NA	NA	0.07	0.12	0.12	-0.05	0.09	0.05	0.06	0.06	6.58%
MASF	NA	NA	NA	NA	NA	0.23	0.17	0.15	0.19	0.18	0.17	0.18	18.00%
QATR	0.24	0.30	0.29	0.28	0.32	0.28	0.28	0.16	0.15	0.13	0.11	0.11	22.19%
DHABI	NA	NA	0.08	0.20	0.24	0.19	0.15	0.01	0.15	0.14	0.11	0.11	13.92%
DUBAI	0.10	0.14	0.20	0.32	0.25	0.26	0.16	0.14	0.06	0.11	0.12	0.13	16.69%
EMIT	NA	NA	0.02	0.06	0.13	0.21	0.27	0.06	0.02	-0.15	0.03	0.04	6.99%
SHAJ	NA	NA	NA	0.09	0.09	0.12	0.08	0.06	0.06	0.06	0.06	0.07	7.62%
AFFN	NA	NA	NA	NA	NA	0.18	0.11	0.10	0.06	0.11	0.13	0.09	11.19%
ALLN	NA	NA	NA	NA	NA	0.05	0.05	0.22	0.13	0.14	0.10	0.09	11.04%
ISLM	0.03	0.07	0.07	-0.54	-5.73	0.63	0.33	0.11	0.20	0.14	0.15	0.15	-36.49%
MUAT	0.03	0.01	-0.06	0.06	0.12	0.07	0.04	0.08	0.07	0.10	0.06	0.06	5.37%
CIMB	NA	NA	NA	-0.19	0.02	0.10	0.10	0.15	0.27	0.21	0.19	0.15	11.03%
HONG	NA	NA	NA	NA	0.08	0.10	0.10	0.11	0.11	0.08	0.11	0.18	10.79%
KFHM	NA	NA	NA	0.00	0.02	0.05	0.04	-0.02	-0.03	-0.34	0.04	0.06	-1.93%
MAY	NA	NA	NA	NA	NA	NA	0.07	0.17	0.10	0.10	0.20	0.19	13.83%
OCBC	NA	NA	NA	NA	NA	NA	-0.01	0.09	0.09	0.07	0.12	0.20	9.23%
PUBC	NA	NA	NA	NA	NA	NA	0.09	0.28	0.24	0.23	0.19	0.15	19.45%
RHB	NA	NA	NA	0.07	0.14	0.17	0.11	0.07	0.07	0.08	0.10	0.09	10.17%
STAD	NA	NA	NA	NA	NA	NA	0.02	0.05	0.13	0.12	0.13	0.09	8.89%

The black box shows the extreme negative ROEs, which would give negative CV and which must be adjusted by replacing them with zero, usually the highest loss for that particular bank.

Note: the ROEs in red are also for the banks that have negative mean ROEs for a specific year of the time series. However, some banks would have a positive but very small mean ROE, which results in a huge positive CV (i.e. a positive outlier). For example, Boubyan Bank has an ROE in 2009 of -49%; calculating the mean ROE and the CV by including the 2009 ROE would give a CV of 13996.42%, which is again an outlier but on the positive side.[89] Therefore, for a reasonable comparison between shareholders' and UIAHs' CVs, these outliers should also be adjusted to avoid extreme positive ROEs.

[89] See Table 5-15, p. 139.

C.3 Method 1 Adjusting Extreme Outliers (Semi-adjusting ROE)

The adjustment methods consist of replacing the extreme values (outliers) in the dataset with zeros in order to calculate the CV; additionally, we are comparing the shareholders' ROEs to the UIAHs' returns in the form of payouts. We do not wish to underestimate the variation between shareholders and UIAHs by removing those extreme outliers or the negative ROE returns; however, adjustments are needed in order to gain meaningful results. If we were looking at the shareholders' ROEs by themselves, then we would not make these adjustments because we would not want to lose the information in the negative returns. However, it is not the ROE itself that interests us, but the variation as measured by the CV. For instance, in method 1 (semi-adjusting ROE we only adjust an outlier if the ROE is causing the entire mean return to be negative over the 12-years period. However, a negative ROE for a bank in a time series for which the mean was positive would not be adjusted except in the case of extreme positive outliers such as in the cases of Boubyan and Ithmaar banks, as explained above. For example, Khaleeji Commercial Bank had a negative ROE of -5.34% in 2010 and -18% in 2013, but these negative returns were not replaced with zeros since the overall mean ROE was positive. Hence, only four banks (see table below) had negative returns that were adjusted to be able to calculate a meaningful CV, plus there are two huge positive outliers. In fact, even adjusting the negative and the positive outliers did not change the classification of banks into those with a CV of shareholders' ROEs higher than the CV of UIAHs' returns, and those for which the CV of shareholders' ROEs is lower.

Table 5-15: Banks whose ROEs would be adjusted in method 1

Bank	Country	Year of adjusting ROEs	Original ROE	Adjusted ROE
Albaraka Islamic Bank	Bahrain	2009	-15.46%	0.00
Bahrain Islamic Bank	Bahrain	2012	-42.31%	0.00
Bank Islam Malaysia Berhad	Malaysia	2006	-573.37%	0.00
KFH-Bahrain	Malaysia	2011	-33.84%	0.00
Boubyan	Kuwait	2009	-46.51%	0.00
Ithmaar	Bahrain	2009	-30.26%	0.00

These ROEs would be replaced with zero; the first four are the banks that have negative ROEs, and the last two banks are those with extreme positive outliers.

Table 5-16: CV of shareholders and UIAHs

Islamic Bank	*Unadjusted ROEs*		*Semi-adjusted ROEs*	
	SH_CV	UIAHs_CV	SH_CV	UIAHs_CV
BARK	-284.36%	33.65%	2821.22%	33.65%
SALM	69.62%	85.02%	69.62%	85.02%
BAHN	-1558.03%	18.71%	699.63%	18.71%
ITHM	14770.45%	17.95%	517.10%	17.95%
KHAJ	217.03%	20.74%	217.03%	20.74%
KFHB	92.43%	37.56%	92.43%	37.56%
AHLI	8.17%	26.46%	8.17%	26.46%
BOU	13996.42%	56.27%	82.49%	56.27%
KFH	52.49%	55.80%	52.49%	55.80%
KIB	81.35%	44.27%	81.35%	44.27%
MASF	13.98%	59.44%	13.98%	59.44%
QATR	36.47%	42.12%	36.47%	42.12%
DHABI	45.54%	77.51%	45.54%	77.51%
DUBAI	45.62%	48.01%	45.62%	48.01%
EMIT	165.65%	47.39%	165.65%	47.39%
SHAJ	33.40%	31.88%	33.40%	31.88%
AFFN	33.71%	22.08%	33.71%	22.08%
ALLN	56.04%	26.88%	56.04%	26.88%
ISLM	-468.85%	37.18%	234.78%	37.18%
MUAT	86.56%	15.98%	86.56%	15.98%
CIMB	122.67%	39.75%	122.67%	39.75%
HONG	29.16%	18.35%	29.16%	18.35%
KFHM	-649.62%	44.38%	176.97%	44.38%
MAY	41.10%	45.84%	41.10%	45.84%
OCBC	74.32%	45.35%	74.32%	45.35%
PUBC	36.09%	50.11%	36.09%	50.11%
RHB	33.52%	17.49%	33.02%	17.74%
STAD	53.00%	39.28%	53.00%	39.28%

The result of unadjusted ROE and semi-adjusted ROE. Still with semi-adjusted ROE, there is considerable variation due to the other outliers that have not been adjusted. The black box shows the extreme negative ROEs from Table 5-14.

The CVs are calculated using semi-adjusted ROEs: a total of six observations out of 247. Four banks with extreme negative ROEs are indicated in the black boxes, and two other banks with very large CVs are considered outliers and have to be adjusted to retain fair comparability between the two payout returns.

C.4 Method 2 Adjusting All Negative ROEs

To avoid the problem of very large CVs for banks with very low mean ROEs, method 2 adjusts all negative ROEs for banks to zero. The ROEs are not the focus of this research, but are required for the comparison of variability. It should be noted that the UIAHs' returns

cannot be negative as they are based on payouts. If there are losses (impairment of UIAHs' capital), these are not observable, as IBs use reserves (such as IRRs) to cover such losses. Hence, we can simply observe the actual payouts rather than the underlying result. In fact, the time series of returns to UIAHs are the results of management decisions on accounting treatment, by virtue of which no negative returns are reported. For example, in the 2009 annual report of Al Baraka Bank, based in Bahrain, the bank sustained a loss of US$26,463,032 but still paid out a 5.62% share of profit to UIAHs after *Mudarib* fees and transfer from reserves. Therefore, to achieve comparability, it is preferable to eliminate losses from the time series of accounting returns to shareholders. An alternative might have been to use the dividend payouts to shareholders, which also cannot be negative, but this would not be a fair comparison to UIAHs' returns since there are no 'retained earnings' for UIAHs (reserves such as IRRs are used only for 'smoothing' payouts).

Therefore, under method 2 all the negative ROEs would be adjusted to zero, changing a total of 24 observations out of 247, following the same procedure as Diaw and Mbow (2011), who replace all negative accounting profits to shareholders (ROE) with zero. In addition, as shown above, if we only adjust negative ROEs for those four banks with a negative mean ROE, the presence of the outliers in the ROEs results in a much lower correlation between the CV differences and the return differences, because of the extreme outliers' effect. Additionally, what is most important is that using adjusted ROEs does not give significantly different results or change the outcome; the same results are obtained in the panel regression of semi-adjusted or unadjusted returns where the independent variables have the same results but different coefficients. For example, the ROA sign is positive and significant (see regression tables below). In fact, *R-squared* in unadjusted ROE is the highest of all; however, for a better comparison with UIAHs' return, we would rather use adjusted ROE to be more consistent with UIAHs' time series and for the reason explained above.

Table 5-17: Percentage of adjustment

Method	Semi adjusted ROEs	Adjusting all negative ROEs
No. of Obs. to be adjusted	6	24
No. of banks	6	12
Total number of Obs. In the sample	247	247
Ratio of changes in sample	2.40%	9.70%

Twelve banks' negative ROEs will be replaced with zero for comparison with the UIAHs' payout returns, since minimum payouts would not be less than zero (24 observations out of 247). This would give a percentage change in the sample dataset of 9.7% (24/247).

Table 5-18: Correlations % of the Difference in Returns

Correlations of the Difference in Returns	Correlation %
Correlation of the difference of unadjusted ROE – UIAHs' return	-17%
Correlation of the difference of semi adjusted ROE – UIAHs' return	-20%
Correlation of the difference of adjusted ROE – UIAHs' return	-59%

C.5 Panel Regression Results

The regression tests were conducted on three different ROEs as follows:

Panel	*Regression test*
Panel A	Unadjusted ROE using fixed effects with GLS weights
Panel B	Unadjusted ROE for group country dummy using GLS
Panel C	Semi adjusted ROE using fixed effects with GLS
Panel D	Semi adjusted ROE for group country dummy with GLS
Panel E	Adjusted ROE using fixed effects with GLS
Panel F	Adjusted ROE for group country dummy with GLS

Group A country dummy includes Bahrain and Malaysia
Group B country dummy includes Kuwait, Qatar and the UAE

C.6 Summary Statistics of Unadjusted, Semi-adjusted and Adjusted ROE

The following tables contain the results of the unadjusted ROE, semi-adjusted ROE, and adjusted ROE correspondingly, where negative returns in unadjusted ROE remain constant, including all the outliers. The sample consists of 28 IBs, and covers the 12 years from 2002 to 2013. The dependent variable is the difference in the rate of return between shareholders (ROE) minus the return to UIAHs, and the independent variables are the same as the above model.

Table 5-19: Unadjusted ROEs regression

Panel A: Unadjusted ROE fixed effects

Variable	Coefficient	Std. Error	Prob.
ROA	7.0208*	0.3256	0.0000
Non-exe-Dirc.	-0.1626*	0.0689	0.0191
TETA	-0.5020*	0.0686	0.0000
LS	0.0065	0.0203	0.7480
Board Size	0.0180*	0.0036	0.0000
CG Comm	0.0372*	0.0147	0.0121
TDTA	-0.0403**	0.0240	0.0952
R-squared	85%		
Adjusted R-squared	83%		
F-statistic	34.8701		
Prob(F-statistic)	0.0000		

Panel B: Unadjusted ROEs group country dummy

Variable	Coefficient	Std. Error	Prob.
ROA	6.6771*	0.2509	0.0000
Non-exe-Dirc.	-0.0599*	0.0256	0.0201
TETA	-0.6098*	0.0487	0.0000
LS	0.0177*	0.0087	0.0434
Board Size	-0.0023	0.0018	0.2124
CG Comm	0.0018	0.0052	0.7318
TDTA	-0.0029	0.0153	0.8519
GroupB	0.0137*	0.0051	0.0082
R-squared	78%		
Adjusted R-squared	77%		
F-statistic	105.6036		
Prob(F-statistic)	0.0000		

The table shows the panel regression for unadjusted ROEs used in difference in returns of the dependent variable (shareholders' returns minus UIAHs' return), using GLS weights to take care of heteroscedasticity. Note: *denotes significance at the 5% level, and **indicates significance at the 10% level.
The dependent variable is the difference in returns between shareholders and UIAHs, for a period of 12 years (2002–2013). Cross-sections include 28 total panel (unbalanced) observations out of 247.

Table 5-20: Semi adjusted ROEs regression

Panel C: Semi_Adj_ROE fixed effects

Variable	Coefficient	Std. Error	Prob.
ROA	3.2687	0.1485	0.0000
Non-exe-Dirc.	-0.0362	0.0322	0.2612
TETA	-0.2337	0.0319	0.0000
LS	-0.0411	0.0106	0.0001
Board Size	0.0162	0.0033	0.0000
CG Comm	-0.0065	0.0074	0.3806
TDTA	0.0685	0.0239	0.0046
R-squared	84%		
Adjusted R-squared	81%		
F-statistic	32.1135		
Prob(F-statistic)	0.0000		

Panel D: Semi_Adj_ROEs Country Dummy

Variable	Coefficient	Std. Error	Prob.
ROA	3.6971	0.1897	0.0000
Non-exe-Dirc.	0.0087	0.0204	0.6687
TETA	-0.3847	0.0392	0.0000
LS	-0.0258	0.0088	0.0039
Board Size	-0.0004	0.0018	0.8346
CG Comm	-0.0126	0.0066	0.0562
TDTA	0.0489	0.0219	0.0263
GroupB	0.0203	0.0060	0.0008
R-squared	71%		
Adjusted R-squared	70%		
F-statistic	73.8420		
Prob(F-statistic)	0.0000		

Only banks with extreme outliers where losses were converted to zero. Note: *denotes significance at the 5% level, and **denotes significance at 10%, using GLS cross-sectional weights, to estimate a feasible GLS specification, assuming the presence of cross-section heteroscedasticity.
***Only extreme outliers of ROE are adjusted to zero.

Table 5-21: Adjusted ROEs regression

Panel E: Adjusted ROE fixed effects

Variable	Coefficient	Std. Error	Prob.
ROA	2.5539	0.1333	0.0000
Non-exe-Dirc.	0.0240	0.0333	0.4728
TETA	-0.1994	0.0328	0.0000
LS	-0.0412	0.0104	0.0001
Board Size	0.0061	0.0025	0.0158
CG Comm	-0.0124	0.0067	0.0649
TDTA	0.0885	0.0202	0.0000
R-squared	83%		
Adjusted R-squared	80%		
F-statistic	29.7835		
Prob(F-statistic)	0.0000		

Panel F: Adjusted ROEs group country dummy

Variable	Coefficient	Std. Error	Prob.
ROA	2.8485	0.1443	0.0000
Non-exe-Dirc.	0.0398	0.0199	0.0467
TETA	-0.3033	0.0346	0.0000
LS	-0.0356	0.0094	0.0002
Board Size	-0.0011	0.0016	0.5071
CG Comm	-0.0149	0.0065	0.0225
TDTA	0.0441	0.0196	0.0256
GroupB	0.0173	0.0057	0.0026
R-squared	71%		
Adjusted R-squared	70%		
F-statistic	72.7514		
Prob(F-statistic)	0.0000		

All losses in ROE were converted to zero, for better comparison with UIAHs' return where all time series are positive and negative returns in the UIAHs' data are not observable due to smoothing techniques used by Islamic banks.

C.7 Final Remarks

For the reasons mentioned above, where the negative ROEs result in very small mean ROEs, leading to these banks being outliers for their CVs, method 2 would be implemented (all negative ROEs would be replaced with zero; a total of 24 observations out of 247). It is important to note that it is not the ROEs as such that matter for this research, but the comparison of the return variability between shareholders and UIAHs. Furthermore, the negative returns in the UIAHs' data are not observable (IBs use reserves such as IRRs to cover losses), and since we are using the difference in return as proxy to test the CV, it would be more applicable to use method 2, in order to obtain a valid comparison. In fact, to have a valid correlation it would be more relevant to treat both returns (ROE and UIAHs' return) equally, because it is a comparison between the two payout returns, where the correct return cannot be less than zero. In addition, the use of the GLS cross-sectional weights would be applied to run the panel regression test to attain heteroscedasticity and serial correlation problems. Therefore, method 2 would be more appropriate in this case.

Appendix D - Correlation between the difference in returns and the difference in CV

D.1 Correlation

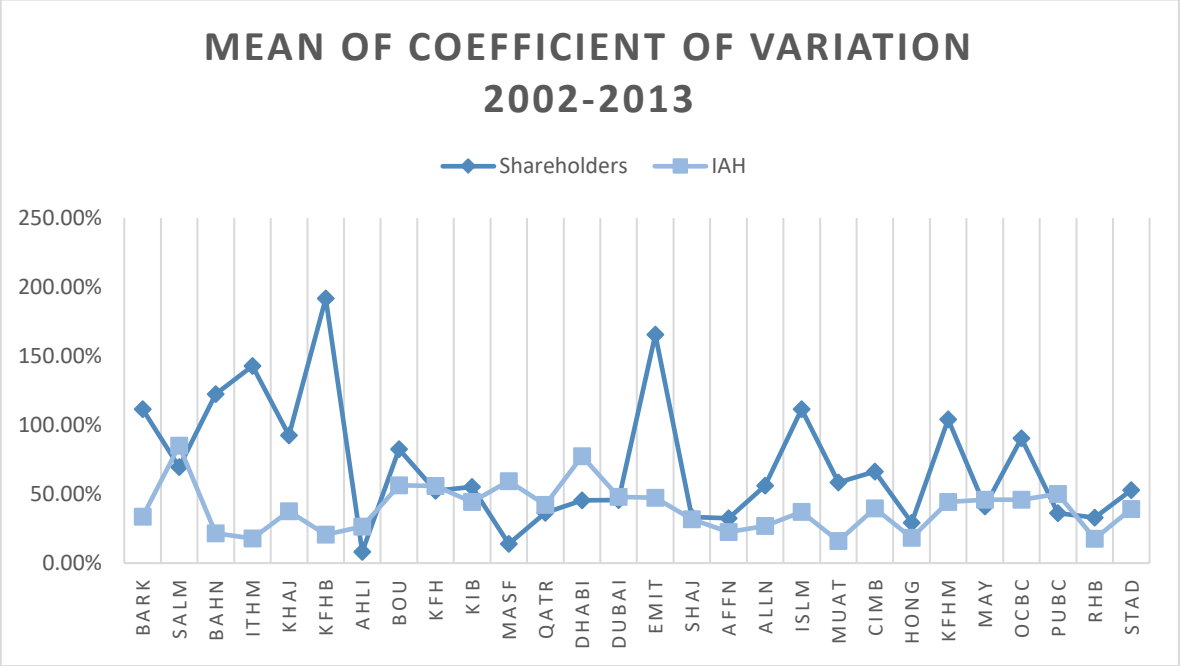
The correlation in table 5-22 is between column 8 (differences in mean returns for shareholders and UIAHs) and column 9 (differences in CV for shareholders and UIAHs). Nine IBs have higher CV for UIAHs. Whereas, the negative CV indicates that UIAHs have a higher CV and it is closely associated with higher difference in returns between shareholders and UIAHs, indicating a strong negative relationship. As the difference in CV for UIAHs gets bigger and more negative, their difference in returns gets bigger and more positive.

Table 5-22: Correlation between difference in the CV and the rate of return spread

2002-2013	*Shareholders*			*UIAHs*			*Differences*	
Islamic banks	**Mean**	**SD**	**CV**	**Mean**	**SD**	**CV**	**Mean diff**	**CV diff**
MASF	18.00%	2.52%	13.98%	3.24%	1.93%	59.44%	14.75%	-45.46%
DHABI	13.92%	6.34%	45.54%	3.17%	2.46%	77.51%	10.75%	-31.97%
AHLI	13.10%	1.07%	8.17%	2.19%	0.58%	26.46%	10.91%	-18.29%
SALM	8.13%	5.66%	69.62%	2.19%	1.87%	85.02%	5.94%	-15.40%
PUBC	19.45%	7.02%	36.09%	2.16%	1.08%	50.11%	17.29%	-14.02%
QATR	22.19%	8.09%	36.47%	3.99%	1.68%	42.12%	18.20%	-5.66%
MAY	13.83%	5.68%	41.10%	2.66%	1.22%	45.84%	11.17%	-4.74%
KFH	16.42%	8.62%	52.49%	3.53%	1.97%	55.80%	12.89%	-3.31%
DUBAI	16.69%	7.61%	45.62%	2.60%	1.25%	48.01%	14.09%	-2.38%
SHAJ	7.85%	2.62%	33.40%	3.79%	1.21%	31.88%	4.05%	1.52%
HONG	10.79%	3.15%	29.16%	3.19%	0.59%	18.35%	7.60%	10.81%
AFFN	11.19%	3.77%	33.71%	2.86%	0.63%	22.08%	8.32%	11.63%
STAD	8.89%	4.71%	53.00%	3.87%	1.52%	39.28%	5.02%	13.72%
RHB	10.17%	3.41%	33.52%	3.35%	0.59%	17.49%	6.82%	16.03%
OCBC	9.38%	6.60%	70.37%	3.26%	1.48%	45.35%	6.12%	25.02%
BOU	5.30%	4.37%	82.49%	2.83%	1.59%	56.27%	2.46%	26.21%
CIMB	13.19%	8.75%	66.33%	3.22%	1.28%	39.75%	9.97%	26.58%
ALLN	11.04%	6.19%	56.04%	3.06%	0.82%	26.88%	7.99%	29.16%
KIB	7.19%	3.96%	81.35%	2.79%	1.23%	44.27%	4.41%	37.08%
MUAT	5.88%	3.43%	58.37%	2.71%	0.43%	15.98%	3.17%	42.39%
KFHB	11.81%	10.92%	92.43%	3.48%	1.31%	37.56%	8.33%	54.87%
EMIT	8.51%	9.06%	106.39%	2.32%	1.10%	47.39%	6.19%	59.01%
KFHM	2.41%	2.50%	104.05%	2.28%	1.01%	44.38%	0.12%	59.67%
BAHN	7.47%	6.84%	91.64%	3.18%	0.59%	18.71%	4.29%	72.93%
ISLM	15.76%	17.57%	111.52%	2.48%	0.92%	37.18%	13.27%	74.35%
BARK	1.04%	1.16%	111.65%	3.18%	1.07%	33.65%	-2.14%	78.00%
KHAJ	8.88%	10.92%	114.82%	4.53%	0.94%	20.74%	4.34%	94.08%
ITHM	7.86%	11.23%	142.94%	4.15%	0.75%	17.95%	3.70%	124.99%

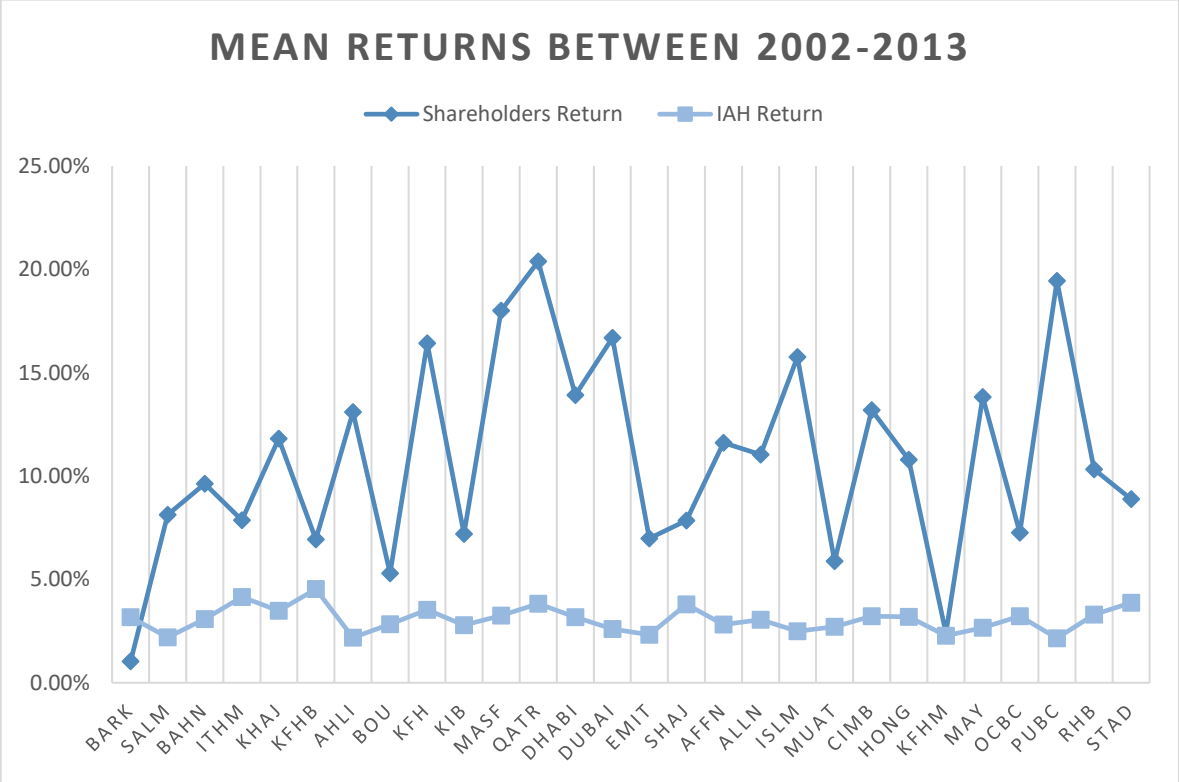
Higher UIAHs CVs indicates that the UIAHs received unfair deal on risk-adjusted returns basis compared to shareholders. The more negative CV which indicates higher UIAHs CV the more difference in the mean return between shareholders and UIAHs.

Figure 5-2: Average for shareholders and UIAHs CV for each bank 2002–2013



The graph shows that in some Islamic banks UIAHs have higher CV, which indicates that the UIAHs are not doing well in proportion to the risk that they are exposed to compared to shareholders.

Figure 5-3: Average of returns for shareholders and UIAHs



Average of returns for shareholders and UIAHs between 2002 and 2013 for each bank as a percentage return to each of the two classes of stakeholders. UIAHs' return seems steady across the Islamic banks, whereas shareholders' returns vary across the sample of Islamic banks; however, shareholders receive much higher returns.

Table 5-23 Return to shareholders 2002–2013

Bank	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Bank Mean	OBS
BARK	NA	NA	NA	NA	NA	NA	0.01	-0.15	0.03	0.01	-0.06	0.01	-2.47%	6
SALM	NA	NA	NA	NA	0.12	0.16	0.15	0.08	0.04	0.00	0.05	0.06	8.13%	8
BAHN	0.06	0.06	0.08	0.12	0.18	0.19	0.13	-0.13	-0.33	-0.17	-0.42	0.08	-1.30%	12
ITHM	NA	NA	0.16	0.16	0.33	0.11	0.02	-0.30	-0.22	-0.05	-0.05	-0.14	0.13%	10
KHAJ	NA	NA	NA	0.12	0.21	0.23	0.20	0.02	-0.05	0.00	0.01	-0.18	6.34%	9
KFHB	0.07	0.09	0.24	0.26	0.27	0.26	0.15	0.01	0.02	0.02	0.03	0.02	11.81%	12
AHLI	NA	NA	NA	NA	NA	NA	NA	NA	0.12	0.12	0.14	0.14	13.10%	4
BOU	NA	NA	NA	0.06	0.09	0.15	0.01	-0.47	0.04	0.03	0.04	0.05	0.13%	9
KFH	0.21	0.21	0.24	0.26	0.25	0.29	0.13	0.10	0.08	0.06	0.07	0.08	16.42%	12
KIB	NA	NA	NA	NA	0.07	0.12	0.12	-0.05	0.09	0.05	0.06	0.06	6.58%	8
MASF	NA	NA	NA	NA	NA	0.23	0.17	0.15	0.19	0.18	0.17	0.18	18.00%	7
QATR	0.24	0.30	0.29	0.28	0.32	0.28	0.28	0.16	0.15	0.13	0.11	0.11	22.19%	12
DHABI	NA	NA	0.08	0.20	0.24	0.19	0.15	0.01	0.15	0.14	0.11	0.11	13.92%	10
DUBAI	0.10	0.14	0.20	0.32	0.25	0.26	0.16	0.14	0.06	0.11	0.12	0.13	16.69%	12
EMIT	NA	NA	0.02	0.06	0.13	0.21	0.27	0.06	0.02	-0.15	0.03	0.04	6.99%	10
SHAJ	NA	NA	NA	0.09	0.09	0.12	0.08	0.06	0.06	0.06	0.06	0.07	7.62%	9
AFFN	NA	NA	NA	NA	NA	0.18	0.11	0.10	0.06	0.11	0.13	0.09	11.19%	7
ALLN	NA	NA	NA	NA	NA	0.05	0.05	0.22	0.13	0.14	0.10	0.09	11.04%	7
ISLM	0.03	0.07	0.07	-0.54	-5.73	0.63	0.33	0.11	0.20	0.14	0.15	0.15	-36.49%	12
MUAT	0.03	0.01	-0.06	0.06	0.12	0.07	0.04	0.08	0.07	0.10	0.06	0.06	5.37%	12
CIMB	NA	NA	NA	-0.19	0.02	0.10	0.10	0.15	0.27	0.21	0.19	0.15	11.03%	9
HONG	NA	NA	NA	NA	0.08	0.10	0.10	0.11	0.11	0.08	0.11	0.18	10.79%	8
KFHM	NA	NA	NA	0.00	0.02	0.05	0.04	-0.02	-0.03	-0.34	0.04	0.06	-1.91%	9
MAY	NA	NA	NA	NA	NA	NA	0.07	0.17	0.10	0.10	0.20	0.19	13.83%	6
OCBC	NA	NA	NA	NA	NA	NA	-0.01	0.09	0.09	0.07	0.12	0.20	9.23%	6
PUBC	NA	NA	NA	NA	NA	NA	0.09	0.28	0.24	0.23	0.19	0.15	19.45%	6
RHB	NA	NA	NA	0.07	0.14	0.17	0.11	0.07	0.07	0.08	0.10	0.09	10.17%	9
STAD	NA	NA	NA	NA	NA	NA	0.02	0.05	0.13	0.12	0.13	0.09	8.89%	6
Year Mean %	10.51	12.7	13.1	8.32	-14.79	18.8	11.5	4.10	6.73	5.69	7.08	8.27	7.75%	7.67%
SD %	8.52	10.0	11.15	20.77	135.6	12.3	8.54	15.58	12.24	12.01	11.69	8.57	10.79%	22.2%
CV %	81.01	78.9	84.75	249.6	-916.7	65.6	74.3	380.2	181.8	210.9	165.2	103.6	139.25%	290%

Return to shareholders (return on equity) for each bank between 2002–2013, calculated from bank annual reports as net profit attributable to equity holders of the bank/average stockholder's equity attributable to the equity holders of the bank.

Table 5-24: Return to UIAHs 2002–2013

Bank	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Bank Mean	OBS
BARK	NA	NA	NA	NA	NA	NA	0.05	0.03	0.02	0.03	0.03	0.03	3.18%	6
SALM	NA	NA	NA	NA	0.05	0.03	0.05	0.01	0.01	0.01	0.01	0.01	2.19%	8
BAHN	0.03	0.03	0.03	0.03	0.04	0.04	0.04	0.02	0.02	0.03	0.03	0.02	3.18%	12
ITHM	NA	NA	0.04	0.03	0.04	0.04	0.04	0.04	0.04	0.05	0.05	0.06	4.15%	10
KHAJ	NA	NA	NA	0.04	0.05	0.05	0.06	0.06	0.05	0.04	0.03	0.03	4.53%	9
KFHB	0.02	0.02	0.04	0.04	0.03	0.05	0.06	0.05	0.03	0.04	0.03	0.03	3.48%	12
AHLI	NA	NA	NA	NA	NA	NA	NA	NA	0.03	0.02	0.02	0.02	2.19%	4
BOU	NA	NA	NA	0.03	0.03	0.05	0.06	0.02	0.03	0.02	0.02	0.01	2.83%	9
KFH	0.03	0.03	0.04	0.06	0.07	0.07	0.04	0.02	0.02	0.02	0.02	0.02	3.53%	12
KIB	NA	NA	NA	NA	0.03	0.05	0.03	0.02	0.03	0.02	0.02	0.01	2.79%	8
MASF	NA	NA	NA	NA	NA	0.05	0.04	0.05	0.04	0.02	0.01	0.01	3.24%	7
QATR	0.05	0.05	0.05	0.05	0.06	0.06	0.06	0.06	0.02	0.02	0.02	0.01	3.99%	9
DHABI	NA	NA	0.04	0.07	0.08	0.05	0.02	0.02	0.02	0.02	0.01	0.01	3.17%	10
DUBAI	0.03	0.03	0.03	0.03	0.04	0.05	0.03	0.02	0.02	0.01	0.01	0.01	2.60%	12
EMIT	NA	NA	0.01	0.01	0.02	0.03	0.04	0.03	0.03	0.02	0.02	0.01	2.32%	10
SHAJ	NA	NA	NA	0.06	0.05	0.04	0.04	0.04	0.04	0.03	0.02	0.02	3.79%	9
AFFN	NA	NA	NA	NA	NA	0.02	0.03	0.02	0.03	0.03	0.04	0.03	2.86%	7
ALLN	NA	NA	NA	NA	NA	0.04	0.04	0.02	0.03	0.03	0.03	0.02	3.06%	7
ISLM	0.03	0.01	0.01	0.03	0.03	0.03	0.03	0.02	0.03	0.02	0.03	0.03	2.48%	12
MUAT	0.03	0.03	0.02	0.02	0.03	0.04	0.03	0.03	0.02	0.02	0.03	0.03	2.71%	12
CIMB	NA	NA	NA	0.00	0.04	0.04	0.04	0.02	0.04	0.04	0.03	0.03	3.22%	9
HONG	NA	NA	NA	NA	0.03	0.04	0.03	0.03	0.02	0.03	0.04	0.03	3.19%	8
KFHM	NA	NA	NA	0.00	0.01	0.02	0.03	0.02	0.03	0.03	0.03	0.03	2.28%	9
MAY	NA	NA	NA	NA	NA	NA	0.01	0.05	0.02	0.02	0.03	0.03	2.66%	6
OCBC	NA	NA	NA	NA	NA	NA	0.00	0.03	0.04	0.04	0.05	0.03	3.26%	6
PUBC	NA	NA	NA	NA	NA	NA	0.00	0.02	0.03	0.04	0.02	0.03	2.16%	6
RHB	NA	NA	NA	0.04	0.03	0.03	0.03	0.02	0.03	0.04	0.04	0.04	3.35%	9
STAD	NA	NA	NA	NA	NA	NA	0.01	0.03	0.05	0.05	0.05	0.04	3.87%	6
Yrs. Mean %	3.15	2.72	3.04	3.31	4.00	4.24	3.49	3.01	2.87	2.78	2.66	2.39	3.08%	3.14%
SD %	0.82	1.23	1.32	1.84	1.57	1.17	1.52	1.29	0.95	1.04	1.15	1.23	0.62%	1.26%
CV %	26.11	45.14	43.37	55.37	39.26	27.56	43.46	42.76	32.98	37.31	43.16	51.30	20.26%	40.11%

Return to UIAHs between 2002–2013 for each bank, which is either taken directly from the annual report or calculated as shown in method 1 (profit distributed to depositors/average of UIAHs depositors' account).

Appendix E - Hausman Test

It is interesting to see whether a fixed effects or a random effects model is more significant or more appropriate to use, and better for our data. A Hausman specification test could be performed to compare between the two models, to examines if the individual effects are uncorrelated with other regressors in the model (Park, 2011). For example, if individual effects are correlated with other regressor, that is random effects would violate a Gauss-Markov assumption and the model is no longer BLUE.

E.1 Hypothesis Test

Null hypothesis: Random-effects model is appropriate.

Alternative hypothesis: fixed effects model is appropriate.

If the null hypothesis is rejected, then the alternative hypothesis or fixed effects model would be preferred over random effects model.

Table 5-25: Hausman Test

Correlated Random Effects - **Hausman Test**
Equation: RANDOM
Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	13.342346	7	0.0442**

**The p-value for the Hausman test is less than 5% which indicate that random effects is not appropriate and the fixed effects could be better test.

Therefore, the Hausman test rejects the null hypothesis and the use of fixed effects model would be favoured to explain the difference in the rates of return between shareholders and investment account holders over the use of random effects model.

Chapter Six: Difference in Returns (Case Study of Kuwait Finance House)

6.1 Introduction

The focus of this chapter is to examine the differences in rates of returns of three banks within the Kuwait Finance House (KFH) group, as a case study. It was noted in chapter 5 that differences in rates of return exist within this banking group itself, i.e. the parent and two subsidiaries. This chapter will place its emphasis on the regulations of the countries with respect to the CG structure of the banks, such as those relating to the board structure, since the subsidiaries are separate companies with their own BODs. Therefore, the board structures will be examined to determine if these have any influence on the UIAHs rates of return and the fairness in receiving a decent return, or, alternatively, if the returns are influenced only by management decisions.

It is necessary to extend the previous findings with case-based research in which some primary data can be gathered that may help to answer some of the questions that cannot be answered solely by reference to secondary data. Using a mixed methods approach, an interview was conducted to clarify some of the implications on rates of return that the panel data regression had previously indicated. For example, the analysis in chapter 5 showed that the main driver is the ROA, and when a bank's profit is good, most of the benefit goes to shareholders, and only a small amount goes to UIAHs, which is arguably a strange way of practicing profit-sharing. Therefore, it is necessary to further investigate the issue of UIAHs' fair treatment by using a mixed methods approach, which involves a two phase project and a procedure known as an explanatory sequential design, where quantitative data is followed by qualitative analysis to help explain the quantitative results (Creswell, 2013). KFH is a suitable case study example, because there is evidence that the UIAH in the parent bank in Kuwait were treated less equitably than those of its two subsidiaries in Bahrain and

Malaysia[90]. In addition, KFH as a group has better data than its peers and all of its financial reports are available publicly online, making it possible to undertake this type of analysis.

By examining the parent and subsidiary banks' behaviour toward UIAHs as reflective of the market and regulatory environment, it might be possible to understand why the risk adjusted rates of return to UIAHs at the subsidiaries is higher than at the parent bank (as indication of better treatment, the CV to UIAHs is lower there than the shareholder CV). More specifically, KFH's CG structure must be examined since the KFH board's governance structures were established to regulate the ethics of the organization, according to KFH-Kuwait (2014). According to Haniffa and Hudaib (2007), the foundation of IBs' business is closely related to the Islamic religion, which gives them a unique ethical identity. For example, *Shari'ah* is concerned with justice and welfare throughout society.

Despite the fact that the two subsidiaries in Bahrain and Malaysia operate in markets with far more competitor IBs than the parent bank in Kuwait, and also a more developed regulatory environment, and that different factors influence the difference in rates of return, the findings show that the main influence on the rate of return difference between the KFH parent and its subsidiaries is the ROA. For that reason, it is necessary to compare KFH in Kuwait with its competitors, using the Kuwaiti Islamic banking peers as a control to compare them against one another. It would be interesting to determine how other banks in Kuwait are treating UIAHs compared to KFH Kuwait in the same market.

6.2 Specific CG issue in Kuwait

With regard to wider regulatory issues and the development of CG in an emerging market economy, the example of Kuwait is worth noting. In 2004, the International Monetary Fund (IMF) reported that the Kuwaiti Securities Exchange Market, where the shares of Islamic

[90] KFH Turkey is not included in the sample, since the focus only in the GCC area and Malaysia, and KFH group has owned 62% of KFH Turkey since 1989. KFH Saudi Arabia also is not included in the sample because the country does not offer UPSIA.

financial institutions are traded, is regulated by more than one agency and, consequently, uses many sets of laws and regulations to govern the market (IMF, 2004a). However, these laws and regulations fail to form a comprehensive legal framework, particularly in relation to uniform financial reporting and the protection of minority shareholders and investors such as UPSIA. The Financial System Stability Assessment, based on a detailed assessment of securities supervision by the IMF, recommends that Kuwait should create a single and independent regulatory agency for securities supervision (IMF, 2004b), which should have a mandate to control the entire capital market in Kuwait, including Islamic financial institutions, and the ability to address the risks associated with inadequately regulated market activities, which will ultimately protect shareholders (especially minority shareholders) and UIAHs from any faulty actions or irregular behaviour by listed companies. The IMF also called for the adoption of a new Capital Markets Law to provide these recommendations with legal force and to guarantee the powers and independence of the proposed new supervisory agency for Kuwait's capital markets. It recommended that the regulator should set rules governing the protection of minority shareholders including UIAHs, and that it should force listed companies to implement CG principles. The Financial System Stability Assessment also noted that the Kuwaiti Stock Exchange is not operationally independent from either public or private sector interference in exercising its functions with respect to regulation and supervision (eStandards Forum Financial Standards Foundation, 2009).

These recommendations have recently been implemented in Kuwait, where the Kuwait Capital Market Authority has been established to oversee the entire capital market in the country, including IBs whose shares are traded on the stock exchange. Time and close oversight are now needed to gauge the impact of the new Capital Market Authority and assess its role and ability to regulate the Kuwaiti capital market. However, the IFSB shares the opinion of the OECD and the Basel Committee on Banking Supervision that there is no "single model" of CG which will work well in every country. Each country or organization should develop its own model of CG in order to fit its own specific needs and objectives (IFSB–3).

A 2008 survey by the International Finance Corporation and the Hawkamah Institute for CG (Hawkamah and IFC, 2008) found that Kuwait had 164 listed companies and 6 listed banks at that time. At the time of writing this thesis in 2016, Kuwait has more than 220 listed companies and 11 listed banks (not including Kuwait Industrial Bank and Saving Credit Bank, or international banks located in Kuwait); five of these 11 banks are IBs. The Kuwaiti government first introduced Islamic banking and an Islamic financial system in 1977 with the initial intention of introducing Islamic finance gradually in a dual-system approach, which would allow both conventional and Islamic financial systems to operate simultaneously. It was also designed to attract Muslim customers who had previously avoided the conventional interest-based financial system into the financial market. In the International Financial Law Review (IFLR) Little and Cunha (2009) noted that: "[t]here are no specific protections available to minority shareholders especially in a target company in the case where its majority shareholders wish to sell their shares".

In April 2007, Kuwait adopted a law regarding the protection of competition (Competition Law), which required the prior approval of the Competition Protection Body in the event that a proposed acquisition results in increased control over the market. Furthermore, Kuwait has recently introduced a new corporation law, the Companies Law of 2012, which sets out new concepts and principles to shape the way companies operate in Kuwait. The new law encourages investment and aims to provide comfort to investors and organizations looking to expand their operations. It also improves the way companies are structured, with particular regard to the separation of the board of directors from the executive management. Most importantly, the new law requires companies to adopt a more stringent adherence to best practice concerning CG. For example, it stipulates a new cumulative voting system for the election of board members, as well as introducing new corporate regulations for the IFI regarding *Sukuk*.

6.3 KFH Kuwait background

KFH, which was established in March 1977, has been the dominant Islamic bank in Kuwait for many years, and was the only Islamic bank in Kuwait until 2005, when Boubyan Islamic Bank was established. KFH has developed a good relationship with its customers over many years, and the bank is still able to attract depositors without providing them with an attractive deal above the benchmark of the Kuwaiti market. For example, looking at the amount of UPSIA in the KFH annual report in recent years, it has been observed that the amount of these deposits has increased; for example, total deposits increased in 2014 to KWD14.3bln compared to KWD 12.5bln in 2013, an increase of 14.4%. On the other hand, KFH market capitalisation has also increased. According to financial news by KFH on 08/02/2015, KFH has gained a market share which will allow the bank to maintain its leadership position locally and globally in the Islamic banking industry.

According to the KFH-Kuwait (2014) annual report, the bank has different types of investment accounts for depositors in order to provide a wide range of investment[91]. For example, it offers the Al-Mustamera investment deposit[92], Al-Sedra, Al-Kawthar, AlKhumasiya, Dimah, Al-Nuwair[93], and foreign currency deposit accounts; these names are given to different investment accounts with different contractual terms. These types of investment deposits are available to individuals, small companies, and corporate customers. In addition, KFH provides several types of savings accounts to customers with

[91] KFH offers various types of investment deposit accounts that differ based on investment term, profit distribution mechanism and currency type.

[92] The bank uses Arabic names for different investment account deposits, for example, Mustamera is an Arabic term implying continuity, where the money is kept in the account after the maturity date unless the customer requests to withdraw it or ends the contract. Al-Sedra is a type of tree, Al-Kawthar means “a lot” in Arabic and in Islam it means a river in heaven, while Alkhumasiya is a five-year investment. As different customers have different investment needs, KFH has different investment accounts, such as offering a choice of different contract lengths (longer terms have higher percentage returns), and terms of contract (some accounts can withdraw cash with ATM card).

[93] At some point, the names given to UIAHs accounts are used as marketing names rather than a description of the account. KFH have various different investment accounts that are branded differently; and the longer the period of investment, the higher the return UIAHs receive.

different specifications in Kuwaiti Dinars, as well as in foreign currency. For example, it has the Mumtaz investment savings account in KD, the Baiti savings account for children, and the premier investment savings account in foreign currency. KFH also has several investment accounts for other purposes, including education and retirement plans. The investment and savings accounts deposits can be withdrawn in whole or in part at any time according to KFH-Kuwait (2014). The investment account receives an annual profit based on the lowest monthly balance. The bank also provides ATM cards to its customers to facilitate deposits and withdrawals. Funds in all the investment and savings accounts it offers are invested on a *Mudarabah* or *Wakalah* contract basis as agreed, and with profit sharing ratios. Under a *Wakalah* contract, the fund manager receives a fee rather than a share of profit as in *Mudarabah*. However, in some *Wakalah* arrangements, in addition to the fixed fee, there is an incentive-based fee by means of which the bank may reach an outcome not dissimilar to a *Mudarabah* contract. However, the difference is that under *Wakalah,* the bank will always receive its minimum fee even if there is no profit because it is a straight management fee rather than a profit share. In some *Wakalah* agreements, the *Wakeel* is also entitled to a performance-related fee, which may make *Wakalah* more interesting for the bank because even if the profit is low, the bank will always get its fee as *Wakeel.*

According to the auditors' report (2014), KFH complies with the international financial reporting standards (IFRS) issued by the International Accounting Standards Board (IASB), as adopted for use by the state of Kuwait. KFH established a CG committee in 2011 and, according to their annual report, the bank works according to the rules and guidelines of the Kuwait central bank. The CG committee is responsible for assisting the BOD in supervising the compliance department in monitoring the implementation of the bank's CG policies. The annual report for KFH stated that the BOD is responsible for overseeing KFH's operations, ensuring a sound financial position, and protecting the interests of its shareholders, depositors, creditors, employees and other stakeholders; nevertheless, the CG committee's primary task is to protect the shareholders. According to the IFSB-3, the CG committee should protect the interests of stakeholders other than shareholders and

manage conflicts of interest between shareholders and UIAHs, especially where the funds are commingled (IFSB-3, 2006). Furthermore, KFH has adopted the Code of Conduct and Ethics of the Kuwaiti central bank for its BOD and all staff. The bank has also implemented a disclosure policy covering all qualitative, quantitative, and material information in accordance with the requirements of the central bank and other bodies, such as the Capital Markets Authority.

6.4 Research Aims and Objectives of this Chapter

The focus of the research reported in this chapter is placed on the KFH group in order to determine the respective effects of the CG structure, competition, and the regulatory environment, which may help to explain why the bank's subsidiaries behave differently from the parent bank. There are a variety of internal and external environmental factors, which may affect the difference in returns between UIAHs and shareholders at KFH. Hence, it is essential to look at the differences in the market conditions to establish whether or not these have had any impact on the way UIAHs and shareholders are treated. KFH has subsidiaries that operate in arguably more competitive markets than the Kuwaiti market itself, and the dataset shows that UIAHs are receiving better risk adjusted rates of return in Bahrain and Malaysia than in Kuwait.

The change in leadership style at KFH parent appears to be associated with the level of UIAHs rate of return; up until 2008 when the KFH parent had a single CEO Chairman, UIAHs received a higher percentage return than in later years, but also a higher CV than shareholders. This meant that UIAHs faced a higher risk compared to the return they received. Therefore, it is important to look at the profit trend, to discover whether or not the difference in risk adjusted rates of return between shareholders and UIAHs increased after 2008. In other words, are the shareholders taking a higher share of the profit (as they do when the bank profit is high), or is the bank less profitable, which is why the UIAHs are not achieving as high a profit pay-out as they did prior to 2008? KFH suffered in the post-

crisis period, and it is important to compare the profit and difference in returns before and after the crisis. In fact, financial institutions worldwide have suffered in the global economic decline following the crisis, so this could be a factor influencing KFH's profits.

Looking at the level of profit, the shareholders' ROE for KFH Kuwait dropped in 2008 from 29% to 13%, and has since continued downward. Hence, part of the research needed here is to examine the actual bank profit and compare the difference in the CVs and rates of return, rather than simply observing what happens to the rates of return between the shareholders and UIAHs when the bank's profit fluctuates.

Since the effects of the economic recession have had an effect on KFH and on other banks in the region, it will also be wise to look at the other IBs in Kuwait and compare them, as some banks in Kuwait have treated UIAHs "fairly"[94] (as indicated in chapter 4). By inspecting the CG structures of the other IBs[95], on the one hand, any differences between the two banks which are treating the UIAHs well (a fair UIAHs return), and on the other, the two banks where UIAHs are poorly treated, can be noted. It may also be asked how the KFH parent got away with treating its UIAHs less favourably. Why do its customers not simply migrate to another bank that offers a better deal? Therefore, the objective of this chapter is to focus on the KFH group in line with the findings of chapter 4 and 5, while also providing more detail about the case of the parent and the subsidiaries, and analysing why the CV or risk adjusted return of the subsidiaries are lower than those of the parent bank[96]. Is this disparity caused by the bank's decisions, or by a lack of governance regulation?

[94] In chapter 4, we noticed that 2 out of 4 Islamic banks in Kuwait have a lower UIAHs CV than shareholder CV, which indicates that the risk adjusted return that the UIAHs received is not a bad deal compared to the volatility UIAHs and shareholders are faced with.

[95] There are 5 Islamic banks in Kuwait; however, Warba Islamic Bank was only recently established and has made insufficient data available for comparison.

[96] Lower CV is a better risk adjusted return for UIAHs.

6.5 Methodology

The results in chapter 5 provided solid evidence of differences between rates of return for shareholders and for UIAHs that are applicable to the KFH group. For example, the panel data results showed that the larger the board size, the wider the rate of return difference between shareholders and UIAHs. Also, the existence of a CG committee reduces the difference in rates of return at a significance level of 10%. However, when a country dummy was introduced in panel B (see table 5-9 p. 133), the CG committee variable became more significant, with a level of significance at 5%, but board size became insignificant, an observation which receives further investigation below. A deeper and more comprehensive view of the above issues can be established using the explanatory sequential mixed method. The intention of this method is to use the qualitative data to help to explain the initial quantitative results. For example, typical survey data gathered in the first phase would be followed by qualitative interviews to further illuminate the meaning of the survey responses. Therefore, with the KFH case study, some of the issues raised by the quantitative analysis can be examined which could not be explained solely by looking at quantitative data, and which require a qualitative interview to follow up.

Yin (2013) points out that the case study method is an empirical inquiry that investigates a contemporary phenomenon with more intensity, and that it can be more appropriate to explain a specific problem by using questions to investigate a subject. The investigation can be conducted in the form of an interview. Furthermore, it allows a researcher to investigate main topics which would not easily be covered by other methods. There are different types of case study designs; however, the present study uses an embedded case study design with different sub-units including quantitative analyses to represent the CV difference situation for KFH group (between the parent bank and its subsidiaries), also using the Kuwaiti Islamic banking peers as a control to compare them with KFH-Kuwait. Along with the quantitative

data that will be analysed, an interview with the KFH management will follow, which aims to answer the following questions[97]:

1. Why do KFH subsidiaries pay higher rates of return to UIAHs than the KFH parent?

2. Even though UIAHs of KFH parent have higher risk adjusted rates of return in the pre-crisis period than they did subsequently, why was it nevertheless significantly lower than the shareholders' rate of return[98]?

6.6 KFH governance over time

The data in table 6-1 shows that from a certain perspective, the current management of the KFH parent treats UIAHs more equitably than the former management had done. The time series of the KFH parent are divided into two periods (before and after the world financial crisis), where up to 2007 the KFH parent had CEO duality (a single CEO and Chairman) and UIAHs received a higher percentage return compared to prior to 2007. Then again, UIAHs also had a higher CV of rates of return than shareholders. Yet as a whole sample, it was found in the previous chapter that banks with separate chairs and CEOs treated UIAHs more equitably (i.e. that there was less of a difference in rates of return compared to shareholders) than banks which have duality, supporting the separation of leadership, though this could be a coincidence as it might be influenced by some other variable.

[97] See the full questionnaire, which is provided in Appendix F at the end of chapter 6.

[98] When the ROA was high, the shareholders got more than 28% and UIAHs got about 7% in return, see Table 6-1, which is a higher profit share return, though still far lower than shareholders. In other words, the difference between what the shareholders get when profits are low and what they get when profits are high is much greater than the corresponding difference for the UIAHs.

Table 6-1: KFH Kuwait return

KFH-Kuwait	ROE	UIAHs	Difference
2002	20.85%	3.35%	
2003	21.28%	2.95%	
2004	24.38%	3.91%	
2005	25.63%	5.55%	
2006	24.87%	6.89%	
2007	28.79%	7.03%	
2008	12.81%	3.50%	
2009	9.57%	2.27%	
2010	8.37%	1.94%	
2011	6.22%	1.54%	
2012	6.69%	1.72%	
2013	7.58%	1.74%	
Return for entire period	16.42%	3.53%	12.89%
SD for entire period	8.62%	1.97%	
Return up to 2007	24.30%	4.95%	19.35%
Return after 2007	8.54%	2.12%	6.42%
SD up to 2007	2.94%	1.79%	
SD after 2007	2.41%	0.72%	
CV up to 2007	12.10%	36.27%	-24.17%
CV after 2007	**28.22%**	**34.14%**	-5.93%
CV for entire period	52.49%	55.80%	-3.31%

A comparison between shareholders and UIAHs for the KFH parent, where the difference in return is much smaller when KFH Kuwait had a separate leadership after 2007. Up to 2007, the difference in return was 19.35%, when KFH had same person as both chairman and CEO (duality). However, after 2007, with KFH having non-duality in their CG structure, the difference in rates of return was only 6.42%, and the difference in CVs becomes less, which indicates more equitable treatment.

It is worth mentioning that the significant change in the economic environment in more recent years may have had an effect on profits for the bank and therefore also on the returns. As a result, it is not clear that the structure of management or the change in the economy alone resulted in the UIAHs achieving lower returns, and it would be very difficult to judge whether the change in the management or the change in the economy resulted in a fairer deal for UIAHs, in the form of a lower UIAHs' CV than that for shareholders. In fact, looking at the overall profitability of KFH Kuwait in more recent years to ascertain if they

are struggling for profit may also help to explain why the UIAHs have obtained a less bad deal compared to the shareholders[99].

However, it has also been noticed that KFH's subsidiary banks are behaving more fairly towards their UIAHs than is the parent bank based in Kuwait, which may suggest that the market and regulatory environment have a strong influence on this behaviour. In addition, Bahrain and Malaysia have more IBs in their markets than Kuwait, which means that competition is likely to be stronger, and that IBs are therefore under more pressure to offer better returns to UIAH to attract depositors. The KFH subsidiaries are fully-fledged banks in their markets and it is clear in the case of Bahrain and Malaysia that they have their own policies. Both are separate companies with their own BOD, and most importantly, it would seem that they respond to their local environment in their treatment of UIAHs. For example, by looking at the differences in the CV between the parent bank and the subsidiaries, as shown later in table 6-14 on page 185, it is evident that the subsidiaries deliver better and fairer treatment to their UIAHs than does the parent bank, suggesting that the market and regulatory environment have a strong influence on this behaviour. This could be due to one or a combination of the following factors:

1. More intense competition in Bahrain and Malaysia.

2. People (in the central bank of the country in which the KFH subsidiaries operate) being more knowledgeable about KFH actual returns; or more transparency and/or more informative financial reporting.

[99] When the ROA is high, the shareholders got much more benefit, and when the ROA is lower, the shareholders' share fell more than the UIAHs share did. For example, when the profit is lower, everyone is gets a poorer deal, but compared to the shareholders the UIAHs are getting a less poor deal. When the profit is low the bank may transfer some of the profit from the shareholders to the UIAHs to keep the UIAHs happy; therefore, when the bank is struggling to make a profit, the UIAHs seem to do better than the shareholders since the bank feels they have to pay the UIAHs some profit to keep the UIAHs in-house, discouraging the UIAHs from shopping for a new bank. Conversely, when the bank is doing well, most of the profit goes to the shareholders and the UIAHs do less well in comparison.

3. IBs in Bahrain follow AAOIFI standards (Ullah, 2013), by which they have to report the transactions of the IRR and the PER from/to the UPSIA, while KFH in Kuwait does not have to do so.

According to KFH Bahrain's annual report 2013, the financial statements of KFH Bahrain were prepared in accordance with the Financial Accounting Standards (FAS) issued by AAOIFI[100]. Also, regarding matters that are not covered by FAS, the KFH Bahrain uses the relevant International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) (KFH-Bahrain, 2013).

It seems that the subsidiary is acting in one way (as it has a separate chairman and CEO), and the parent is acting in another way because its regulatory environment has a different structure, the difference in CG structure suggesting a difference in the ethical views of the respective boards. Hence, the difference in returns is more of a policy issue and the subsidiaries are acting differently from the parent bank; it could be concluded that this variance in behaviour toward the banks' UIAHs is influenced by their differences in governance. However, it could also be influenced by differences in competition, market conditions, or the supervisory environment, and in fact, these differences may even be more influential. For example, by using country dummies in the preceding chapter, an attempt was made to measure the potential effects of competition, the market conditions, and the supervisory environment, but when the results in table 5-8 of the previous chapter were examined, it seemed that the country dummy makes the non-executive director more

[100] Their *Shari'ah* rules and principles are determined by the *Shari'ah* Supervisory Board of the Bank, the Bahrain Commercial Companies Law, the Central Bank of Bahrain (CBB) and Financial Institutions Law, which follows the rule of CBB rule book (volume 2 and applicable provisions of volume 6) and CBB directives. Also, there is a statement by the bank auditor, Ernst and Young, in the KFH Bahrain 2014 annual report, that KFH Bahrain's consolidated financial statements present fairly, in all material respects, the financial position of KFH Bahrain as of 31 December 2014, the results of its operations, its cash flows, changes in equity and changes in off-balance sheet equity of investment account holders for the year then ended in accordance with the Financial Accounting Standards issued by AAOIFI.

significant and removes the significance of board size. Apart from that, the use of the country dummy to reflect the different environment does not actually change the results much with regard to the treatment of the UIAHs.

6.7 Comparative analysis of CG at Kuwait Islamic Banks

IBs in Kuwait fall under the regulation of the central bank, which means that they already have a CG standard in place[101]. According to Capital Standards Report (2013), the Central Bank of Kuwait (CBK) has issued new CG rules which replace the previous regulations of May 2004, covering banks operating in Kuwait. The new CG rules were implemented in June 2013. For example, the new CG regulations support non-duality by prohibiting the chairman from being the same person as the CEO. Similarly, a new Companies Rule (Decree Law 25 of 2012) from the Ministry of Commerce, replacing the old company law of 1944, also focuses on the CG practices of companies, and was implemented in mid-2013. Moreover, the Kuwait Capital Market Authority[102] (CMA) issued its CG regulation number 25 in June 2013, based on the "comply or explain" principle for listed companies on the Kuwaiti stock exchange, to take effect on 30 June 2016[103]. This rule covers all aspects of a corporate entity, including its board structure, the selection criteria for constituent members, risk management, and other regulations such as remuneration, audit and nomination committees. It also stipulates the separation of duties of the chairperson and the CEO, and regulates the relationships between the shareholders, the BOD, and the executive management in listed companies. The CMA CG regulations recognise new guidelines concerning the establishment of clear roles and responsibilities, strengthening board composition, recruiting highly qualified candidates for the BOD, safeguarding integrity in financial reporting, promoting ethical standards and responsible conduct, and

[101] The Central Bank of Kuwait established its CG code in September 2012.
[102] The CMA was established in 2010 as an independent statutory body reporting directly to the office of the Prime Minister.
[103] The CMA does not affect decisions made during the period covered in this thesis; however, Kuwait's Central Bank is the supervisor authority for banks which already have CG in place.

ensuring timely and high quality disclosure, as well as respecting the rights of shareholders, and recognising the legitimate interests of stakeholders and the importance of social responsibility. The CMA regulations were enhanced in 2014, and among the most prominent changes to the CG code were the enhancement of shareholder protection and provisions relating to transparency and competition. Furthermore, the CG code improves the protection of other stakeholders' rights.

Therefore, it is important to compare the CG structure of the KFH parent with those of similar IBs in Kuwait. The tables below show the board structure at Kuwaiti Islamic banks, and analyse their leadership structures and other CG components over 12 years. The sampled banks are analysed in terms of having duality or separate CEO-chairman, their ratio of non-executive members in the BOD, board size, the existence of a CG committee attached to the BOD, and the number of members of the *Shari'ah* board. Then, the board structure is examined to find any association with the rate of return spread, and to determine whether or not leadership structure is one of the CG elements which influences the returns for both types of investors. As shown at the bottom of each bank table below, the difference in the rates of returns can be 2 to 3 times (or even more) more for shareholders compared to UIAHs, and when risk is factored in and the CV is observed, it is clear that UIAHs are not getting a fair deal[104].

6.7.1 Leadership Structures at Kuwait Islamic Banks

6.7.1.1 Ahli United Bank

The Ahli United Bank (formerly known as the United Bank of Kuwait and Middle East) was established in 1971, having previously been affiliated to a British bank since 1941[105]. The Ahli United Bank Kuwait converted to become a *Shari'ah*-compliant bank on April 1, 2010. Therefore, it only has 4 sets of data observations to compare with other Kuwaiti IBs. The

[104] See the bottom of each bank board structure table.
[105] Ahli United website (http://www.ahliunited.com.kw/en/about/index.html), accessed18/7/2015.

Ahli United CV for Shareholders was 8.17%, compared to a UIAHs CV of 26.46%, giving a difference in CV of -18.29%, but perhaps as a result of the lack of information these numbers are not very representative.

Table 6-2 Ahli United Bank board structure

Year	Name of Chairman & CEO	CEO duality	Ratio of non-executive	Board Size	CG Committee	No. Of Sharia board
2010	Hamad Al-Marzouq Chairman and MD Adel A. El-Labban – Group CEO & MD	No	.50	8	0	4
2011	Hamad Al-Marzouq Chairman and MD Adel A. El-Labban – Group CEO & MD	No	.50	8	0	4
2012	Hamad Al-Marzouq Chairman and MD Adel A. El-Labban – Group CEO & MD	No	.50	8	0	4
2013	Fahad Al-Rajaan – Chairman Adel A. El-Labban - Group CEO & MD	No	.82	11	0	4

	Shareholders	UIAHs	Difference
Number of Observations	4	4	
Mean return	13.10%	2.19%	10.91%
Standard Deviation	1.07%	0.58%	
Coefficient of Variation	8.17%	26.46%	-18.29%

Source: data obtained from Ahli United bank Annual Report (2010-2013). MD = Managing Director. The calculation of CV shows that UIAHs are worse off compared to shareholders, with a difference in rate of return of -18.29%. This indicates that there is volatility in the UIAHs rates of return as a signal that UIAHs face more risk, compared to the return they received, implies bad deal in rates of return to UIAHs.

The mean return to shareholders for the 4 years of observations was 13.10%, with a UIAHs return of 2.19%, meaning that there was a difference in return of 10.91%. Even though Ahli United has always separated the roles of chair and CEO in its leadership structure, the UIAHs' CV is higher than the shareholders' CV; this may suggest that, regardless of leadership structure, all boards primarily look after their shareholders' interests. The bank did not have a separate CG committee in their BOD, as suggested by the IFSB.

6.7.1.2 Boubyan Bank

Boubyan Bank (established in 2004, and based in Kuwait) issued its first annual report in 2005. The bank reported an unrealised loss of KD 51.7 million for the year 2009 due to precautionary provisions that affected their financial results, and to address the impact of

the global financial crisis which began in 2008. As Boubyan's Annual Report indicated, the bank has restructured its board, as can be seen in the following table.

Table 6-3 Boubyan Board Structure

Year	*Name of Chairman & CEO*	*CEO duality*	*Ratio of non-executive*	*Board size*	*CG Committee*	*No. Of Sharia board*
2005	Yacob AlMuzaini Chairman & MD	Yes	0.89	9	0	5
2006	Yacob AlMuzaini Chairman & MD	Yes	0.89	9	0	5
2007	Yacob AlMuzaini Chairman & MD	Yes	0.89	9	0	5
2008	Mohammed Al-Roumi – Chairman Yacob Al-Awadi - Acting, Chief Executive Officer	No	0.89	9	0	5
2009	Ibrahim Ali Al-Qadhi – Chairman Adel Al Majed CEO	No	0.89	9	0	6
2010	Ibrahim Ali Al-Qadhi – Chairman Adel Al-Majed Vice Chairman & MD	No	0.89	9	0	6
2011	Ibrahim Ali Al-Qadhi – Chairman Adel Al-Majed Vice Chairman & MD	No	0.89	9	0	5
2012	Adel Al-Majed Chairman & MD	Yes	0.89	9	1	4
2013	Mahmoud Y. Al-Fulaij – Chairman Adel Abdul Wahab Al-Majed - Vice-Chairman & CEO	No	0.89	9	1	5

	Shareholders	UIAHs	Difference
Number of Observations	9	9	
Mean return	5.30%	2.83%	2.46%
Standard Deviation	4.37%	1.59%	
Coefficient of Variation	82.49%	56.27%	26.21%

Source: Bank Annual Report (2005-2013). The UIAHs risk adjusted return is better than the shareholders' according to the CV; whereas the CV to UIAHs is 56.27%, compared to shareholders' 82.49%, a difference of 26.21%.

In 2011, Boubyan Bank established an audit committee to ensure that the CG principles published by Kuwait's Central Bank were in place, and in 2012 the bank formed a CG committee attached to the BOD; however, it did not mention its responsibility toward UIAHs, as had been suggested by the IFSB. Also in 2012, only the chairman and the managing director were entrusted with executive roles in the bank. All other board members were non-executive directors. In their 2013 annual report, Boubyan Bank stated

the names of their major shareholders and their percentages of ownership. At that time, the shares in the bank mostly belonged to the National Bank of Kuwait (NBK), who held 58.3%. NBK is the largest conventional bank in Kuwait, and the Public Institution for Social Security (a government entity) is a major shareholder of the NBK, but it only holds 5.030% of the shares, according to Kuwaiti stock exchange in April 2015. The second largest shareholder of Boubyan is the Commercial Bank of Kuwait, which is a conventional bank owning 19.9%. In fact, Boubyan could be run in the interests of the majority shareholders of NBK, since NBK owns nearly 60% of shares in Boubyan.

6.7.1.3 Kuwait Finance House - Kuwait

KFH was established in Kuwait in 1977, and until 2005[106] it was the only bank in Kuwait offering *Shari'ah* compliant products. In 1984, the bank was listed on the Kuwaiti stock exchange. The following table shows the ownership disclosure of the major shareholders of KFH, most of which are government entities.

Table 6-4: ownership of KFH

Name	Disclosure Type	Percentage	Published On
General Authority for Investment	Direct	24.080	2011
General Authority for Minors Affairs	Direct	10.480	2011
General Secretariat of Awqaf	Direct	8.290	2011
General Organization for Social Insurance	Indirect**	6.690	2015

Source: Kuwait Stock Exchange (2015)[107]. **indirect ownership through agencies. All of the above authorities and organisations belong to the Kuwaiti government; therefore, the government ownership share in KFH is about 50%.

[106] Boubyan Bank initial public offering (IPO) was in 2004, but was open to public in the second half of 2005.
[107] http://www.kse.com.kw/EN/Markets/ListedCompanies/Pages/CompanyInfo.aspx?stockcode=108

Table 6-5 KFH Board Structure

Year	*Name of Chairman & CEO*	*CEO duality*	*Ratio of non-executive*	*Board Size*	*CG Committee*	*No. Of Sharia board*
2002	Bader Al-Mukhaizeem Chairman & MD Jassar D. Al-Jassar - General Manager	Yes	0.90	10	0	6
2003	Bader Al-Mukhaizeem Chairman & MD Jassar D. Al-Jassar - General Manager	Yes	0.90	10	0	6
2004	Bader Al-Mukhaizeem Chairman & MD Jassar D. Al-Jassar - General Manager	Yes	0.90	10	0	6
2005	Bader Al-Mukhaizeem Chairman & MD Mohammed Al-Omar - Deputy GM	Yes	0.90	10	0	6
2006	Bader Al-Mukhaizeem Chairman & MD Mohammed Al-Omar - General Manager	Yes	0.90	10	0	6
2007	Bader Al-Mukhaizeem Chairman & MD Mohammed Al-Omar - General Manager	Yes	0.90	10	0	6
2008	Bader Al-Mukhaizeem Chairman & MD Mohammed Al-Omar – CEO	No	0.90	10	0	6
2009	Bader Al-Mukhaizeem Chairman & MD Mohammed Al-Omar – CEO	No	0.90	10	0	6
2010	Bader Al-Mukhaizeem Chairman & MD Mohammed Al-Omar - CEO	No	0.90	10	0	6
2011	Sameer Al-Nafeesi – Chairman Mohammed Al-Omar – CEO	No	1.00	10	1	5
2012	Mohammed Al-Khudairi – Chairman Mohammed Al-Omar – CEO	No	1.00	10	1	5
2013	Mohammed Al-Khudairi – Chairman Mohammed Al-Omar - CEO	No	1.00	10	1	5

	Shareholders	UIAHs	Difference
Number of Observations	12	12	
Mean return	16.42%	3.53%**	12.89%
Standard Deviation	8.62%	1.97%	
Coefficient of Variation	52.49%	55.80%	-3.31%

Source: Bank Annual Report (2002-2013). MD = Managing director. **the mean return to UIAHs is 3.53% for the entire period of observations, which is higher than the other Kuwaiti banks. However, if the mean return is calculated for the last 4 years compared to the Ahli United bank observations, it would give a return of 1.73% to the UIAHs, see table 6-9. The UIAHs' CV is higher than the shareholders' CV, indicating that UIAHs are worse off than shareholders.

The Governance Committee was established at KFH Kuwait pursuant to a Board of Directors' meeting on 1 August 2011, and initially it was also concerned with BOD nominations and remuneration. However, in a BOD meeting on 11 February 2013, the Governance Committee was separated from the Nomination & Remuneration Committee in order to carry out its tasks individually, discharging its functions on this basis (KFH Annual Report, 2013).

6.7.1.4 Kuwait international Bank

The Kuwait International Bank was founded in 1973 and became fully *Shari'ah*-compliant in 2007 as the third Islamic bank in Kuwait. Kuwait International Bank (KIB) was originally known as Kuwait Real Estate bank. As of December 2015, KIB operated 26 branches, spread across Kuwait.

Table 6-6: Kuwait International Bank leadership structure

Year	*Name of Chairman of the Board of Directors & CEO*	*CEO duality*	*Ratio of non-executive*	*Board Size*	*CG Committee*	*No. Of Sharia board*
2007	Abdul Wahab Al-Wazzan - Chairman Adil Ahmad – GM	No	0.89	9	0	5
2008	Abdul Wahab Al-Wazzan - Chairman Hameed Al-Rasheed – MD	No	0.89	9	0	5
2009	Abdul Wahab Al-Wazzan - Chairman Hameed Al-Rasheed – MD	No	0.89	9	0	5
2010	Sheikh Mohammed Al-Sabah – Chairman Dr. Mahmoud Abdul Eyoun – CEO	No	0.89	9	0	5
2011	Sheikh Mohammed Al-Sabah – Chairman Loai Maqamis - Acting CEO	No	0.89	9	0	4
2012	Sheikh Mohammed Al-Sabah Chairman Loai Maqamis - CEO	No	0.89	9	0	4
2013	Sheikh Mohammed Al-Sabah – Chairman Loai Maqamis - CEO	No	0.89	9	1	4

	Shareholders	UIAHs	Difference
Number of Observations	7	7	
Mean return	7.10%	2.38%	4.72%
Standard Deviation	8.24%	1.55%	6.69%
Coefficient of Variation	116.02%	65.25%	50.77%

Source: Bank Annual Report (2006-2013). The mean return to the UIAHs is 2.38%, whereas the mean return to shareholders is 7.10%. Note that the CV for shareholders is 116.02%, compared to the UIAHs CV of 65.25%, which indicates that the UIAHs are being fairly treated, according to the risk adjusted returns.

KIB have always supported non-duality in their board composition and kept their board size stable in terms of numbers. However, they did not establish their CG committee until 2013.

6.7.2 Return to shareholders and UIAHs (2002-2013)

The return on equity was calculated by taking the net profit from the banks' annual reports (profit attributable to the equity holders of the Bank), divided by the average stockholder's equity attributable to the equity holders of the bank for the years 2003 to 2013. The percentage returns to the UIAHs were taken from the annual report, or if this return was not published as percentage returns, they were calculated as the profit distributed to depositors/average of UIAHs depositors' accounts[108].

Table 6-7 Shareholders' and UIAHs' returns at Kuwait Islamic Banks

Kuwait Islamic Banks	Ahli United Bank		Boubyan Bank		KFH		KIB	
Year	ROE	UIAHs	ROE	UIAHs	ROE	UIAHs	ROE	UIAHs
2002	NA	NA	NA	NA	20.85%	3.35%	NA	NA
2003	NA	NA	NA	NA	21.28%	2.95%	NA	NA
2004	NA	NA	NA	NA	24.38%	3.91%	NA	NA
2005	NA	NA	6.41%	3.00%	25.63%	5.55%	NA	NA
2006	NA	NA	9.12%	3.00%	24.87%	6.89%	6.66%	3.24%
2007	NA	NA	14.54%	4.85%	28.79%	7.03%	11.97%	5.19%
2008	NA	NA	1.36%	5.70%	12.81%	3.50%	12.27%	3.31%
2009	NA	NA	-46.51%	1.76%	9.57%	2.27%	-4.87%	2.22%
2010	11.96%	3.03%	3.76%	2.70%	8.37%	1.94%	9.07%	2.60%
2011	12.42%	2.03%	3.33%	2.22%	6.22%	1.54%	5.37%	2.49%
2012	14.14%	1.72%	4.04%	1.70%	6.69%	1.72%	6.21%	2.41%
2013	13.87%	1.96%	5.13%	0.56%	7.58%	1.74%	5.99%	0.83%
Number (N)	4	4	9	9	12	12	8	8
Mean	13.10%	2.19%	0.13%	2.83%	16.42%	3.53%	6.58%	2.79%
SD	1.07%	0.58%	17.92%	1.59%	8.62%	1.97%	5.36%	1.23%

Note: N = number of observation, SD = standard deviation. The majority of shareholders' returns are higher than the UIAHs' returns, except in 2009 for Boubyan and KIB as their negative ROE in 2009 was not adjusted as in the previous chapter, since here the CV is not being measured.

[108] See Appendix H for shareholders and UIAH return calculations

Table 6-8: Kuwait Islamic banks CV between the years 2002 – 2013

CV for Kuwait Banks	CV for Shareholders returns (ROE)	CV for UIAHs returns
CV for Ahli United	8.17%	26.46%
CV for Boubyan	82.49%	56.27%
CV for KFH	52.49%	55.80%
CV for KIB	81.35%	44.27%

The coefficient of variation for shareholders and UIAHs from 2002-2013. Ahli and KFH had a UIAHs CV higher than that for shareholders, which indicates that their risk-adjusted return is not reasonable compared to the risk UIAHs are exposed to.

As the above table shows, there is more variability in the UIAHs risk-adjusted returns than in the shareholders' returns in the Ahli United and KFH banks; whereas in the other banks (Boubyan and KIB), CV shows more volatility in the shareholders' risk-adjusted returns than for the UIAHs' returns.

Table 6-9: Kuwait Islamic banks CV between the years 2010 – 2013

Kuwait Islamic Banks	Ahli United Bank		Boubyan Bank		KFH		KIB	
Year	ROE	UIAHs	ROE	UIAHs	ROE	UIAHs	ROE	UIAHs
2010	11.17%	3.03%	3.76%	2.70%	8.37%	1.94%	9.07%	2.60%
2011	12.42%	2.03%	3.33%	2.22%	6.22%	1.54%	5.37%	2.49%
2012	14.14%	1.72%	4.04%	1.70%	6.69%	1.72%	6.21%	2.41%
2013	13.87%	1.96%	5.13%	0.56%	7.58%	1.74%	5.99%	0.83%
Mean	12.90%	2.19%	4.06%	1.79%	7.22%	1.73%	6.66%	2.08%
SD	1.38%	0.58%	0.77%	0.92%	0.95%	0.16%	1.65%	0.84%
CV	10.69%	26.46%	18.90%	51.25%	13.22%	9.48%	24.73%	40.22%

Since Ahli Bank has only 4 observations, it would also be necessary to compare the last 4 years between this bank and their peer Islamic banks in Kuwait. As a result, KFH has the lowest UIAHs mean return of 1.73% even though its UIAHs CV is lower.

6.7.3 Hypothesis Testing for the Return difference

Different tests can be used to determine whether or not there is a significant difference between the percentage returns to shareholders and to UIAHs; however, a t-test will be performed to determine whether or not the two percentage returns are significantly different. The percentage return of shareholders (mean) as ROE (μ_1) and the percentage returns of UIAHs (mean) (μ_2) are calculated from 2002 to 2013[109]. We are hypothesising

[109] Some banks have fewer than 12 years of observation since they are new as Islamic banks.

that the shareholders and UIAHs should not have significantly different rates of returns based on risk exposure to both stakeholders in our sample banks' annual reports. If we look at the mean for both investors' returns and identify any significant difference between the return for each bank, we will be constructing our test of hypothesis as:

$\boldsymbol{H_0}$**:** There is no significant difference between the two means $\mu_1 = \mu_2$

$\boldsymbol{H_1}$: There is significant difference between the two means return $\mu_1 \neq \mu_2$

In the following table, both the summary of shareholders' and UIAHs' mean returns are shown for Kuwait's IBs from 2002 to 2013, along with the t-statistic for those years.

Table 6-10: Mean return and CV by bank for Kuwait Islamic banks

2002-2013	*Shareholders*			*UIAHs*			*Differences*	
Islamic banks	Mean	SD	CV	Mean	SD	CV	Mean diff	CV diff
AHLI	13.10%	1.07%	8.17%	2.19%	0.58%	26.46%	10.91%	-18.29%
BOU	5.30%	4.37%	82.49%	2.83%	1.59%	56.27%	2.46%	26.21%
KFH	16.42%	8.62%	52.49%	3.53%	1.97%	55.80%	12.89%	-3.31%
KIB	7.19%	3.96%	81.35%	2.79%	1.23%	44.27%	4.41%	37.08%

Note: in 2009, Boubyan's ROE was -46%, which was replaced by a 0% return. KFH means that the returns for both shareholders and UIAHs are higher than other banks. However, the UIAHs CV is also higher than the shareholders' CV, which indicates that UIAHs are not being fairly treated in terms of risk adjusted returns. Also noted that when UIAHs CV is higher than shareholders' CV (result to a negative CV difference), the difference in rate of return is also higher.

Table 6-11: t-statistic of Islamic banks' rates of return in Kuwait

Different between shareholders and UIAHs returns for Kuwait Islamic banks		
Time series annual pay-out mean for the period of 2002 - 2013		
	Shareholders	UIAHs
Mean	0.1075	0.0300
Variance	0.0058	0.0003
Observations	33	33
Level of significance	5%	5%
t-statistic	5.7154	
One-tail	0.0000	
t-critical one-tail	1.6896	
Two-tail	0.0000	
t-critical two-tail	2.0301	
Standard deviation	0.0762	0.0159
Coefficient of variation	0.7094	0.5321

Data for 4 Kuwaiti Islamic banks returned a t-test with a significant level (α) of 5%, which indicates that there is significant difference in returns.

Therefore, by looking at the rate of return differences in the t-test, the null hypothesis, in which no difference between the two returns can be rejected, as expected. By observing the annual reports, it has been established that most of the time shareholders receive a higher ROE than the UIAHs' return, and as the t-test shows, there is a significant difference between the returns to these two groups.

6.8 KFH Case Study

6.8.1 Difference in return of KFH - Kuwait

By considering KFH-Kuwait individually, the variations between the annual rates of return can be determined. The following table shows KFH's annual rates of return.

Table 6-12: KFH ROE and UIAHs' returns 2002 – 2013

Year	ROE	UIAHs
2002	20.85%	3.35%
2003	21.28%	2.95%
2004	24.38%	3.91%
2005	25.63%	5.55%
2006	24.87%	6.89%
2007	28.79%	7.03%
2008	12.81%	3.50%
2009	9.57%	2.27%
2010	8.37%	1.94%
2011	6.22%	1.54%
2012	6.69%	1.72%
2013	7.58%	1.74%
Number (N)	12	12
Mean	16.42%	3.53%
Standard Deviation	8.62%	1.97%

KFH Kuwait's mean ROE to shareholders is more than 4 times the mean rate of return to UIAHs.

Again, by looking at the two returns, for shareholders and UIAHs, for KFH Kuwait alone, the hypothesis to be tested is constructed as:

$\boldsymbol{H_0}$**:** There is no significant difference between the two means $\mu_1 = \mu_2$

$\boldsymbol{H_1}$: There is significant difference between the two means return $\mu_1 \neq \mu_2$

Table 6-13: KFH Kuwait t-Test for the difference in the rate of return 2002-2013

Difference between shareholders and UIAHs returns			
Time series of annual pay-out mean return difference between shareholders and UIAHs 2002 - 2013			
	Shareholders		*UIAHs*
Mean	0.1642		0.0353
Variance	0.0074		0.0003
Observations	12		12
Level of significance	5%		5%
t-statistic	5.0491		
One-tail	0.0001		
t-critical one-tail	1.7822		
Two-tail	0.0002	**	
t-critical two-tail	2.1788		
Standard deviation	8.62%		1.97%
Coefficient of variation	52.49%		55.80%

Note: ** denotes significance at the 5 per cent level; the p-value is much smaller than the α level of 5% in KFH's returns for the period 2002-2013, which indicates that there is a statistically significant difference between returns for the two classes of equity investors (shareholders and UIAHs).

The annual rate of return for the period 2002-2013 was used to test the significance difference between shareholders and UIAHs. The hypothesis was tested using the significance test approach under a two-tailed test with a significance level of α = of 5%. Since the p-value is less than α, and the t-test score is 5.0491, which falls in the rejection region, the null hypothesis is rejected, and an alternative hypothesis is stated: that there is a significant difference between the returns to shareholders and to UIAHs.

6.9 Discrepancy in UIAHs' rates of return and smoothing

6.9.1 KFH parent and its subsidiaries

Table 6-14 shows a difference in risk-adjusted rates of return between the parent bank and its subsidiaries; moreover, when ROA is high, shareholders receive more of the benefits than UIAHs. Therefore, it is necessary to examine the CG of the bank, and also the market conditions, in order to clarify why differences in risk adjusted rates of return exist.

Table 6-14: returns comparison between KFH and its subsidiaries

Kuwait Financial House	KFH - Kuwait		KFH - Bahrain		KFH - Malaysia	
Year	Shareholders	UIAHs	Shareholders	UIAHs	Shareholders	UIAHs
2002	20.85%	3.35%	6.82%	1.75%	NA	NA
2003	21.28%	2.95%	8.70%	1.75%	NA	NA
2004	24.38%	3.91%	23.77%	3.50%	NA	NA
2005	25.63%	5.55%	26.10%	3.51%	0.11%	0.22%
2006	24.87%	6.89%	26.65%	3.19%	2.03%	0.99%
2007	28.79%	7.03%	25.77%	5.00%	4.72%	2.29%
2008	12.81%	3.50%	14.97%	6.00%	4.46%	3.08%
2009	9.57%	2.27%	0.91%	5.00%	0.00%	2.46%
2010	8.37%	1.94%	2.08%	2.79%	0.00%	2.56%
2011	6.22%	1.54%	1.86%	3.75%	0.00%	2.97%
2012	6.69%	1.72%	2.57%	3.00%	4.07%	3.20%
2013	7.58%	1.74%	1.52%	2.50%	6.29%	2.77%
Observation	12	12	12	12	9	9
Mean	16.42%	3.53%	11.81%	3.48%	2.41%	2.28%
SD	8.62%	1.97%	10.92%	1.31%	2.50%	1.01%
CV	52.49%	55.80%	92.43%	37.56%	104.05%	44.38%

A comparison between the rates of returns of the parent company and of the subsidiaries of Kuwait Finance House for shareholders and UIAHs. Note the higher CV, meaning there is more variability in the returns. KFH Malaysia in 2009-2011 had negative ROE (losses) which have been adjusted to a zero return to be more comparable with the UIAHs return (see chapter 5 Appendix C for more explanation). KFH Malaysia shareholders are not doing well and this could be another factor influencing why UIAHs are getting a better deal.

Bank disclosure and transparency in the annual reporting between the parent and its subsidiaries may also be useful here. For example, an examination of the annual report of KFH-Bahrain (2013) reveals that the bank gave up part of its *Mudarib* share to compensate UIAHs with a fair return. The bank may also forgo part of its shareholder's profit when UIAHs' return is very low[110]. It would therefore be worthwhile to look at the evolution of the percentage of UIAHs in the balance sheet and the evolution of the Commodity Murabahah Transactions-based term deposits (CMT) for wholesalers and retailers. Changes in the balance sheets of IBs over time should in principle be investigated; however, this is a

[110] When an Islamic bank give up some or all of its Mudarib share of profits to "smooth" the rate of profit pay-out to UPSIA, it creates a displaced commercial risk.

new trend for IBs and there is as yet insufficient data for a proper comparison. The point is that if UIAHs funds are a relatively small part of the total deposit or capital, it would be easier for their return to be smoothed using the share of the shareholders. However, if UIAHs' share is small, this will also affect the size of the *Mudarib* share, which can sometimes reach up to 70%. In all cases[111], the *Mudarib* share on the assets goes to the shareholders, and if the total return to shareholders is significant (the shareholders' share of the profit plus the *Mudarib* share), and the return on the assets is poor, then the shareholders can still donate some profit to the UIAHs in order to enhance their returns. Although the bank may not be able to use shareholders' retained earnings to compensate UIAHs by boosting their returns, they can use PER or IRR to smooth the returns to UIAHs.

If the bank does not have UPSIAs then the investment funds must come from somewhere else[112]; banks tend not to use much shareholders' equity. Usually IBs have two alternatives: either CMT-based deposits, or a large volume of current accounts, as Alrajhi does in Saudi Arabia. However, KFH Kuwait consistently has higher total deposits over total assets (TDTA) ratio, whereas its subsidiaries have a lower TDTA ratio, which may give the subsidiaries the flexibility to forgo some of the *Mudarib* share (see table 6-15). For example, in the case of KFH Bahrain, it would be easier to pay the UIAHs a higher rate of return than shareholders when the ROA is low, since the percentage of TDTA is low[113]. The bank can always sacrifice some of its *Mudarib* share to boost the return to UIAHs. In contrast, if the bank has a high proportion of UPSIAs, then this would tend to give the bank a higher *Mudarib* share, but make "smoothing" more costly to the shareholders.

[111] Except when the bank smooths the UIAHs' return.

[112] All banks are highly leveraged; the Basel ratio only requires 3% of total exposures to be financed by core common equity Tier 1, which is considered the minimum. Banks generally try to use other people's funds rather than their shareholders' funds to achieve the leverage effect.

[113] *Mudarib* is not allowed to use the PER under the terms of contract to pay an amount to the *Rabb Almaal* to make up for a loss, but they could use the IRR. PER is an account to which the *Mudarib* has also contributed, where the IRR is set up entirely from the profits of UIAHs.

Table 6-15: TDTA of KFH and its subsidiaries

	KFH-Kuwait			KFH-Bahrain			KFH-Malaysia		
Year	TD	TA	TDTA	TD	TA	TDTA	TD	TA	TDTA
2002	6602.21	8530.88	0.77	0.00	94.15	0.00	NA	NA	NA
2003	7805.23	10319.31	0.76	82.71	268.35	0.31	NA	NA	NA
2004	8697.66	11734.31	0.74	127.39	468.62	0.27	NA	NA	NA
2005	10922.26	16031.16	0.68	264.36	693.09	0.38	31.40	133.62	0.24
2006	12899.98	21836.48	0.59	387.77	1071.81	0.36	292.00	854.54	0.34
2007	19638.10	32226.74	0.61	1048.94	1955.59	0.54	628.23	1800.89	0.35
2008	23959.41	38210.18	0.63	739.63	3416.76	0.22	1239.41	2779.19	0.45
2009	25320.08	39367.85	0.64	627.93	3652.66	0.17	1242.55	3380.44	0.37
2010	27259.80	44720.24	0.61	647.87	3847.61	0.17	1478.84	3529.92	0.42
2011	31880.47	48312.28	0.66	969.41	4088.83	0.24	1485.02	3192.41	0.47
2012	33402.21	52287.70	0.64	764.36	3918.88	0.20	1755.98	2885.33	0.61
2013	35829.79	52287.70	0.69	1004.79	4162.50	0.24	1628.10	2880.05	0.57

Source: Bankscope. TDTA as a percentage, where KFH Kuwait has higher percentage of TDTA than its subsidiaries. Having a high TDTA gives the bank a high *Mudarib* share; however, a lower TDTA gives flexibility to the bank to forego some of the *Mudarib* share or to smooth the return to UIAHs.

6.10 Interview with KFH management

This section will discuss the interview that took place with a representative of KFH Kuwait's management, and which formed the second part of the explanatory sequential mixed methods approach. The intent of this method is to use the qualitative data to help to explain the initial quantitative results.

The interview (see the interview questionnaire in Appendix F at the end of chapter 6) was organized through one of the KFH board members (Mr. Ahmad Al-Omar) and through KFH Kuwait's CEO Office. A copy of the interview questionnaire was emailed to KFH and to the CEO's office prior to the interview. The interview was conducted at 12:30pm on September 9, 2015 at KFH's headquarters with Dr. Mohamed El-Shebshiry (Report and Research Manager of the Strategy and Corporate Affairs Department). It was agreed that the interview would be recorded. I started by explaining the purpose of the research and clarified that any question would be omitted on request; however, the interviewee was very flexible and had no concerns. The interview proceeded using a semi-structured path to

allow sufficient freedom to explore the findings, outlining the importance of the research to ensure coverage of the topic. The interviewee was happy to answer any questions. The discussion was in Arabic, which was later translated into English for the purposes of the research, then the interview was transcribed and a copy was sent to Mohamed El-Shebshiry on October 5, 2015. It is worth noting that since KFH is based in Kuwait, it was difficult to arrange other meetings, as the schedule of top executive directors would not allow for this during the time I was in Kuwait.

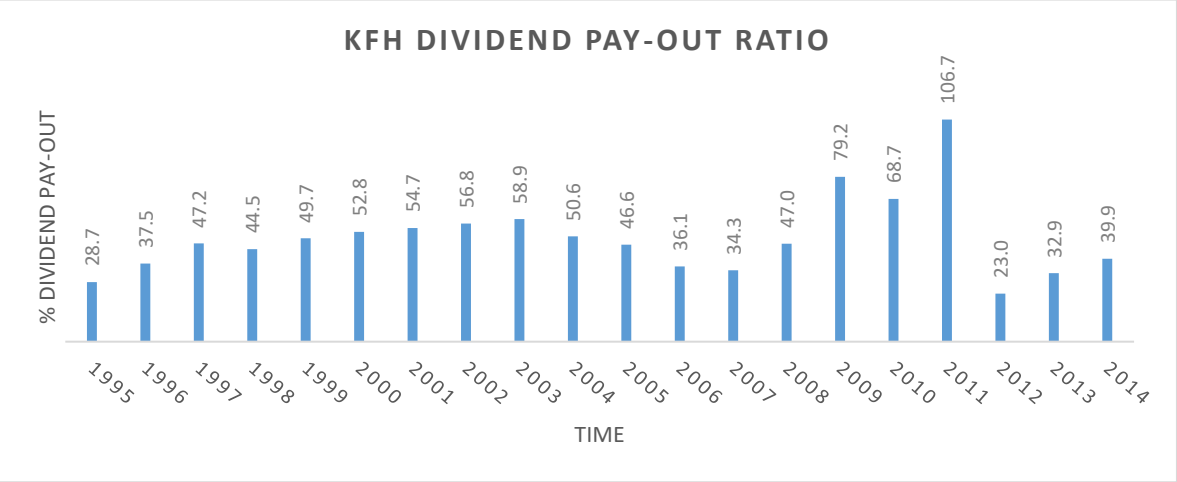
6.11 Interview Analysis

Referring to the study undertaken by KFH (see Appendix F, p.204, question 4) the interviewee argued that the UIAHs had done as well as the shareholders because the share price was 3.5 KWD back in March 2008, and at the time of the interview had fallen to about 0.580 KWD. Therefore, it is crucial to further investigate this matter, since it undermines the argument of the thesis whereby the shareholders are getting a much better deal than the UIAHs. Even though the KFH argument here is different, the interviewee was referring to dividends and changes in the value of shares, rather than accounting profit. However, it is necessary to analyse the real value added to the shareholders, corresponding to the study done by KFH and to the period of time used[114]. It is worth mentioning that the KFH study did not reflect the gain from retained earnings and, hence, the bank growth rate. It used dividends and capital gains for the return to shareholders and ignored the fact that, as table 6-16 (on the dividend pay-out ratio (DPR)) shows, more than 50% of profits has been kept as retained earnings by KFH in most years; it is therefore necessary to examine where the other 50% has gone[115].

[114] As KFH was listed on the Kuwait stock exchange in 1984, data is not available for the whole KFH internal study period of 1978 to 2014, while Bloomberg historical data goes back to 1999.

[115] A significant amount of value was (arguably) lost in the 2008 global financial crisis, which seems to have led to a big fall in the KFH share price; see Table 6-18.

Table 6-16: KFH Dividend pay-out ratio



Source: *Bankscope*. KFH was first listed on the Kuwait stock exchange in 1984; therefore, data is not available for the whole KFH internal study period of 1978 to 2014. As indicated by the graph, KFH kept more than 50% of their profit in most years as retained earnings. Where dividend pay-out = dividend paid *100 / net Income. Dividend paid = common dividends relating to the period. Net income = net income before profit transfers - profit transfers to parent companies. Most KFH shares are owned by the government of Kuwait, which does not actively trade in the market.

What is the effect on the value to the shareholders of having more than 50% earnings retention? It does not make sense for a firm to retain more than 50% of the annual profit if doing so brings no benefit to the shareholders; otherwise the firm would pay out all the profit as dividends[116]. It should not be forgotten that UIAHs do not benefit from the retained earnings. The other issue is, what happens to the share price if, for example, any new stock has been issued, or a stock split or bonus issue has affected the share price[117]. Therefore, the expected effect on share price given the cost of equity[118] must be analysed by examining

[116] A bank may need to retain some earnings to meet the capital adequacy requirement, in an attempt to meet the 12% minimum ratio of all eligible risk weighted assets; however, KFH's level constantly remains above 16% according to their annual report. Also, when a country has a higher income tax rate, people like to buy shares in companies which do not pay dividends; however, we are dealing with KFH Kuwait where stockholders do not pay income tax.

[117] Of course, UIAHs do not bear the risk of stock price fluctuations, but they do bear the risk of losing their entire fund invested with the bank.

[118] Different methods can be used to evaluate companies, including CAPM, which is used to determine the cost of capital especially for large firms. Also, in 1961 Modigliani and Miller determined the required rate of return on equity where the firm value is equal to the number of shares multiplied by their price, substituting for new issues.

the dividend pay-out ratio, and the market capitalisation (market cap) to calculate the bank's growth rate over the period of years, which will reflect the value created by retained earnings. The Gordon Growth Model (GGM) concept is used in this research to assess the growth rate of the bank, and is described in the next section.

6.12 Rationale for using Gordon Growth Model

The focus here is to look at the behaviour of the stock market and the amount of value that shareholders could have obtained from the retained earnings as suggested by the Gordon growth model. The KFH study did not consider the gain from retained earnings that shareholders could have had (KFH only used dividends and capital gains for the return to shareholders) and ignored that more than 50% of profits has been kept as retained earnings. Therefore, it would be essential to examine the additional value from retained earnings that goes to shareholders, since UIAHs do not benefit from it.

GGM, also known as the dividend discount model, measures the fundamental value of a company stock at today's prices by calculating the present value of a stock's future dividends taking the pay-out ratio into account. According to Quiry *et al.* (2009), the model is based on the assumption that the value of a company is indicated by the stream of dividends the investor expects to receive over a period of time. In other words, it is determined by the expected cash flows investors will receive from holding a stock.

Constant Dividend Growth Model:

$$P_0 = \frac{Div_0(1+g)}{r_{E-}\,g} = \frac{Div_1}{r_{E-}\,g} \qquad \textbf{Equation 6-1}$$

Where:
P_0 = value of stock
Div_0 = dividends at time 0
Div_1 = expected dividends at time 1
r_E = required rate of return for equity investors or discount rate
g = constant growth rate.
Note that this is a form of the valuation formula for a growing perpetuity where r_E = the discount rate and g = the rate of growth.

Also, as explained by different authors including Sharpe *et al.* (1999), Gordon's Growth Model is a share valuation model where the market price of a share can be calculated as follows, with the dividend being expressed as earnings multiplied by a payout ratio:

$$P = \frac{E\ (1 - b)}{ke - \ br} \qquad \textbf{Equation 6-2}$$

Where:

P = Market price of equity share
E = Earnings per share of the firm
b = Retention ratio (1- pay-out ratio)
r = Rate of return on investment of the firm on retained earnings
ke = Cost of equity share capital
br = Growth rate of the firm

There are two ways of generating cash flows from owning a stock: one is from the dividends paid to investors, and the other is via stock price appreciation as capital gains (Berk, 2014). Miller and Modigliani (1961) pointed out that when a company receives money from operating profits and the issuing of new equity, that money has two particular purposes: investment and dividends. However, when managers pay dividends, they reduce the amount of free cash flows available to spend on themselves. This may raise the incentive to increase the retained earnings and reduce the dividend pay-out, which creates an agency problem (Easterbrook, 1984).

Miller and Modigliani (1961) also claimed that a company's value is determined by its earnings and business risk. Accordingly, KFH has shown stable growth, paid constant dividends, and become highly leveraged. Given that it is a bank, it would be suitable to use the GGM to estimate the value of the bank and the real benefit to shareholders, as the interviewee ignored the value created by the retained earnings. For example, if the bank wanted to expand in one way or another and raised capital by retaining earnings to support that expansion which is expected to be profitable, this would be reflected in the value of

the bank[119]. This is included as the growth of DPS (g) in the Gordon Growth Model. Also, the model divides the dividend into earnings and the retained portion, designated by b, and analyses growth as two components, b plus the return on b. The GGM proposition on the value for the shareholders is created if the rate of return on the retained earnings r is greater than the cost of capital ke. GGM highlights the significance of having a rate of return on retentions greater than the cost of capital; otherwise, there is no benefit to shareholders from retaining earnings.

Therefore, taking the idea behind GGM that retained earnings create value for firms, which lead to a company growing, as it will be reflected in shareholder value. In that sense looking at KFH's DPR as shown in table 6-17, it is evident that more than 50% has been retained; the other 50% of the profit did not simply disappear, but was used to create some value for the shareholders, although this is not reflected in the KFH study calculation which only considered the dividend. This needs to be addressed by KFH, as retained earnings do not benefit UIAHs, which does not give a fair comparison or ensure a fair deal between UIAHs and shareholders.

6.13 Capital Adequacy Requirement

Banks generally retain some of their earnings to help meet their capital adequacy requirements. The capital adequacy ratio refers to eligible capital[120], which is essentially stockholders' equity divided by risk-weighted assets (BCBS, 2004; IFSB-15, 2013). This is not to be confused with the unweighted "exposures" used for the leverage ratio; instead, in Basel 2 pillar 1 it is the assets multiplied by the risk weights, which range from 0 (certain sovereign exposures as rated AAA to AA-) to 100% or more for normal receivable exposures. Banks' shareholders' funds on the balance sheet contribute to their capital adequacy; in

[119] According to the GGM retained earnings would be reflected in the value of the bank, provided r > ke.
[120] According to Basel 2 pillar 1, total eligible capital covering market risks consists of shareholders' equity and retained earnings in Tier 1 capital and supplementary Tier 2 capital as defined in paragraphs 49(i) to 49(xii). For IIFS, this is the sum of Tier 1 and Tier 2 capital, IFSB-15 (2013).

other words, they can increase the amount of eligible capital compared to the risk-weighted assets. Having more capital allows the bank to expand its assets and hence to increase its earnings, and if the market believes that the expansion will be profitable, the share price should increase. This would be one reason for retaining earnings, but retaining more than 50% of retained earnings over the period (as shown in table 6-17) considerably builds up eligible capital (given the requirement set out in Basel 2), which is hardly necessary unless the bank's assets are being significantly expanded. The bank is, in fact, aggressively expanding its assets, generating significant new financing that requires the eligible capital to support those assets[121].

Table 6-17: KFH Dividend pay-out ratio

Year	Dividend paid	Net Income	DPR
1995	9.00	31.4	28.66
1996	12.90	34.4	37.50
1997	17.40	36.9	47.15
1998	19.30	43.4	44.47
1999	22.70	45.7	49.67
2000	25.80	48.9	52.76
2001	29.30	53.6	54.66
2002	32.10	56.5	56.81
2003	35.80	60.8	58.88
2004	39.10	77.3	50.58
2005	60.20	129.1	46.63
2006	69.80	193.2	36.13
2007	111.50	325.4	34.27
2008	82.10	174.6	47.02
2009	56.90	71.8	79.25
2010	49.30	71.8	68.66
2011	39.60	37.1	106.74
2012	28.40	123.3	23.03
2013	49.00	149.1	32.86
2014	63.90	160.1	39.91

Source: Bankscope database, obtained on 27 November 2015; net income is in KWD, and DPR as a percentage. In most years, 50% of profit is kept as retained earnings by the KFH BOD.

[121] Except with the assets that are zero risk weighted such as certain sovereign exposures (AAA rated), which is normally not the case here.

Table 6-18: KFH financial analysis

Year	Market Cap	Share outstanding	DPS	Dividend Yield (%)	P/E	EPS Diluted	Market/book value	UIAHs return
1996	367.21	2785.14	0.01	3.25	11.67	NA	3.33	5.96%
1997	434.74	2785.12	0.01	3.72	12.29	0.12	3.38	6.07%
1998	423.31	2785.12	0.01	4.56	10.68	0.12	2.83	6.13%
1999	431.67	2785.12	0.01	5.26	10.27	0.06	1.24	5.75%
2000	460.07	2627.47	0.01	5.60	9.62	0.12	1.20	5.64%
2001	598.22	2837.67	0.01	4.89	11.64	0.01	1.44	3.69%
2002	778.33	3007.93	0.01	4.12	14.23	0.06	1.76	3.35%
2003	1147.02	3007.93	0.01	3.13	19.70	0.06	2.36	2.95%
2004	1281.51	3007.93	0.01	3.05	17.04	0.26	2.34	3.91%
2005	2603.64	3936.62	0.02	2.31	19.56	0.40	2.86	5.55%
2006	2671.03	3936.62	0.02	2.61	16.48	0.06	2.48	6.89%
2007	4940.21	4223.56	0.03	2.26	17.33	0.08	2.95	7.03%
2008	2799.44	4223.56	0.02	2.94	17.83	0.03	1.76	3.50%
2009	2500.62	4223.78	0.01	2.27	21.16	0.03	1.49	2.27%
2010	2859.62	4223.78	0.01	1.72	26.92	0.02	1.61	1.94%
2011	2377.37	4223.56	0.01	1.67	29.76	0.02	1.31	1.54%
2012	2302.77	4223.56	0.01	1.23	26.30	0.02	1.15	1.72%
2013	3013.40	4765.04	0.01	1.63	27.86	0.03	1.81	1.74%
2014	3118.93	4765.04	0.01	2.08	24.26	0.03	1.79	1.69%

Source: Bloomberg. As can be seen from the table above, the market cap for KFH has increased over the years except after 2007 (global economics crisis), which indicates that the bank grew steadily until 2008 in which year it fell significantly and did not resume growth until 2012, although the retained earnings are being invested. As a result, since 2007 until 2012 it does not appear that the value for shareholders has been increased by share price appreciation in addition to the cash dividends and bonus shares they have received. However, the Kuwaiti stock market is far from efficient, so that it is not clear what can be concluded from this.

The capital adequacy requirement and the fact that retained earnings increase the bank's eligible capital enable it to grow its assets and, hence, potentially its profit. It should be borne in mind that the capital adequacy ratio based, not on unweighted assets, but on risk-weighted assets, where the risk weights of the assets held by the bank could be anywhere between 0 and in excess of 100%.

6.14 KFH ratios

It is necessary to consider some of the ratios for KFH to analyse the real benefit to shareholders, such as DPR in table 6-17, in which KFH pays out less than 50% of its profit as

dividends. The study by KFH, which was based on the pay-out dividends that only account for the 50% of profits, took no account of the other 50% as retained earnings. The other 50% or more did not simply vanish; the bank would normally reinvest the money to continue growth, adding some benefit to shareholders, or to pay off debt, or even use it as a cash reserve for future acquisitions. Also it is worth mentioning the bonus shares issued to shareholders (see table 6-21 p. 214), which dilutes the shares so that the share price will adjust downwards accordingly.

On the other hand, market cap and share price are other factors which can be used to show how much a company has grown in value; because, presumably, it has been building value through retaining earnings. For a bank in particular, the retained earnings increase the eligible capital, allowing the bank to expand or to grow the assets on its balance sheet while still meeting the capital adequacy ratio of 12%. The higher the earnings retained by the bank, the more it can expand its assets in which its funds are invested, given that most funds that are being invested are not equity at all. Increasing equity can increase the assets under management; however, these assets are financed largely by non-equity such as current accounts or UPSIA. In other words, in terms of the amount of equity on which leverage is applied, the more equity a firm has, the more equity it can leverage by bringing non-equity funds to finance assets. This is the case even though it creates profit for the shareholders and also for the UIAHs (but mainly for the shareholders). Therefore, by examining market capitalisation as set out in table 6-18, it can be seen that it has been increasing over the years until 2008, which would be expected during the period of global financial crisis.

Alternatively, the Market to Book ratio, or price to book ratio, compares a company's market price or market value to its book value (Wahlen *et al.*, 2014). A higher market to book ratio implies that investors expect management to create more value from a given set of assets, reflecting confidence in the company's ability to generate profits and future cash flows. If the market to book value is less than 1, then shares are selling at a discount to the company's net asset value (NAV), a situation which may be caused by misjudgement by the management, and may create a negative reputation. Normally, it would be expected that

shares are selling at a slight premium to NAV, but occasionally it may be that banks also have intangible assets which are not reflected in the balance sheet, such as goodwill or reputational assets. However, as table 6-18 shows, the market to book ratio has always been above 1 in this case.

Kuwaiti stock market is far from efficient, therefor the total shareholder returns (TSR) doesn't really mean anything and that it is difficult to draw any conclusions from it. However, since the data is available here, it may be of interest to examine whether or not the rate of stock market return to shareholders has a bigger CV than the rate of return to UIAHs. (see Appendix G, for TSR)

6.15 Findings

By examining the three countries, it has been established that the two subsidiaries in Bahrain and Malaysia operate in the context of far more competitor IBs than does the parent bank in Kuwait. Additionally, Bahrain and Malaysia enjoy better regulation than Kuwait. For example, by looking at the annual report for the two subsidiary banks, it can be seen that they have greater transparency of financial reporting. KFH Bahrain and Malaysia disclose full details about the PER and IRR reserve accounts in their annual reports, while KFH Kuwait does not mention the transactions between these reserve accounts. KFH Kuwait enjoyed a long period as the only Islamic bank in Kuwait before Boubyan bank entered in 2005 followed by others later. However, the newcomers are yet to have an effect on the results of KFH Kuwait, which shows in the returns to UIAHs, an increase in the amount of UIAHs deposits even though the bank's return has been lower since 2008. It is worth mentioning that the UIAHs are passive investors, not sophisticated ones, who are not encouraged to shop around. In general, people mostly change banks because of their customer service, location, and *Shari'ah* compliance (Hanif *et al.*, 2012).

The roles of the regulator and supervisor in the transparency aspect of the CG are important, as can be seen in the difference between the KFH parent and the KFH subsidiaries. KFH Kuwait claims that it uses IFRS in its annual report, but the main problem

with using IFRS is that IFRS does not specify information about PER and IRR, and the bank may claim to be applying IFRS even though it does not disclose these particular reserves, which is normally expected in the spirt of the IFRS. One of the contributions of the research is to let the Kuwait Central Bank know that some IBs are not as transparent as they claim to be, especially toward UIAHs.

Looking at the board composition of KFH Kuwait, it has been noticed that while the chairman and CEO were the same (CEO duality), the UIAHs had a "poor deal", while when the top management was changed, the treatment of the UIAHs also changed. This may suggest that new top management policies have been focused towards better treatment for UIAHs returns, and could be an indication of the competition effect brought by the new IBs in Kuwait that KFH now have to compete with. However, looking at the profit of KFH Kuwait, the top management policies toward UIAHs may not be the cause, and competition could be another (though less important) macroeconomic factor which is a reason why the return on assets is lower. Although there may be some explanation relating to their governance structure, it seems that all other influences are simply being dominated by the effect of ROA. For example, when profits are high, shareholders get a higher return; the difference in returns between them and UIAHs is biggest in the years when ROA is highest, and shareholders receive good returns. But when ROA is low, the shareholders obviously cannot pay themselves out of non-existent profit, and it appears that the bank is treating the UIAHs "more fairly" by comparison, which consequently produces the incorrect inference that UIAHs are being treated "more fairly" when the profit is low, compared to their return when profit is high. In fact, UIAHs may not be being treated fairly at any stage but this is not so apparent when profit is low because the shareholders are also receiving a low return on their assets. Therefore, the discrepancy between the rates of return paid to shareholders and to the UIAHs is greater when profits are higher, because shareholders receive most of the benefit from these higher profits.

Influential factors other than management policy might include customer service and branch locations, since there is a benchmark for return which the central bank is currently

imposing. UIAHs would not generally wish to have to deal with the complexities of closing down one account only to go to a different bank and sign a new contract, receive a new card, etc., especially if they have been with same bank for a long time and have a *Shari'ah* compliant return. For example, KFH Kuwait has branches all over the country and if the newly arrived bank has very few branches, UIAHs would usually rather not change their bank for little extra return.

In addition, the long period without competition gave KFH advantages over newcomers. There is also evidence that the Kuwaiti market is not behaving efficiently; UIAHs are staying with KFH even though some competitors are offering a better deal; the obvious reason for this that KFH is well-established in the market while the others are newcomers, though this situation may not persist. In a sense, the Kuwaiti market is in a state of transition from the virtual monopoly of KFH, which for many years enjoyed a *de-facto* monopoly in the national market.

In the interview[122], KFH management mentioned that IBs are less risky than conventional banks. KFH may be a solid bank, but such an evaluation depends on what kind of risk is being discussed. For example, in conventional banks, the depositors know what return they will get, or at least know that their return is based on the market rate of interest, and also that their capital is safe unless the bank goes bankrupt. However, in IBs the capital is not necessarily safe; the assets may go down in value. The bank could be perfectly solid but the capital may still be reduced, and returns to UIAHs would be negative. However, if asset allocation is discussed (less risky than in conventional banks) then the situation changes, since KFH deal mostly in *Murabahah* and real estate (that said, real estate can be very risky).

Therefore, the basic proposition in analysing the return difference between KFH parent and its subsidiaries is that the driver is the ROA. In a sense, KFH Malaysia seems to treat its UIAHs well, because their shareholders are not doing well at all. In fact, KFH Malaysia

[122] See Appendix E

decided to pay the UIAHs when the profit is negative. As far as Bahrain is concerned, the picture is rather mixed; while Bahrain suffered more in the post-crisis period, looking at the profit may suggest that the UIAHs are doing quite well, whereas in fact it is the shareholders who are doing badly. Therefore, the suggestion that UIAHs in Bahrain and Malaysia are having a better deal than Kuwait because of competition may now seem less convincing because to a large extent it appears that the ROA is driving the return.

In a sense, we would expect the shareholders to obtain higher returns, since this is how UPSIA tends to work. However, with the methods that we have (the CV), the bank could still pay shareholders more, but the CV for shareholders would be higher, and this would be our criterion for judging whether UPSIA is working fairly. By answering which party is being allocated the higher rate of return, and which party has the higher CV, the rationale is to justify higher mean return by having higher risk, but not having higher risk and low return, which is the case where CV is higher.

Even though the interview is crucial, there are some points discussed in the interview that needed to be addressed and clarified. According to KFH-Kuwait (2014), annual report, and the statement by Mr. Al-Marzouq, chairman of the KFH board[123], KFH BOD has proposed a cash dividend of 15% for 2014 with additional issuance of bonus shares of 10% of paid up share capital [29.68 fills (KWD 0.02968) earnings per share, equivalent to US$0.0974], whereas in 2013 the cash dividend was 13% and bonus shares of 13% were also issued[124]. *"GuruFocus"* financial analysis[125], calculates the average dividends per share growth rate

[123] Source: KFH website. "Profits Reflect KFH's Solid Financial Position, Healthy Performance, and Successful Implementation of Plans", 02 August 2015. Retrieved 29 Nov. 2015 from: http://www.kfh.com/en/about/news/ArchiveNewsDetails.aspx?q=okcVzr8Hi3sIPpIwyk7DmQ==

[124] KFH chairman Al-Marzouq announced that KFH Posts net profit of Kuwaiti Dinar (KWD) 145.8 mln for 2015 17% cash dividends, 10% bonus shares, 31.1 fils (0.031 KWD) earnings per share. Source: Zawya website, KFH related news, Kuwait, January 28th 2016. Retrieved 13-6-2016 at http://www.zawya.com/mena/en/company/5083/

[125] Source: KFH website. "Kuwait Finance House Dividend Pay-out Ratio", as of Dec. 2014. Retrieved 29 Nov. 2015 from: http://www.gurufocus.com/term/payout/KUW:KFIN/Dividend%2BPayout%2BRatio/Kuwait%2BFinance%2BHouse.

for KFH as 42.90% in the last 12 months. However, the interviewee claimed that the value of 1KD invested in shares back in 1978 has produced slightly more value than 1 KD invested in UPSIA. The KFH study used stock price changes and dividends and ignored the bonus shares to shareholders and the retained earnings of more than 50% of its profit. Unlike in UPSIA, where no value is created from profit retention, logically the shareholder should benefit from retained earnings, otherwise there is no point in having the retained earnings; one might as well have a DPR of 100%. Therefore, UIAHs do not benefit from retained earnings the way shareholders do, and UIAHs do not profit from having more assets.

For example, when the bank needs to expand, it will raise more UIAHs funds to finance these extra assets. The bank raises more non-equity capital given that, under BCBS III, equity only has to be about 3% of total assets (97% of assets are financed by non-equity), which is a mixture of current account, UIAHs, and possibly CMT-based term deposits. The more the 3% increases, the more the 97% will also increase, but the UIAHs are putting more money in and are not receiving better returns on their existing money. The fact that the bank is actually raising more UPSIA money to finance its assets means that the 1KD invested in UPSIAs does not grow in the way it does with shares, because to finance these extra assets the bank has to raise additional UPSIAs; however, they are not receiving any bonuses to fund such extra assets (either from the same UPSIAs or from a different investment account).

Therefore, it is clear that the KFH study disregarded the logic behind the dividend growth model. Shareholders may not benefit much in terms of share price appreciation from retained earnings in an inefficient market, so it is therefore difficult to understand why KFH retained so much of its earnings, except perhaps to boost its regulatory capital. For this reason, it is important to include the hidden value created for shareholders by including the market cap in 1978[126] compared to the market cap in 2014, as well as looking at the number

[126] KFH was listed in Kuwait stock exchange in 29/9/1984.

of shares outstanding plus the share price. In fact, the market cap increased between 1996[127] and 2014 (as shown in the table 6-18), and hence, so has the bank size. Similarly, growth in the market cap up to 2008 could have been a reflection of the value created by the retained earnings in addition to some new share issues, because the earnings retained by the bank boosted its eligible capital, allowing it to take on more assets and still maintain an acceptable capital adequacy ratio, although the market fall in 2008 (due to the global financial crisis) affected the share prices of KFH and many other institutions.

6.16 Concluding remarks

From the CG perspective, the big difference between KFH Kuwait and the KFH subsidiaries in other counties is not only related to the management policy, or at least this is unlikely to be the main influence, since the size of the return on the assets is the main factor. As KFH Kuwait's profit is consistently better than its subsidiaries, with possible exceptions for KFH Bahrain in 2005, 2006, and 2008, then arguably the profit is what drives the differences in return rather than any issue of management policy. Also, from a CG perspective issue, where UIAHs lack the rights of governance, the management behave as though they are only accountable to the shareholders, to give them the maximum return possible[128]. The profit availability to shareholders arises from the accounting process chosen by the top management, and possibly from different asset allocations, which are not really profit sharing processes. CG's way of working is that top management sees itself as accountable to the shareholders, in seeking always to give them the best possible deal. In contrast, the bank gives the UIAHs just enough return to prevent them from transferring to a different bank, which seems to be the policy of the top management. Again, the question is how the top management can use the above situation as an ongoing policy. A significant reason for the difference in the percentage returns is that UIAHs have no governance rights. In

[127] 1996 was the earliest data which was obtained from Bloomberg.
[128] This refers to the profit available for dividend rather than the dividend itself.

addition, UIAHs lack the ability to use what rights they do have. UIAHs are unsophisticated retail depositors who do not move their deposit to search for best return, unless extreme circumstances compel them to withdraw their funds and go somewhere else. Additionally, it is not obvious that even if the UIAHs had the power to appoint and move directors, the outcome would be any different, because this would not make most of them any less passive as investors.

It is worth mentioning that UPSIAs are in a number of cases being replaced by sale-(*Murabahah*) based fixed profit deposits such as CMTs (IFSB-Report, 2015). According to the stability report issued by the IFSB in 2015, UPSIAs have slipped by 50% across IBs. A new bank law in Malaysia requires UPSIAs to operate on a strict *Mudarabah* basis without smoothing, etc., while UIAHs expect losses. This contrasts with the previous authority of the central bank's instructions to banks not to lose the capital invested by UIAHs (similar to Qatar). For example, if an Islamic bank lost the capital of UIAHs, then they could find themselves in trouble with the supervising authority. However, this has now been changed; Malaysia went from one extreme to the other, and the Malaysian authority might create CG issue without realising, by focusing on *Mudarabah* being *Shari'ah* compliant.

In the KFH study, the 1 KWD grew to 102 KWD for shareholders between 1978 and 2014, whereas in fact it grew to more than 102 KWD, because there were also several bonus issues. This means that a shareholder who bought in 1978 and held until 2014 would have ended up with more than 1 share for each share bought. In fact, in an efficient market, the retained earnings cannot simply be ignored[129]; they must be taken into account. Therefore, the UIAHs receive only a pay-out; in contrast, the shareholders similarly get a pay-out but also bonus shares and retained earnings, which normally create value. This is especially true for a bank, because retaining earnings increases the eligible capital, allowing it to grow its assets and its earnings streams.

[129] Even though the retained earnings may have been wiped out by the share price fall in the 2008 global financial crisis.

It is worth pointing out that most shares in KFH are owned by the government of Kuwait, which does not actively trade in the market, making the share price more sensitive. This means that private shareholders who own a percentage (depending on what percentage is actively traded) can have an influence on the share price; in particular, if an investor owns about 10%, trading this 10% would have an impact on the price (either up or down); this is the main reason why stock market data is not used to any large extent.

Generally, today's share price depends on future growth in dividends discounted by the discount factor minus the growth rate, as the Gordon Growth Model attempts to measure the effect on value. Hence, retained earnings lead to a company growing, provided that the funds which are retained earned more than the cost of capital. This will boost the value of the company, and hence will be reflected in shareholder value.

It seems that KFH is using UPSIAs purely to satisfy *Shari'ah* compliance; they may not believe in profit sharing but they have to use it, and they are doing so in such a way that their business model is as close as possible to that of a conventional bank model. It is true that when comparing KFH's returns to UIAHs with those of their competitors, they have generally been paying more, since their profit is higher, but if we compare KFH's returns in the last 4 years they have been paying less than their competitors. KFH pays a low, fairly stable return just to keep UIAHs in-house, and they appear to have no ethical problem in claiming that this is profit sharing. In fact, they are just bankers working with prohibitions and have no problem with the idea of paying a fixed low return to depositors, with the rest going to shareholders, just as *Shari'ah* allows them to do. However, the bank is not entering into the spirt of *Shari'ah*, in terms of the issue of juristic compliance. They are using a *Mudarabah* contract, which is a *Shari'ah* compliant contract, but they are using the flexibility that the *Mudarabah* contract gives them, such as a high *Mudarib* share, in order to produce an outcome somewhat similar to a conventional bank. The problem is that they are claiming to practise profit sharing, when in fact they are doing something rather different.

Appendix F The Interview Questionnaire

F.1 The interview

The following numbered sections form a brief questionnaire which was sent to KFH Kuwait prior to the interview, and during the meeting it was explained to them that the questionnaire is a part of a research project at the University of Reading, UK, with the objective of completing a PhD degree in Finance (CG) under the supervision of Professor Simon Archer and Dr. Carol Padgett.

It was further explained to KFH that the main purpose of the research is to evaluate the returns between two classes of investors in IBs (shareholders and Unrestricted Investment Account Holders). The research is not interested in the differences in the rates of return as such, but the reasons for the differences in the rates of return on a risk-adjusted basis, that is to say the coefficients of variation of the rates of return (i.e. the standard deviation of the rates divided by the average rate paid by each bank between the period 2002-2013).

At the beginning of the interview, I explained to the interviewee that it would be greatly appreciated if they could kindly spare a few minutes to answer the following brief set of questions. I assured them that all information provided would be treated as strictly confidential and would be used only for this project[130].

1. **How does the management of KFH consider the bank's fiduciary duties towards unrestricted Investment Account Holders (UIAHs) on the one hand, and towards shareholders on the other hand?**

   KFH operates according to the CG rules and guidelines of the Central Bank of Kuwait. It is imperative that KFH meets its CG obligations and implements all the mandatory requirements imposed by the Central Bank of Kuwait. Furthermore, KFH developed a set of policies and procedures on the disclosure of material information to

[130] The focus is in the KFH parent company accounts, not the consolidated accounts.

stakeholders, and put in place a new remuneration policy; the approved policies are also included in the Code of Conduct and Ethics for the members of the Board of Directors, officers and staff. The Board of Directors shall be fully responsible for KFH's operations and sound financial position, and as such the Board shall confirm compliance with the Central Bank of Kuwait's requirements, and protect the interests of the shareholders, depositors, creditors, employees and other stakeholders and related parties.

2. How are the respective shares of profits available to unrestricted UIAHs and shareholders determined?

Islamic banks create investment accounts to generate profit. KFH has 4 different investment accounts:

a. Savings account 40-60, where KFH invest 40% and keep 60% for cash withdrawals. Savings can be withdrawn at any time, but no cheque books are issued.
b. Investment account (Khumaseia): 5 years' investment period, intended for long run investors.
c. Sedra is quarterly calculated profit, where the UIAHs gets a return.
d. Alkuwthar investment account, where the profit is calculated monthly and the UIAHs have a monthly return; this account was created based on UIAHs demand.

Therefore, KFH has different investment accounts for different purposes and different investors. The longer the period in which the money is kept in the account, the greater the return the investors receive.

These investment accounts are based on *Mudarabah* or *Musharakah*, since the bank is an expert in investment and investors have excess cash, and therefore the bank invests the excess cash accordingly, based on profit distribution.

The return to UIAHs could be 0, or they could even lose all their money, or could have a very good return. The return to UIAHs depends primarily on the result of activities, which is the return on asset. However, when KFH gave 8.4% back in 2006, the central bank intervened to protect other banks from a potential systematic crisis; the market gave 6% and the interest rate was 6.5%. Nowadays the market interest rate is the cost of money, which is used as a benchmark. There is a future plan to create a profit index.

3. What have been the *Mudarib*'s annual percentage shares of profits for the period 2002-2013?

It has been different over the year. See the annual report.

4. Do the unrestricted UIAHs receive the full amount of their share of the available profits, or are there transfers to or from a Profit Equalisation Reserve or Investment Risk Reserve (or similar) accounts?

There has been a strong debate or argument from the UIAHs (I placed my money in an UPSIA and didn't get much return). A study was done by KFH Kuwait on the value of money for both UIAHs and shareholders, which asked: does the 1 KD deposited

in the bank by depositors have the same value as the 1 KD placed by the stockholder? Both UIAHs and shareholders carry a risk in investment. The bank did an internal study in 2014 on returns between 1978-2014 for the depositors and shareholders, to find out if 1 KD placed by the depositors in the bank in 1978 compared to the 1 KD placed by the stockholders. The study found that the 1 KD placed by the stockholders in 1978 made 102 KD in 2014, while the UIAHs 1 KD made 99-100 KD, which shows that there was not much difference. The study did not address the market returns to shareholders in terms of stock prices difference of the stock market. The shareholders' returns are either dividends or new shares issued by the banks. They have found that the shareholders face two types of risk: credit and market risk. For example, the share price now in 2015 is about 0.500 KD, while it used to be 3.400 KD in 2006, therefore the shareholders face a higher risk according to KFH. In this case, giving a higher return to shareholders is justifiable. However, the depositors who placed their 1KD from 1978 still have the same value plus a return of 99-100 KD. The nature of the risks between the two investors are different. KFH distributed a return to UIAHs in 2006-2007 of about 8.4%, and the bank also gave 2.2% in 2012-2014; however, depositors are increasing even though the bank return is less.

The question now is why customers are still with KFH and have not withdrawn their money? The study showed that the UIAHs see KFH Kuwait as more stable; also, some customers see that Islamic banks (IB) are less risky than conventional banks and they are satisfied with the bank itself and the returns they receive.
There are different factors which characterize depositors' interests:
1. Stability factor
2. Bank location factor
3. Customer service and their connection with the bank.

The interest rate is not a strong factor leading customers to switch banks. For example, if a depositor places money in Switzerland, he or she will receive a negative return (2.5% service charge); the Swiss banks have high liquidity and many depositors; in that case the bank is just holding the money as a safe place for the depositors, according to KFH. Even though Islamic banks represent less than 1% of the world's total capital, investors worldwide are still interested in that 1% because it has a fast growth rate of 15-17%.

5. Regarding the purpose of creating a Profit Equalisation Reserve and an Investment Risk Reserve: was it a policy by the bank or due to central bank regulation?

The regulation of KFH by the central bank started in 2004. In 2006-2007, when KFH gave 8.4%, the central bank intervened to protect other banks, especially the ones that had paid out amounts below the market return, from a crisis of massive withdrawals. KFH thinks that over-regulation will create a crisis; however, deregulation with awareness of the importance of IB is better, as KFH worked from

1977-2004 without any regulation. Under the Ministry of Commerce, the central bank did not have any authority, yet KFH did a great job and had successful growth.

6. **What are the implications of the use of unrestricted profit-sharing loss-bearing investment accounts by Islamic banks as a type of deposit product in terms of CG, and in particular, the rights of unrestricted profit-sharing investment account holders?**

   KFH has the largest investment deposits in the country, and also the largest investment tools using UIAHs, which poses the challenge of how to manage the high liquidity to generate a return in terms of how and where to invest the huge amount of cash, while investors are expecting a return even with low market returns. This is in the current context of the world financial crisis in which Greece's loan default is about to finish, and now we are entering a Chinese crisis.

7. **Does KFH follow AAIOFI or IFSB standards or guidelines in providing the recommended level of information? If not, what are the reasons for this? (IFSB recommends a "comply or explain" approach.)**

   No Islamic banks follow AAIOFI 100%. KFH follows the International Accounting Standards Board (IASB) and International Financial Reporting Interpretations Committee (IFRIC), which can be found in the annual report. However, AAIOFI designed two great models which are used as the accounting standard for Islamic banks, and also set the standard for investment tools in *Shari'ah*. KFH also takes the standard regulations from the IFSB, since the IFSB coordinates with central banks to make regulations for Islamic banks, for example, in adopting Basel 3 and capital adequacy. Also, the IFSB has many recommendations: considering UPSIA as part of bank capital and taking 50% of that capital to adjust the capital adequacy equation are recommended by the IFSB (see IFSB standard).

8. **From the KFH's annual reports, it appears that unrestricted UIAHs received a much higher rate of returns prior to the 2008 crisis. What were the reasons for this?**

   KFH is the largest bank that does research, as well as having research done about it; many think that KFH is not fair with UIAHs and don't believe that the return calculation represents the real return to UIAHs. But again, if we look at the study of the 1KD then we can see the difference. The main reason is ROA, then the market return benchmark.

9. **How can you explain the differences between the risk-adjusted annual rates of return to unrestricted UIAHs of the parent company and those of the KFH's subsidiaries in Bahrain and Malaysia, which appear to be higher? (The differences in the coefficient of variations.) See table 1 below.**

   As mentioned before, KFH did a study of both shareholders and UIAHs, showing the comparative value of money. The KFH study calculated that 1KD of UIAHs placed in

1978[131] is still there, however the 1KD from the shareholders is less now, and since shareholders are facing more risk in losing their money, then it is deemed acceptable for them to receive higher returns. Comparing KFH parent with its subsidiaries is not correct since they are part of us. KFH values and appreciates the wealth both of shareholders and UIAHs.

High returns concerned the head of KFH; Al Yaseen, the former KFH Chairman, was worried about the high profit of 8.4%, and told the bank not to undertake large-scale advertising because there would be huge demand to open new accounts. KFH was less affected by the world crisis; however, all banks (including all Islamic banks) suffered from the economic crisis which began back in 2008. KFH has to agree to live in a world in crisis since they want to do business.

Also, the Dow Jones has created a new index called ethics funds, which is based on Christian doctrine.

10. Recently the KFH parent company reformed its structure, separating the retail bank and the investment bank. Will this have any effect on the profits payable to the unrestricted UIAHs? (Presumably, the UIAHs will place their funds in the retail bank rather than the investment bank.)

KFH is selling KFH Malaysia. They are investors; if we can agree a good sale then we sell. It is also closing research in Malaysia, to cut expenses, as previously KFH helped the market with that research department almost free of charge. For example, the Sukuk report had a cost to KFH, however the market benefitted from it for free. KFH has now transferred the research department to Kuwait.

KFH is strong in Bahrain, and the strategy of the bank was that they wanted to open a bank, not just a branch. The story started when the Bahraini government gave KFH Kuwait land to build on, and open a fully-fledged bank. As a result, KFH helped with residential housing in Bahrain and other investment services. I think you should also look at KFH Turkey, which generates very high profits.

11. Does the CG committee represent the UIAHs as recommended by IFSB 3 and 4?

The CG committee attached to the BOD does not represent the UIAHs, it represents the shareholders, although there is a debate over that. KFH are improving in CG terms over the years. They have an independent director on the BOD, Mr. Noor Al Rahman Abid. Mr. Noor started his career in 1976 in the U.K. with KPMG, then joined Ernst & Young in Jeddah in 1979 and moved to Kuwait in 1986. He became partner in the office in charge of the Bahrain practice in 1993, after previously serving as

[131] KFH was the first Islamic bank, established in 1977, in the State of Kuwait.

Chairman of the Accounting Standards Committee, and Vice Chairman of Accounting and Auditing Standards Board of AAOIFI.

About 20 years ago, the governor of the Bank of England was attending an Islamic banking conference when one of the speakers talked about the debt transaction from the Holy Quran (Sorat al Dayin) which was translated and explained to him. Even though the governor of the Bank of England stopped Islamic banking in 1992 during the credit crisis and the al Baraka problem, they studied IB tools and opened the first IB in the UK after 7 years. Now, the British government have issued Sukuk. CG is built within IBs. The *Shari'ah* goal simply relates to ethics, in terms of organising how business is conducted. Therefore, IB had CG committees before the US even came up with the Sarbanes–Oxley Act of 2002.

12. Does the *Shari'ah* board have any fiduciary duties towards unrestricted Investment Account Holders? Or have any influence on their rate of returns, or is it only the board of directors' decision?

The *Shari'ah* board does not intervene in the return distribution; however, they advise on other issues which concern UIAHs, like the zakat of the return and so on. The *Shari'ah* board know that UIAHs should receive a return when there is a profit. The supervisory committee is a monitoring system which includes CG monitoring, not just *Shari'ah* monitoring, that existed before the BOD CG committee. There has been criticism that IB uses people's beliefs toward Islam; however, when KFH opened they did not open under the banner of an Islamic bank. It was, and still is, a Kuwaiti finance house, and customers are increasing even if in some years there is no return. The first BOD was well aware of the name of KFH; they didn't want to use the name of Islam in case the bank did not succeed.

13. How did KFH maintain good relations with its customers? What is the different effect that KFH made compared to conventional banks?

KFH did two things and these are considered as a model in IB:

a. They made a connection between the current account and the asset market, not the interest rate itself; look at the oil price and the fluctuation of the US dollar, which go in opposite directions. KFH works with commodities, and if the $ increases against the KD, that means that the supply will decrease and demand will increase. But in conventional deposits, if the $ increases against the KD, that means that my money is worth less against the $. A middle commodity has to be in the process to lower the risk; that is a *Shari'ah* requirement.
b. Also, in real estate, in the 1980s Kuwait had a housing crisis; most Kuwaitis lived with their parents, then KFH started facilitating the process of Ijarah and Musharakah, which enabled lots of people to buy their own homes. As the saying goes, don't put all your eggs (or money) in one basket; IB bank has at least two baskets, not just one.

14. Why do the KFH subsidiaries seem to generate a higher rate of return than the KFH parent?

It is unfair to compare the KFH parent with its subsidiaries, as the subsidiaries are part of us; please refer to the study done by KFH Kuwait.

15. Although in the pre-crisis period the UIAHs received a higher return, their return is now much lower than that of the shareholders; what is the reason for that? Why did the shareholders get most of the benefit from the high return rather than the UIAHs? This shows that the concept of profit sharing is being interpreted in another way. Profit sharing is expected in a partnership.

The argument of profit is always there; however, look at the factors to which depositors refer when depositing their funds: the stability of the bank, customer service, bank location, and of course the return. As I said, the return to UIAHs depends on the results of the bank's activities and the return on assets. For example, before the economic crisis, KFH gave 8.4%, because profit was high. KFH has many types of UIAHs and the longer the period the funds stay in the account, the higher the return will be.

16. There is evidence that IB uses UPSIAs as leverage.

Remember that Islamic banks created investment accounts to generate profits, not as leverage.

Table 6-19: Returns comparison between the KFH parent company and subsidiaries

Kuwait Financial House	KFH - Kuwait		KFH - Bahrain		KFH - Malaysia	
Year	ROAE	UIAHs	ROAE	UIAHs	ROAE	UIAHs
2002	20.85%	3.35%	6.82%	1.75%	NA	NA
2003	21.28%	2.95%	8.70%	1.75%	NA	NA
2004	24.38%	3.91%	23.77%	3.50%	NA	NA
2005	25.63%	5.55%	26.10%	3.51%	0.11%	0.22%
2006	24.87%	6.89%	26.65%	3.19%	2.03%	0.99%
2007	28.79%	7.03%	25.77%	5.00%	4.72%	2.29%
2008	12.81%	3.50%	14.97%	6.00%	4.46%	3.08%
2009	9.57%	2.27%	0.91%	5.00%	0.00%	2.46%
2010	8.37%	1.94%	2.08%	2.79%	0.00%	2.56%
2011	6.22%	1.54%	1.86%	3.75%	0.00%	2.97%
2012	6.69%	1.72%	2.57%	3.00%	4.07%	3.20%
2013	7.58%	1.74%	1.52%	2.50%	6.29%	2.77%
Observations	12	12	12	12	9	9
Mean return	16.42%	3.53%	11.81%	3.48%	2.41%	2.28%
Standard Deviation	8.62%	1.97%	10.92%	1.31%	2.50%	1.01%
Coefficient of Variation	52.49%	55.80%	92.43%	37.56%	104.05%	44.38%

Comparison between the return for shareholders and UIAHs for the Kuwait finance house parent and its subsidiaries. ROAE is the return on average equity, and UIAHs return is the average annual rate of return from the annual report. A higher CV means worse off. The subsidiary banks of KFH have a lower CV which indicates that the UIAHs have a better or fairer risk-adjusted return than those of the parent bank based in Kuwait. This may suggest that the market and regulatory environment have a strong influence on this particular behaviour. In addition, Bahrain and Malaysia have more Islamic banks than Kuwait, which may signal that competition is strong and that Islamic banks have to offer better returns in order to attract investors. Note that in 2009-2011, negative ROE (losses) in KFH Malaysia were adjusted to 0, to be more comparable with UIAHs returns.

Appendix G - Total Shareholders Return

G.1 KFH Stock Market Return

In efficient stock markets, it is also usual to calculate the total shareholder return (TSR), which is the return received by a shareholder on a share bought at the beginning of a period, earned a dividend, and received a payment at the end of the period equal to the most recent share price (Quiry *et al.*, 2009). This study has avoided using stock market return as a measure because the GCC markets are not efficient, the data may not be available, there is insufficient data for subsidiaries, etc. but given that the data is available here for KFH Kuwait, it may be of interest to examine whether or not the rate of stock market return to shareholders has a bigger CV than the rate of return to UIAHs. TSR can be calculated as:

Total shareholder returns = $TSR = \frac{P_1 - P_0}{P_0} + \frac{Div_1}{P_0}$ **Equation 6-3**

Table 6-20: Total Shareholder Return

Year	*Market Cap*	*Share outstanding*	*DPS*	*Market price/share*	*TSR (Market)*	*UIAHs return*
1996	367.21	2785.14	0.004	KWD 0.132	NA	5.96%
1997	434.74	2785.12	0.006	KWD 0.156	6.14%	6.07%
1998	423.31	2785.12	0.007	KWD 0.152	4.13%	6.13%
1999	431.67	2785.12	0.008	KWD 0.155	5.59%	5.75%
2000	460.07	2627.47	0.009	KWD 0.175	7.21%	5.64%
2001	598.22	2837.67	0.010	KWD 0.211	8.17%	3.69%
2002	778.33	3007.93	0.011	KWD 0.259	8.93%	3.35%
2003	1147.02	3007.93	0.012	KWD 0.381	15.38%	2.95%
2004	1281.51	3007.93	0.013	KWD 0.426	7.43%	3.91%
2005	2603.64	3936.62	0.015	KWD 0.661	25.85%	5.55%
2006	2671.03	3936.62	0.018	KWD 0.679	4.32%	6.89%
2007	4940.21	4223.56	0.026	KWD 1.170	51.37%	7.03%
2008	2799.44	4223.56	0.020	KWD 0.663	-47.74%	3.50%
2009	2500.62	4223.78	0.014	KWD 0.592	-4.78%	2.27%
2010	2859.62	4223.78	0.012	KWD 0.677	10.24%	1.94%
2011	2377.37	4223.56	0.010	KWD 0.563	-9.71%	1.54%
2012	2302.77	4223.56	0.007	KWD 0.545	-0.50%	1.72%
2013	3013.40	4765.04	0.011	KWD 0.632	10.38%	1.74%
2014	3118.93	4765.04	0.014	KWD 0.655	4.29%	1.69%
2015	2716.07	4765.04	0.016	KWD 0.570	-5.65%	NA
				TSR Mean	5.32%	4.07%
				TSR SD	18.29%	1.96%
				TSR CV	343.99%	48.16%
				TSR Mean up to 2007	**13.14%**	**5.24%**
				TSR SD up to 2007	14.15%	1.40%
				TSR CV up to 2007	107.74%	26.62%
				TSR Mean after 2007	-5.43%	2.06%
				TSR SD after 2007	18.61%	0.68%
				TSR CV after 2007	-342.44%	33.03%

Source: Bloomberg. Market price per share is calculated as market cap over share outstanding. UIAHs' returns are taken directly from the bank annual report and is the average of all UIAHs accounts in one year. CV to shareholders is bigger than the CV to UIAHs, because looking at the market cap there is a peak in 2007, and if 2007 is excluded then there is little variation for shareholders. Also, new shares have been issued, and there is growth, but this is corrected by the fact that the market cap is being divided by the share outstanding.

The share price peaked in 2007 but has continued falling since 2008, so the shareholders would have made losses. However, if the calculation is corrected for bonus issues to shareholders (as indicated in table 6-21), which dilute the share price, the shareholders will make back some of those losses.

Table 6-21: KFH cash dividends and bonus share

Year	Cash Dividend	Bonus Share capital
1991	NA	NA
1992	NA	NA
1993	5%	10%
1994	14%	6%
1995	20%	6%
1996	25%	6%
1997	32%	6%
1998	36%	6%
1999	40%	6%
2000	42%	6%
2001	45%	5%
2002	47%	5%
2003	50%	6%
2004	50%	10%
2005	55%	12%
2006	57%	15%
2007	65%	20%
2008	40%	12%
2009	25%	8%
2010	20%	8%
2011	15%	8%
2012	10%	10%
2013	13%	13%
2014	15%	10%

Source: KFH annual report. Bonus share issued at no cost to the shareholders, as an alternative to increasing the dividend pay-out; hence, the share price will adjust downwards accordingly to reflect the dilution effect.

For example, in 2011, cash dividends of 0.015 KWD per share were paid on outstanding shares and bonus shares of 8% of paid-up share capital, and in 2012 every 100 shares received a bonus share of 10 shares and a 10% dividend.

Chapter 7: The Comparison of Dividend Yield and UIAHs Return

7.1 Introduction

This chapter compares the shareholders' dividend yields to the UIAHs' percentage returns, both of which are based on cash pay-outs. This is necessary to complement the analysis in chapter 4 and 5, which was based on accounting returns. This cannot be satisfactorily achieved using stock market returns, since the GCC stock markets are inefficient (as discussed later, in section 7.2), which means that basing a comparison of returns on stock market returns would not yield reliable results.

It is therefore appropriate to re-evaluate the assessment between UIAHs and shareholders by comparing the rates of return based on cash pay-outs for the sample of IBs used in chapters 4 and 5. As UIAHs' percentage returns are also based on cash pay-outs, this will provide a useful basis for comparison between shareholders and UIAHs, especially in the post-crisis period. However, the data are available only for 20 banks out of our sample. Nevertheless, it can be seen that the results of the comparison are supportive of the conclusions reached in chapter 4 and 5. The dividend yield used to measure the shareholders' returns, as explained by Quiry *et al.* (2009), is the ratio of the last dividend paid to the closing share price:

$$\text{Dividend Yield} = \frac{Dividend\ per\ share}{Share\ price} \qquad \textbf{Equation 7-1}$$

7.2 Research Aims and Objectives

Because of the lack of market efficiency in the Gulf Cooperation Council (GCC) stock markets, another examination is to be conducted to observe the differences in rates of return between the UIAHs and the shareholders. The shareholders' dividend yield is compared against the UIAHs' rate of return, which are similar in that both are based on cash payments.

7.3 Overview of Stock Market Efficiency

Fama (1970) argued that an efficient market reflects all available information, and this author categorised market efficiency into three different groups. First is weak-form efficiency, where current prices reflect all the information in historical prices, which cannot be used to predict future prices. Second is the semi-strong form, where prices efficiently and quickly adjust to new information that becomes publicly available, such as stock split and annual earnings announcements. Normally, in a semi-strong form of efficient market, the retained earnings would flow through to increases in share price, as the Gordon Growth Model suggests. However, in a real world market (in particular in thin markets such as the GCC thin market), it cannot be assumed that the retained earnings will create any realisable value for the shareholders. See table 7-1 stock market trading volume.

Table 7-1: Stock Market Trading Volume

Stock Market Volume	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Bahrain	426	738	1494	840	610	489	574	1813	1123	513
Kuwait	111540	66232	2826	1155	973	380	42062	126764	52867	41510
Saudi Arabia	32453	50066	47943	40426	22956	34807	63100	42182	65437	61141
Abu Dhabi	9301	47821	48312	37272	17603	15845	16372	51019	56965	25474
Dubai (DFM UH Equity)		14476	8541	14444	5053	2031	3066	7185	6728	2817
Dubai (DFMGI Index)	33813	93733	72488	106287	36011	21410	34319	97425	115060	65034
Malaysia (BURSA MK Equity)	444	663	419	309	199	225	172	264	143	127
Malaysia (FBMKLCI Index)	28980	55755	54651	55513	28574	31862	33545	37113	30763	33374
Qatar	266	573	1586	2883	1646	1671	1063	1601	2805	1893

Note: stock market trading volume in millions of dollars. Source: Bloomberg.

For example, after the exposure of shareholders to the stock market in the 2008 financial crisis, the shareholders could withdraw their funds by selling their shares; however, if they chose to do so at that time then they were likely to face losses[132]. Finally, the strong form of efficiency is where the available information includes public and private information, and all investors have information symmetry. According to Basu (1977), stock prices in an efficient market reflect the available information in an unbiased and quick mode, by providing an estimate of underlying values.

According to Hassan *et al.* (2003), GCC stock markets are relatively small, trade infrequently and at low volume, and have few listed companies, which indicates a thin market. Also, their study found that the Kuwaiti stock exchange is an example of weak-form inefficiency. Abdmoulah (2010) agreed, finding that the GCC markets are highly sensitive to previous stock prices (in the absence of 'random walk')[133], and are thus weak-form inefficient (i.e. not even weak-form efficient) markets.

7.4 Examining the dividend yield

The coefficient of variation test is used again here to compare the return differences between shareholders and UIAHs. In this test, dividend yield represents the percentage return that investors receive as a cash pay-out on stocks (Berk, 2014), where the dividend plus/minus the change in share price would give the total return to investors from stock. The information is available for 20 IBs rather than 28 as was the case in chapter 4. By examining the dividend yield relative to the UIAHs pay-out rate of return, as shown in table 7-2, we can observe that in most cases, shareholders have a higher rate of return and sometimes a lower degree of variation. This is apparent, for example, if we look at the BARK

[132] In fact, this can and does happen when markets are semi-strong or even strong-form efficient, not just in a weak-form efficient market, but the issue is whether shareholders are able to reliably 'cash in' their stock market returns in thin and shallow markets where bid-ask spreads are very wide and transactions tend to move prices.

[133] Random walk where the future directions of the stocks cannot be predicted in the basis of past actions (Malkiel, 1999).

bank, where shareholders received a mean return of 4% and their CV (risk-adjusted return) was 29%, while UIAHs received a mean return of 3% but had a higher degree of variation of 34%.

Table 7-2: Dividend yield and UIAHs % pay-out for 2002-2013

2002-2013	Dividend yield			IAH pay-out		
Bank	Mean	SD	CV	Mean	SD	CV
BARK	0.04	0.01	29%	0.03	0.01	34%
SALM	0.08	0.03	41%	0.02	0.02	85%
BAHN	0.04	0.01	36%	0.03	0.01	19%
ITHM	0.07	0.03	49%	0.04	0.01	18%
AHLI	0.05	0.02	34%	0.02	0.01	26%
KFH	0.02	0.01	34%	0.04	0.02	56%
KIB	0.02	0.01	38%	0.03	0.01	44%
MASF	0.07	0.04	61%	0.03	0.02	59%
QATR	0.04	0.03	69%	0.04	0.02	42%
DHABI	0.05	0.03	60%	0.03	0.02	78%
DUBAI	0.05	0.04	72%	0.03	0.01	48%
SHAJ	0.05	0.02	44%	0.04	0.01	32%
AFFN	0.02	0.01	68%	0.03	0.01	22%
ALLN	0.02	0.01	51%	0.03	0.01	27%
ISLM	0.03	0.02	57%	0.02	0.01	37%
MUAT	0.02	0.01	52%	0.03	0.00	16%
CIMB	0.02	0.01	41%	0.03	0.01	40%
HONG	0.03	0.02	49%	0.03	0.01	18%
MAY	0.04	0.02	45%	0.03	0.01	46%
OCBC	0.03	0.01	32%	0.03	0.01	45%
Mean	**3.90%**			**3.07%**		

Source: Bloomberg and annual report. In 7 banks out of 20 the CV of UIAHs' returns were higher, which indicates that UIAHs are not treated fairly according to the risk adjusted return.

As can be seen from the table above, shareholders have somewhat higher average returns; however, if the risks between UIAHs and shareholders are comparable, there are nevertheless 7 banks out of 20 for which the CV of UIAHs rates of return was higher. As can be seen in table 7-2, shareholders at OCBC, for example, enjoyed higher rates of return with a much lower degree of variation compared to UIAHs. It is interesting to notice that AlSalam Bank, KFH-Kuwait, Abu Dhabi Islamic, and Maybank Islamic Berhad are the same banks that have a higher CV to UIAHs as in chapter 4.

The (unweighted) mean of the means of dividend yields equals 3.90%, while the unweighted mean of the UIAHs rates of return is only 3.07% (22% lower). Indeed, for a total of 7 cases out of the 20 banks (35%), the CV of the UIAHs rates of return was higher than the CV of

the dividend yields. Apart from the fact that the bank is entitled to remuneration as fund manager (*Mudarib*), the only benefit held by the UIAHs which may be considered to justify the lower rates of return, is a kind of 'put option' whereby they are generally able to withdraw their funds and in so doing, to obtain repayment of the NAV of the assets financed by their funds. While these considerations may justify the lower rates of return in the 65 percent of cases where the CV if the shareholders' dividend yield is higher than that of the UIAHs' percentage returns, they do not do so in the 35 percent of cases where it is lower.

7.5 Concluding Remarks

As was seen in the analyses presented in chapters 4 and 5, the term "profit sharing" is somewhat misleading as a description of the actual practice of the treatment of Unrestricted Profit Sharing Investment Accounts in IBs. The "profit shares" paid to UIAHs are largely a matter of management discretion, which operates on two levels. In the first place, the *Mudarib* share is set at a very high level. Secondly, the use of reserves such as the PER and IRR to "smooth" the pay-outs provides management with a further means of manipulating the UIAHs profit pay-out. It is therefore questionable whether such practices constitute "profit sharing" in any meaningful sense.

It would be misleading to point to the use of *Mudarabah* to indicate that there is no issue, because what is actually being used is a form of "tweaked" *Mudarabah* which does not behave like the classical *Mudarabah*, and more closely resembles a conventional deposit account. There is no contradiction with *Shari'ah* here, since the UPSIA product has been approved by the *Shari'ah* supervisory board, but the UPSIA product currently used in IBs is a tailored *Shari'ah*-compliant account which is certainly not the same as classic *Mudarabah*. The principle of profit sharing applied to the UIAHs has been reduced to an absolute minimum, and this is apparently what the market wants, or at least, what it is prepared to put up with. From a purely juristic point of view, it is "profit sharing" since it does not have a contractually pre-determined rate either based on a benchmark or fixed rate. But, it is

shared profit of a type managed in order to provide a return which is perceived as competitive in the market compared to conventional deposit accounts.

Hence, this chapter focuses on cash pay-outs in order to consider the issue from a different perspective. Thus, table 7-2 indicates that during a 12-year period (2002-2013) in 7 cases out of 20 (35%), the CV of the UIAHs returns was greater than the CV of the dividend yields, while the mean percentage cash pay-out to UIAHs was 83 basis points (22%) lower than that made to shareholders – arguably the price the former pay for management of their funds and their "put option" whereby UIAHs may withdraw the NAV of their funds, normally at short notice.

Consequently, we may say that generally, UIAHs are looking for a safe place for their funds, and do not want to take any market risk; otherwise, they would buy shares or invest in collective investment schemes. IBs are looking for a product that behaves as closely as possible to a conventional deposit while also paying a *Shari'ah* compliant return. However, calling this product "profit sharing" is somewhat misleading, and does not reflect the actual operation of the account. Often, in pure profit sharing terms, UIAHs are not getting a fair deal, and there is also the problem of a significant lack of transparency.

In terms of profit sharing, a significant proportion of the UIAHs receive a return that is low in relation to the amount of risk that they are taking, compared to the risk taken by shareholders. Bearing in mind that UIAHs are typically passive investors and are not likely to move their funds for a 0.5% change in returns, a major event would be needed to drive them to take such action. Muslim investors seek IBs because of their *Shari'ah* compliance compared to conventional banks. However, the choice between two IBs usually depends on the confidence in the bank held by the UIAHs. Also, some Muslim investors may look at who sits on the *Shari'ah* board as an additional factor in selecting an Islamic bank with which to invest. A more knowledgeable UIAHs may look at the level of transparency with regard to the rate of returns and investment risk. In practice, it is hard for UIAHs to move their funds based on the small amount of relevant information available to them or small differences in returns; however, in theory, the lack of such confidence by UIAHs in an Islamic bank may

result in their withdrawing funds, which in turn reduces the bank's liquidity and opportunity for more investment, and hence its chance to make more profit. As a result, passive investors are easy victims for the banks or, more precisely, for the management of the banks.

Chapter Eight: General Discussion and Conclusions

8.1 Introduction

This chapter summarises the research findings in terms of the implications for UPSIA concerning their CG rights and the conflict of interest which they face compared with the shareholders, in the light of their respective risk-adjusted rates of return, in terms of both profit-sharing and cash payouts. In addition, the contribution and the significance of the research will be assessed, with some concluding remarks.

8.2 Research Summary

This research has examined the difference in the rates of return received by shareholders and by UIAHs at various IBs from a CG perspective, by undertaking various methods of measurement, such as profit-sharing and cash payouts, and in doing so, an unfavourable picture of the treatment of UPSIA has emerged. The scope of the study was based on the GCC countries plus Malaysia, which represent the main markets of IBs worldwide. For example, looking at the share of the IBs' assets by including the GCC and Malaysia, the majority of the market is likely to have been covered. According to the World Islamic Banking Competitiveness Report by Ernst & Young, 93% of the Islamic banking industry's assets, estimated to exceed US$920 billion in 2015, were located in nine core market nations, including the GCC (but excluding Oman), Malaysia, Indonesia, Turkey, and Pakistan. GCC countries and Malaysia account for 84% of the Islamic banking industry (Ernst & Young, 2016).

For IBs, UPSIAs raise some complex CG issues. On the one hand, UIAHs are a type of equity investor, but as *Rabb Al Maal* in a *Mudarabah* (sleeping partners) they have no governance

rights. The question then arises as to whether this leads to them being treated unfairly compared to shareholders, who do possess governance rights.

From a purely (accounting) profit-sharing point of view, UIAHs generally receive a much lower rate of return on investment than the bank as *Mudarib* for the benefit of shareholders. Moreover, the variability of this rate (measured by the coefficient of variation) is not significantly lower on average than that of the shareholders; in fact, in about 1/3 of cases it is actually greater. For example, at KFH Kuwait, UIAHs' rates of return had a CV of 55.80%, while that of shareholders had a CV of 52.49%, which means that UIAHs are exposed to a high level of risk despite being compensated with a low level of rates of returns. The much higher rates of return that shareholders receive are supposedly justified by their taking on more risk than UIAHs. Theoretically, both UIAHs and shareholders should be paid a rate of return on their investment corresponding with the risk exposure that they are facing, subject to the banks receiving a level of remuneration as fund managers which does not distort the respective rates of return. As the normal investment model describes, when the relative risk increases, known as the uncertainty of payment, the expected return on investment should also increase. In contrast, in the other 2/3 of cases where the CV of UIAHs is lower than shareholders, the rates of pay-out to UIAHs are less variable than the ROE to shareholders; this is simply because the higher rates of return in good years are going to the shareholders but not to the UIAHs. In fact, the profit payouts to UPSIAs are being "smoothed" up in bad years when returns on investment are low, and "smoothed" down with the profits being transferred to "smoothing reserves" (the PER and IRR) in good years. The implication here is that IBs "skim off" the higher returns when the banks have good years of profit, rather than sharing these higher returns with the UIAHs as a profit sharing contract such as a *Mudarabah* would normally imply. This suggests that IBs are in fact stabilising the returns to UIAHs in return for taking significantly higher rates of return, which answer the research question that IBs do attempt to make the UPSIA behave similarly to conventional deposit in term of stability of returns. Also by using the PER and IRR IBs attempt to protect the UPSIA against losses as well as stabilising the returns. Therefore, focusing on profit sharing, the UIAHs appear to be getting a bad deal, because what is

happening is not really profit sharing; the banks simply share the profit as they see fit, and the share going to the UIAHs tends to be relatively small.

A panel data approach provides enough data to fit a statistical model given the limited number of years of data was undertaken in chapter 5 of this research to investigate the CG effect on the CV difference between shareholders and UIAHs. In this analysis, different CG variables were included together with non-CG factors that impact differently on the differences in rates of return. The results indicated that for the banks in the sample, the usual GC independent variables had little explanatory power with regard to the 'fairness' of the profit sharing. Instead, what was observed was that when profits were high, the *Mudarib* (i.e. the shareholders') % return was considerably higher than that of the UIAHs, while when profits were poor, the *Mudarib* % share fell much more than that of the UIAHs. In other words, the main driver of the differences in the levels of % return was the Return on Assets measure. In addition, a large discretionary element is apparent in the way management divides profits between the *Mudarib* and the UIAHs as *Rabb Al Maal*. Again, this suggests that "profit sharing" in the normal sense does not actually exist; rather, the banks make what is in effect a discretionary payment to UIAHs in place of interest, in order to make the deposit product *Shari'ah* compliant. Thus, if the profit is high, most of the benefit goes to the shareholders and the share passed to UIAHs is low. It thus seems that in the absence of control rights and lack of information there is an unfair treatment of the UIAHs, as well as a highly questionable version of profit sharing.

On the other hand, in the light of the interview with KFH, it appeared important to look at other returns besides the sharing of the accounting profit. However, stock market returns in inefficient markets such as those in the GCC countries are not very reliable; this means that the value of the retained profits is questionable. They represent unrealised gains that may not be truly realisable in terms of sustainable share price appreciation. This is especially true when the shares are listed in inefficient markets such as those in the GCC countries. For similar reasons, using stock market returns (dividend plus the change in share price) to measure shareholders' returns for the purpose of a comparison with UIAHs returns is

unlikely to be reliable enough for the purpose of this research. This suggests that the issue of the 'fair treatment' of UIAHs should rather be considered by comparing the percentage (cash) returns paid to them against those paid to shareholders as dividend yields. Making this latter comparison, based on the data presented here, the average dividend yields of this study's sample of IBs is 83 basis points higher than the average UIAHs return, while the degree of variability is comparable. Given that, in the case of KFH Kuwait at least, there were numerous bonus share issues, the difference of 83 basis points is an underestimation.

Although it perhaps does not present the evident injustice that has been observed through looking at profit sharing, the situation is still questionable from the UIAHs' point of view. The results were robust and the dividend yield is in line with the information from the CV in chapter 4, which presents a similar picture of the UIAHs being paid a lower return without obvious justification for doing so in terms of risk. For example, looking at the sample of 20 banks over 12 years, the UIAHs on average are receiving a lower mean pay-out than the average dividend yield (see table 7-2) while encountering similar levels of variability. Nearly 40% of the UIAHs variability is higher than that faced by the shareholders.

An additional 83 basis points might perhaps be considered as a return to the bank for managing the funds, but does a difference of at least 83 basis points constitute unfair treatment of UIAHs? The latter benefit from having the right to withdraw the net asset value of their investment, which may or may not be subject to a minimum notice period (UPSIAs are classified as 'puttable instrument' according to IAS 32 Financial Instrument Presentation (2008)). Thus, comparing UPSIA to a managed fund, it might be argued that cost of fund management plus the price of this withdrawal or 'put' option is at least 83 basis points. Whether this is a fair price is not an easy question to answer, as different UIAHs might have different opinions on the issue. However, fairness would require that they at least have the necessary information to make an informed decision. This is generally far from the case, and the lack of information is indeed an important CG issue. It was addressed by the IFSB in its Standard IFSB-4, issued in December 2007, but implementation of this Standard has been poor.

One of the main CG issues highlighted by this research is the lack of transparency which deprives actual and potential UIAHs of the basis for making informed decisions about the management of their funds. This is relevant to the research question, to the effect that UIAHs have no rights of information or control rights. Hassan and Christopher (2005) have argued that, because of the characteristics and values of Islam, at least in Malaysia, there is an expectation of IBs to make additional governance disclosures that differentiate them from conventional banks. Therefore, the actual lack of transparency is aggravated in two ways. First, by the use of a form of 'profit sharing' which is profit sharing in name only rather than in substance, because of the degree of discretion used by management in deciding the share allocated to UIAHs. Second, by the lack of governance rights granted to UIAHs, as a result of which their only recourse if they are dissatisfied with returns is to withdraw their funds, a right which is considerably weakened by the lack of transparency.

The IFSB has pointed out the questionable nature of the way these UPSIAs are operated, in various publications. This, however, has had little practical effect, although it might be one reason why Bank Negara in Malaysia decided to ban smoothing and to require 'pure *Mudarabah*' in their products. This might be in response to IFSB whistle blowing, which has had no other effect on the industry. The market is now moving towards a preference for CMT-based term deposits. For example, AFFIN Islamic Bank in Malaysia started CMT-based term deposits in 2013 with 1,021,789,000 RM, increasing in 2014 to 5,190,631,000 RM (AFFIN Annual Report, 2014).

As a result of the issues raised here, authorities at the central bank or capital market supervisors should examine the problems with UIAHs, rather than simply leaving them up to the BOD or to the *Shari'ah* board to resolve. Indeed, there is no evidence that the *Shari'ah* board is as active in CG issues, as their statements in banks' annual reports would indicate. In most of the cases *Shari'ah* boards deal with the *Shari'ah* compliance issue in the juristic sense, rather than attending to issues of the best ethical practice and social expectations. In fact, the evidence from the results of the empirical chapters suggests that *Shari'ah* boards have no inclination, even if in principle they have the power, to affect such

outcomes as unfair treatment of UIAHs. This may raise an issue regarding the scope of the influence of *Shari'ah* Boards, since they go along with the 'tweaking' of the *Mudarabah* contract to produce an acceptable deposit product (as UPSIAs are approved as a product by the *Shari'ah* Board), instead of having a more far-reaching involvement extending to the ethical aspects of such matters.

Even though the evidence is that IBs are less unethical than some conventional banks (no IBs have yet been found to have been guilty of market malpractice, as has been the case with a number of major international banks which have been sanctioned for seriously unethical conduct), our analysis suggests that supervisory authorities should place more emphasis on UIAHs' rights. Nevertheless, the discrepancy we noted between the treatment given by a significant proportion of IBs to shareholders and to UIAHs is an indication of ethical shortcomings in general and a breach of Islamic principles in particular, as the working of the *Mudarabah*-based deposit accounts raises serious questions which may be considered to be ethical issues. Indeed, it seems that each of the stakeholders in the banks have compromised so far (UIAHs haven't really been given any choice) in creating a "tweaked *Mudarabah*" and shifting the operational nature and mechanism of *Mudarabah* and importantly the nature of profit-and-loss sharing, which has become an arranged profit-sharing mechanism. According to Asutay (2012), insofar as Islamic finance principles are supposed to be based on ethics, values and norms which derive from Islamic deontology, the principles followed by IBs should likewise reflect these ethics, norms and values in their policies and operations, beyond mere juristic compliance.

In the line with new regulations designed for IBs, supervisors should place additional emphasis on fiduciary responsibility or the establishment of detailed regulations intended to monitor potential conflicts of interest. Regulators should highlight the fiduciary responsibility of IBs to comply at all times with Islamic *Shari'ah* rules and principles (IFSB-3, 2006). There should be an adequate disclosure of relevant information about IBs, their investment objectives, policies, and the operational guidelines that govern the relationship between the IB and its stakeholders, as higher levels of disclosure reduce information

asymmetry between UIAHs and IBs, which may help UIAHs to make informed decisions about their investments (IFSB-4, 2007).

8.3 UPSIA Implications

If UPSIAs are genuinely PLS ('pure *Mudarabah*)', then in principle they should have governance rights as equity investors, as argued by Williamson (1996), although in *Fiqh* investors in *Mudarabah* are treated as sleeping partners with no such rights, which was logical when *Mudarabah* was used to fund one-off trading ventures. 'Pure *Mudarabah*' for banking deposits seems to be a misuse of a contract devised for an entirely different purpose (originally, this was for one-off commercial ventures normally involving export-import using ships or caravans, in which the *"Rabb Al Maal"* could not exercise any governance over the *Mudarib* until he returned, when the profits were calculated and divided and the *Mudarabah* was terminated).

If in fact they are a type of secured creditor (through ownership of the NAV of the underlying assets as *"Rabb Al Maal"*), then UIAHs' governance rights as creditors only come into play in the event of the bank's financial failure, in which case they depend on the bankruptcy laws of the relevant jurisdiction. Thus, if in substance UIAHs have the status of a type of secured creditors, to whom a type of 'profit sharing' applies which is manipulated to pay them a sort of 'going rate' to prevent them from going elsewhere, then the profits that they forego are the price they pay (more or less willingly) for not being exposed to stock market losses, as they are potentially exposed only to the losses (reductions of the NAV) of their underlying assets.

The use of the pure (unmanipulated) *Mudarabah* model for bank deposits (as in Malaysia under the new Banking Act) is exceptional, and raises a major CG issue: the existence of a class of equity investor who has no governance rights as an investor, and uncertain rights as a creditor. In the event of a bank insolvency, UIAHs should be able claim the NAV of their underlying assets as *"Rabb Al Maal"*, but the success of this would depend on whether

bankruptcy law recognises this claim, which is different from that of a conventional depositor. Their exposure is thus different from that of shareholders.

Such a state of affairs might not be accepted in more advanced regulatory environments; however, it is accepted in Malaysia, which seems to have become an exception to the general rule that UPSIAs are treated as a type of secured creditor[134]. According to IFSB-Report (2015), Bank Negara of Malaysia used to insist that UPSIAs were not exposed to losses, but the recent Islamic Financial Services Act (2013)[135] takes the opposite position and requires them to be 'pure *Mudarabah*'. Also according to the IFSB report, there is some evidence that following recent Malaysia's new rule, the percentage of UPSIAs in Malaysian IBs' balance sheets has fallen and the percentage of CMT-based term deposits has risen (the case of Affin Bank was cited above).

By examining the way that profits are shared, it seems likely that UIAHs are being treated unfavourably (by receiving a small share of the profit compared to *Mudarib*). Moreover, in investigating the situation more deeply by making a comparison of dividend yields to UPSIA rates of return, the impression of unfairness in relation to the UIAHs' returns is largely corroborated. This issue was examined in chapter 7.

From table 7-2 on p.218, it can be seen that the (unweighted) mean of the means of dividend yields equals 3.90%, while the unweighted mean of the mean UIAHs returns is only 2.99%. In 7 cases out of 20 (35%), the CV of the UIAHs returns was greater than the CV of the dividend yields. Apart from fund management, the only benefit to the UIAHs, which may be considered to 'justify' the lower returns, is the previously-discussed 'put option' whereby they are generally able to withdraw their funds and obtain the repayment of the NAV of the assets financed by their funds. On the other hand, there is also the issue of what the bank gets as a return for fund management, typically a high *Mudarib* share.

[134] Quite possibly, the Malaysian courts would uphold the UIAHs' claim to the NAV of the *Mudarabah* assets in liquidation.
[135] For more details of the banking Act see http://www.bnm.gov.my/documents/act/en_ifsa.pdf

Thus, while UIAHs are close to being secured creditors, albeit in principle (juristically) having the status of equity investors, then there is certainly a CG issue: this is not just a lack of clarity regarding their status and rights, but the fact that in a significant proportion of cases the variability of the percentage cash pay-outs to UIAHs is greater than the variance of the dividend yields to shareholders.

While the UPSIA is a *Shari'ah*-compliant product, it appears that there is an issue with the terminology of 'profit sharing' in the *Mudarabah* that has been "tweaked" into something different from the historic understanding of *Mudarabah*, in order to create a deposit product which is acceptable under this term. Indeed, the way that *Mudarabah* is used for the UPSIA is misleading, because in general no genuine profit sharing takes place. The UPSIA have been engineered to minimise the degree of profit sharing and risk sharing and to ensure that the account behaves as closely as possible to a conventional deposit, while still juristically adhering to the form of *Mudarabah*. Asutay (2012) argued that IBs have converged towards conventional banking practices in order to operate in global markets, and have not followed the moral principles of Islamic economics. In a sense, this strategy is market driven, in that the IBs and their *Shari'ah* advisors have come up with a product that more or less meets the market requirement to be a viable product. In the process, the banks have distorted the concept of profit sharing and risk sharing (to the extent that these are reduced to the point where they resemble a mere shadow of these concepts). The evidence is that IBs have been influenced by juristic considerations and the 'real world' of banking, and have never been much influenced by the 'ideal world' of Islamic economics.

8.4 Significance of the research outcome

The background of the research has centred upon the issue of the fair treatment of UIAHs, from the CG perspective of the rights of stakeholders. The study is based on the function of CG in ensuring the accountability of certain individuals within an organisation to its key stakeholders; this is a function that a number of international bodies have indicated,

including the OECD, the BCBS, and the IFSB, whose standards draw attention to issues concerning the interests of UPSIAs. The research casts light on some significant anomalies in the treatment of UIAHs, and calls for urgent reconsideration of this treatment in the context of the CG of IBs. This implies that IBs have unique CG requirements that must both fit their business model and function effectively to address the issues concerning UIAHs. The analysis conducted in this research shown that the main issue is not simply that, on a risk-adjusted basis, UIAHs are (in a significant proportion of cases) treated unfavourably in terms of profit sharing. Perhaps more serious is the fact that, as the analysis in chapter 7 shows, the percentage cash pay-outs to UIAHs, also on a risk-adjusted basis, compare unfavourably in a significant proportion of cases to those made to shareholders. In addition, the mean percentage pay-out to UIAHs for the whole sample is somewhat lower than the mean dividend yield. This raises the question of how far this difference is justified by the banks' entitlement to remuneration for fund management and the UIAHs' withdrawal rights. More generally, there is the CG issue that UIAHs are treated in an ambiguous and non-transparent manner because their status and rights as stakeholders in IBs are unclear. The new Banking Law in Malaysia may appear to clarify the issue, but it also raises the question of whether the resultant *Mudarabah* product can be perceived as an acceptable alternative to a conventional deposit.

It is worth noticing that the empirical results show a better position of Bahrain and Malaysia in the rates of return treatment of UIAHs, which may also be because of the role of AAOIFI and IFSB on the nature of regulation and governance in general at country level and their impact on individual banking. For example, AAIOFI designed two models that are used as the accounting standard for IBs, and also set the standard for investment tools in *Shari'ah*, where Bahrain follows AAIOFI financial reporting standards.

8.5 Research limitations

Even though the literature on CG is widely available, the CG resources in the context of Islamic banking remain limited and in need of further development. The availability of data for IBs is often restricted to secondary source data, especially for CG issues, because Islamic banking is a relatively new industry, and there are limitations in the historic data. It is therefore necessary to generate new primary resource data, for example by carrying out interviews where the researchers have to produce the primary data. Therefore, there are two aspects to the limitations of the present research; one is that the industry has a relatively brief history (so there is an inevitable lack of historical data); a number of banks have been operating for less than 10 years. In addition, there is the problem of the disclosure issue; more specifically, the fact that international financial reporting standards do not result in high levels of disclosure of *Shari'ah* compliant transactions, assets and liabilities. Hence, there is gap in the financial reporting regime which affects what information is available, such as that relating to the use of smoothing techniques. Also, there is very limited information about the UIAHs returns in any data base, or the percentage return; these are not even stated clearly in the annual report, so researchers often have to calculate these figures manually, except in Bahrain where the AAIOFI financial reporting standards are followed.

However, it is argued that this research has successfully overcome these limitations and has been able to reach a significant result, as noted in the previous chapters' findings. For example, the panel data has produced the clear conclusion that the way in which profit sharing is operated is primarily driven by the size of the ROA, whereas there is only a relatively small influence from the CG variables.

8.6 Recommendations for Future Study

This research has covered the bulk of IBs in the GCC countries and Malaysia; however, most IBs are relatively new and have not yet implemented the IFSB recommendations. For example, by testing the proposal of the IFSB to establish a governance committee attached to the board of directors which is specifically responsible for oversight of the fair treatment of UIAHs, the effectiveness (or otherwise) of the governance committee in mitigating UIAHs' governance problems within IBs could be assessed. Most of the CG committees which have been created in IBs do not represent the UIAHs and are more focused on protecting shareholders' interests. The IFSB has issued a CG standard which explicitly recommends a Governance Committee to watch over the interests of the UIAHs. The problem with this seems to be that the banking regulators and supervisors in most, if not all countries have so far failed to act on this proposal. In addition, in order to study the impact of the governance committee proposed by the IFSB to oversee UPSIAs, research should be conducted to examine CG principles and regulations at Islamic financial institutions where it has been adopted by banks in any GCC countries. Then, the effectiveness of the governance committee in solving CG complications within IBs could be tested, especially with regard to issues with UIAHs. For example, how would good CG practice increase the efficiency and the financial performance of Islamic financial institutions? How would it improve the relationship between IBs and UIAHs, assuming that the governance committee implementation has safeguarded disclosures to UIAHs in a timely and effective manner? A comparative evaluation could be performed using the CAMELS criteria of the performance of selected case study banks with a particular emphasis on the capital, asset quality, and earnings of IBs which have adopted the proposal on the one hand, and of banks that have not on the other.

UIAHs capital impairment risk would also be an interesting and worthwhile research area. Historically, capital impairment cases at IBs have been rare, although the risk of losing the UIAHs capital still exists. Even in the present study's test of the coefficient of variation where the shareholders' return was higher than the UIAHs', did not measure the risk of

capital impairment, and the test results do not necessarily mean that UIAHs are getting a fair deal. A very unfair deal for UIAHs may be measured, but we cannot measure whether or not UIAHs appear to receive a fair deal based on CV, and this therefore remains a subject for further research.

Furthermore, the data needed to compare concentrated vs. not concentrated shareholders were not available for our entire sampled banks; such research would be very interesting in the future if data became available, to see if it has any effect on the UIAHs' returns. For example, IBs could be divided into three categories; non-subsidiaries (controlled by relatively few shareholders), non-subsidiaries (controlled by a large number of dispersed shareholders) and subsidiaries (which by definition are non-dispersed, but are in a separate category from banks with concentrated private shareholders). The hypothesis would be that if the shareholders are more concentrated, this allows the shareholders to take a more strategic view of the market position of the bank. However, when the shareholders of the bank are more dispersed, this may mean that they are only shareholders of the bank for a short term, and that they expect a return and a dividend and so on, leaving less returns for UIAHs. On the other hand, an ownership concentration such as a wealthy family can afford not to take more profit than a dispersed bank, although the level of information disclosure can vary and is likely to be lower because less information is demanded than in a dispersed ownership situation (Akhtaruddin *et al.*, 2009). However, the data required to compare the concentrated vs. not concentrated shareholders were not available for our entire sample of banks; future research along these lines would be very interesting.

8.7 Concluding Remarks

The research has examined the consequences of the absence of governance rights for UIAHs rather than looking at the governance rights themselves (in fact, they have barely any). The fact that the absence of these governance rights is well established in the literature meant that the objective was to explore the consequences of the lack of governance rights in terms

of the rates of return paid to the UIAHs. The findings of the empirical chapters 4 and 5 show the consequences arising from the lack of governance rights. In about a third of the cases, it is clear that if UIAHs had information and control rights they would probably demand better treatment than that they are receiving. IBs operate using a weak form of governance and with inefficient market discipline, which implies that the authorities should take an active role to protect the interests of the UIAHs.

The reflection of the findings in the light of the material presented in the empirical chapters recognises the tensions in relation to the best practices which would be consistent with the normative theory of Islamic economics. Specifically, IBs would need to have some changes in their CG practice to avoid the questionable uses of *Mudarabah* for their deposit products, and to achieve the ethical goals of equity and fairness in the treatment of UIAHs. In the extreme, the whole use of *Mudarabah* may need to be removed for deposit products (not from asset management products), that is, IBs should use another contract, like *Musharakah*. However, the main problem is how we look at governance rights, is it from the proper international standard viewpoint or from the bank perspective of CG. At a minimum, IBs should have proper disclosure especially concerning the UPSIA, to allow UIAH to exercise their governance right of 'voting with their feet' in a well-informed way. Thus, IBs should be more transparent in the annual report, as IBs do not mention how profit distribution has been calculated and governance rules on how PER and IRR are being used and transferred. Also, as a minimum, they should have, as IFSB-4 recommended, a separated report to address the issues of IAH, using a simple language, and to have the CG committee as recommended by IFSB-3 and working effectively representing the IAH.

We need to distinguish between different forms of governance rights; one is the control rights, and the other is information rights. The control rights will not be valuable without the information rights. The IAHs as *Rabb Almaal* are sleeping partners and will not get control rights (apart from 'voting with their feet') so long as *Mudarabah* is used. However, the IAHs are not being giving proper information rights which would allow them to vote with their feet in a well-informed way. The CG committee is compatible with the very

limited rights of *Rabb Almaal* and could be used as a proxy for, or a mitigation of the absence of, control rights, provided members are appointed to represent IAHs. Therefore, from the CG perspective is not just a matter of fairness and unfairness, it is the fairness in the descriptions of what happening: the IBs claim to be profit-sharing but in fact they pay what they want to pay by using various devices, but at least they avoid interest.

This research has fulfilled its objectives as the results in the previous chapter have shown. The research therefore calls for urgent reform to the CG of IBs in terms of the fair treatment of UIAHs.

Appendix H - Returns to shareholders and UIAHs

H.1 Calculations of ROE and UIAHs return

The following tables are based on the country currency reported in the annual report. This does not need to be converted to a uniform currency since we are trying to calculate the percentage return, in order to calculate the percentage CV for the purpose of comparison, and to illustrate the point.

H.2 Bahrain Islamic banks

Table H-1: the calculation of ROAE and UIAHs return for Bahrain Islamic bank (A)

Bahrain IBs	*Albaraka Islamic Bank*				*AlSalam Bank*			
Year	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**
2002	NA	NA	NA	NA	NA	NA	NA	NA
2003	NA	NA	NA	NA	NA	NA	NA	NA
2004	NA	NA	NA	NA	NA	NA	NA	NA
2005	NA	NA	NA	NA	NA	NA	NA	NA
2006	NA	NA	NA	NA	16,418	136,401	12.04%	5.20%
2007	NA	NA	NA	NA	23,148	159,470	15.65%	3.20%
2008	2,510,979	185,657,440	1.35%	5.26%	25,542	172,483	15.39%	4.60%
2009	(26,463,032)	156,590,063	-15.46%	2.55%	13,962	198,191	7.53%	1.25%
2010	4,955,557	161,695,247	3.11%	2.34%	7,209	198,628	3.63%	1.00%
2011	1,777,659	157,022,224	1.12%	3.27%	312	196,469	0.16%	1.00%
2012	(8,607,741)	150,594,500	-5.60%	2.91%	10,272	208,065	5.08%	0.70%
2013	968,876	148,176,234	0.65%	2.74%	12,372	235,279	5.58%	0.60%
		Number (N)	6	6			8	8
		Mean	-2.47%	3.18%			8.13%	2.19%
		Standard Deviation	7.03%	1.07%			5.66%	1.87%
		Coefficient of Variation	-284.36%	33.65%			69.62%	85.02%

Alsalam bank currency is presented in thousands of Bahrain Dinars. SD refers to Standard Deviation; Obs. N refers to the number of observations. ROAE is an average of stockholders' equity that is based on one year of profit attributed to the equity holder of the bank divided by (two years of the equity attributable to the equity holders of the bank / 2), i.e. 2010 and 2009 shareholders' equity divided by 2.

Table H-2: the calculation of ROAE and UIAHs return for Bahrain Islamic bank (B)

Bahrain IBs	*Bahrain Islamic Bank*				*Ithmaar Bank*			
Year	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**
2002			5.81%	3.45%				
2003	2500	40000	6.25%	3.45%	13,800	62,400	NA	NA
2004	3700	53000	7.96%	3.45%	22,133	214,533	15.98%	4.00%
2005	7400	72000	11.84%	3.45%	36,533	247,359	15.82%	3.40%
2006	13,053	74,924	17.77%	3.83%	168,200	758,491	33.44%	3.70%
2007	25,025	187,176	19.10%	3.96%	102,755	1,087,808	11.13%	3.80%
2008	22,313	166,447	12.62%	3.51%	22,168	923,909	2.20%	3.80%
2009	(19,397)	140,501	-12.64%	2.34%	(247,415)	711,435	-30.26%	3.60%
2010	(39,712)	100,061	-33.02%	2.16%	(150,149)	654,016	-21.99%	3.70%
2011	(17,352)	101,329	-17.23%	3.11%	(23,708)	217,464	-5.44%	5.15%
2012	(36,195)	69,763	-42.31%	3.07%	(11,491)	222,096	-5.23%	4.82%
2013	6,069	76,874	8.28%	2.34%	(30,300)	200,401	-14.34%	5.57%
		Number (N)	12	12			10	10
		Mean	-1.30%	3.18%			0.13%	4.15%
		Standard Deviation	20.23%	0.59%			19.48%	0.75%
		Coefficient of Variation	-1558.03%	18.71%			14770.45%	17.95%

Bahrain Islamic bank and Ithmaar bank currency is presented in thousands of Bahrain Dinars.

Table H-3: the calculation of ROAE and UIAHs return for Bahrain Islamic bank (C)

Bahrain IBs	*Khaleeji Commercial*				*KFH Bahrain*			
Year	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**
2002	NA	NA	NA	NA	242	35,242	6.82%	1.75%
2003	NA	NA	NA	NA	3,244	38,439	8.70%	1.75%
2004	NA	NA	NA	NA	NA	NA	23.77%	3.50%
2005	4,107	33,907	12.11%	4.25%	15,166	63,802	26.10%	3.51%
2006	7,986	42,573	20.88%	4.73%	21,130	87,103	26.65%	3.19%
2007	20,836	134,990	23.47%	5.21%	31,399	153,782	25.77%	5.00%
2008	27,304	137,982	20.00%	5.50%	35,686	348,833	14.97%	6.00%
2009	3,100	126,574	2.34%	5.60%	6,132	351,114	0.91%	5.00%
2010	(6,533)	118,158	-5.34%	5.27%	9,325	360,248	2.08%	2.79%
2011	518	118,923	0.44%	3.61%	9,586	372,924	1.86%	3.75%
2012	751	119,448	0.63%	3.26%	10,043	381,806	2.57%	3.00%
2013	(19,209)	100,011	-17.51%	3.35%	7,392	367,782	1.52%	2.50%
		Number (N)	9	9			12	12
		Mean	6.34%	4.53%			11.81%	3.48%
		Standard Deviation	13.75%	0.94%			10.92%	1.31%
		Coefficient of Variation	**217.03%**	**20.74%**			**92.43%**	**37.56%**

Khaleeji Commercial and KFHB currency is presented in thousands of Bahrain Dinars.

H.3 Kuwait Islamic banks

Table H-4: the calculation of ROAE and UIAHs return for Kuwait Islamic bank (A)

Kuwait IBs	*Ahli United Bank*				*Boubyan Bank*			
Year	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**
2002	NA	NA	NA	NA	NA	NA	NA	NA
2003	NA	NA	NA	NA	NA	NA	NA	NA
2004	NA	NA	NA	NA	NA	NA	NA	NA
2005	NA	NA	NA	NA	6,854	106,917	6.41%	3.00%
2006	45,111	235,097	NA	NA	10,259	118,175	9.12%	3.00%
2007	48,179	269,884	NA	NA	18,562	137,187	14.54%	4.85%
2008	51,365	243,006	NA	NA	1,846	135,148	1.36%	5.70%
2009	14,262	213,159	NA	NA	(51,695)	87,135	-46.51%	1.76%
2010	27,444	245,679	11.96%	3.03%	6,109	238,190	3.76%	2.70%
2011	31,544	262,190	12.42%	2.03%	8,025	244,245	3.33%	2.22%
2012	38,539	282,809	14.14%	1.72%	10,050	253,650	4.04%	1.70%
2013	579,374	3,148,824	13.87%	1.96%	13,408	269,487	5.13%	0.56%
		Number (N)	4	4			9	9
		Mean	13.10%	2.19%			0.13%	2.83%
		Standard Deviation	1.07%	0.58%			17.92%	1.59%
		Coefficient of Variation	**8.17%**	**26.46%**			**13996.42%**	**56.27%**

Currency is presented in thousands of Kuwaiti Dinars

Table H-5: the calculation of ROAE and UIAHs return for Kuwait Islamic bank (B)

Kuwait IBs	*Kuwait Financial House*				*Kuwait International Bank*			
Year	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**
2002	54,613	261,969	20.85%	3.35%	NA	NA	NA	NA
2003	58,160	284,586	21.28%	2.95%	NA	NA	NA	NA
2004	74,412	325,938	24.38%	3.91%	NA	NA	NA	NA
2005	118,687	600,210	25.63%	5.55%	NA	NA	NA	NA
2006	162,004	702,489	24.87%	6.89%	9,491	142,532	6.66%	3.24%
2007	275,266	1,210,000	28.79%	7.03%	17,982	157,852	11.97%	5.19%
2008	156,960	1,240,283	12.81%	3.50%	19,800	164,818	12.27%	3.31%
2009	118,741	1,241,817	9.57%	2.27%	(8,235)	173,203	-4.87%	2.22%
2010	105,983	1,290,330	8.37%	1.94%	16,754	196,128	9.07%	2.60%
2011	80,342	1,292,353	6.22%	1.54%	10,841	207,629	5.37%	2.49%
2012	87,676	1,328,098	6.69%	1.72%	13,165	216,573	6.21%	2.41%
2013	115,893	1,728,865	7.58%	1.74%	13,208	224,362	5.99%	0.83%
		Number (N)	12	12			8	8
		Mean	16.42%	3.53%			6.58%	2.79%
		Standard Deviation	8.62%	1.97%			5.36%	1.23%
		Coefficient of Variation	**52.49%**	**55.80%**			**81.35%**	**44.27%**

Currency is presented in thousands of Kuwaiti Dinars

H.4 Qatar Islamic banks

Table H-6: the calculation of ROAE and UIAHs return for Qatar Islamic bank (A)

Qatar IBs	*Masraf Al Rayan*				*Qatar Islamic Bank*			
Year	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs Return**
2002	NA	NA	NA	NA	101,000	422,000	23.93%	4.50%
2003	NA	NA	NA	NA	145,000	542,000	30.08%	4.50%
2004	NA	NA	NA	NA	294,000	1,497,000	28.84%	4.50%
2005	NA	NA	NA	NA	511,252	2,095,786	28.46%	4.50%
2006	NA	NA	NA	NA	1,012,039	4,254,538	31.87%	5.55%
2007	1,192,451	5,158,618	23.12%	5.37%	1,255,404	4,628,962	28.26%	5.50%
2008	917,040	5,694,265	16.90%	4.45%	1,642,541	7,142,892	27.91%	5.75%
2009	880,658	5,961,754	15.11%	5.32%	1,322,106	9,005,103	16.37%	5.75%
2010	1,211,344	7,126,449	18.51%	3.75%	1,334,535	9,124,004	14.72%	2.30%
2011	1,408,350	8,503,934	18.02%	1.54%	1,365,149	11,202,419	13.43%	2.11%
2012	1,504,213	9,595,991	16.62%	1.19%	1,241,445	11,473,875	10.95%	1.70%
2013	1,702,270	10,523,348	16.92%	1.09%	1,335,400	11,859,714	11.45%	1.25%
		Number (N)	7	7			12	12
		Mean	17.89%	3.24%			22.19%	3.99%
		Standard Deviation	2.55%	1.93%			8.09%	1.68%
		Coefficient of Variation	14.25%	59.44%			36.47%	42.12%

Currency is presented in thousands of Qatari Riyals. UIAHs returns are taken directly from the annual report, as Qatari Islamic banks do publish the UIAHs returns.

H.5 UAE Islamic banks

Table H-7: the calculation of ROAE and UIAHs return for UAE Islamic bank (A)

UAE IBs	*Abu Dhabi Islamic*				*Dubai Islamic Bank*			
Year	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**
2002	NA	NA	NA	NA	159,798	1,573,986	10.15%	2.964%
2003	NA	NA	NA	NA	234,456	1,698,180	14.33%	3.136%
2004	122,910	1,505,643	8.16%	3.92%	461,033	2,986,596	19.68%	3.057%
2005	344,677	2,014,799	19.58%	6.57%	1,061,069	3,717,559	31.65%	2.847%
2006	571,014	2,768,359	23.88%	7.79%	1,560,093	8,537,150	25.46%	3.978%
2007	768,475	5,417,845	18.77%	4.77%	2,500,421	10,414,307	26.39%	5.051%
2008	851,262	5,634,108	15.40%	1.88%	1,554,327	8,749,271	16.22%	2.866%
2009	77,778	5,141,681	1.44%	1.55%	1,207,491	8,975,890	13.62%	2.314%
2010	1,023,345	8,107,577	15.45%	1.56%	553,153	9,326,079	6.04%	2.032%
2011	1,154,969	8,568,458	13.85%	1.55%	1,010,141	9,135,435	10.94%	1.070%
2012	1,199,931	12,598,107	11.34%	1.26%	1,150,072	9,588,562	12.28%	0.977%
2013	1,447,829	13,017,705	11.30%	0.87%	1,610,939	14,291,685	13.49%	0.858%
		Number (N)	10	10			12	12
		Mean	13.92%	3.17%			16.69%	2.60%
		Standard Deviation	6.34%	2.46%			7.61%	1.25%
		Coefficient of Variation	45.54%	77.51%			45.62%	48.01%

Currency is presented in thousands of UAE Dirhams. Customer deposits (including investment, saving and *Wakalah* accounts) exclude current accounts and margins. Distribution to depositors includes investment accounts and savings accounts (but excludes amounts payable to *Sukuk* holders and investment accounts by financial institutions since the amounts of the profit distribution to depositors in the balance sheet are not separately identifiable).

Table H-8: the calculation of ROAE and UIAHs return for UAE Islamic bank (B)

UAE IBs	*Emirates Islamic Bank*				*Sharjah Islamic Bank*			
Year	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**
2002	NA	NA	NA	NA	NA	NA	NA	NA
2003	NA	NA	NA	NA	NA	NA	NA	NA
2004	19,570	816,321	2.40%	0.84%	NA	NA	NA	NA
2005	50,753	859,841	6.06%	1.13%	186,068	2,107,699	8.83%	5.84%
2006	117,460	965,872	12.87%	2.44%	200,648	2,109,339	9.52%	4.64%
2007	238,533	1,332,906	20.75%	2.84%	301,839	2,226,357	13.92%	4.47%
2008	400,583	1,581,197	27.49%	4.02%	231,579	4,159,197	7.25%	3.98%
2009	130,794	2,780,498	6.00%	3.48%	260,135	4,264,311	6.18%	4.32%
2010	61,262	2,836,735	2.18%	3.29%	266,409	4,348,809	6.19%	3.63%
2011	(401,495)	2,434,702	-15.23%	2.41%	251,121	4,406,158	5.74%	2.86%
2012	81,220	2,578,748	3.24%	1.60%	272,003	4,443,898	6.15%	2.23%
2013	139,488	4,157,505	4.14%	1.17%	307,068	4,535,907	6.84%	2.17%
		Number (N)	10	10	9	9	9	9
		Mean	6.99%	2.32%			7.85%	3.79%
		Standard Deviation	11.58%	1.10%			2.62%	1.21%
		Coefficient of Variation	165.65%	47.39%			33.40%	31.88%

Currency is presented in thousands of UAE Dirhams.

H.6 Malaysia Islamic banks

Table H-9: the calculation of ROAE and UIAHs return for Malaysia Islamic bank (A)

Malaysia IBs	*Affin Islamic Bank Berhad*				*Alliance Islamic Bank Berhad*			
Year	Net Profit	Equity Return	ROAE	UIAHs	Net Profit	Equity Return	ROAE	UIAHs
2002	NA	NA	NA	NA	NA	NA	NA	NA
2003	NA	NA	NA	NA	NA	NA	NA	NA
2004	NA	NA	NA	NA	NA	NA	NA	NA
2005	NA	NA	NA	NA	NA	NA	NA	NA
2006	36,568	196,696	NA	NA	NA	NA	NA	NA
2007	39,440	235,607	18.25%	2.00%	47,784	1,041,809	4.59%	3.68%
2008	28,002	262,671	11.24%	3.41%	31,722	333,794	4.61%	4.41%
2009	32,784	398,071	9.92%	2.10%	83,770	416,468	22.33%	2.27%
2010	26,026	433,504	6.26%	2.70%	56,121	467,942	12.69%	3.14%
2011	50,020	481,498	10.93%	2.99%	72,630	547,090	14.31%	2.93%
2012	74,062	655,439	13.03%	3.66%	55,742	592,554	9.78%	3.00%
2013	59,151	705,067	8.70%	3.19%	54,705	626,062	8.98%	1.96%
		Number (N)	7	7			7	7
		Mean	11.19%	2.86%			11.04%	3.06%
		Standard Deviation	3.77%	0.63%			6.19%	0.82%
		Coefficient of Variation	33.71%	22.08%			56.04%	26.88%

Currency is presented in thousands Malaysian Ringgit.

Table H-10 the calculation of ROAE and UIAHs return for Malaysia Islamic bank (B)

Malaysia IBs	*Bank Islam Malaysia Berhad*				*Bank Muamalat Malaysia Berhad*			
Year	Net Profit	Equity Return	ROAE	UIAHs	Net Profit	Equity Return	ROAE	UIAHs
2002	34,259	1,042,416	3.29%	3.21%	9,617	349,434	2.75%	2.82%
2003	78,210	1,113,126	7.26%	0.67%	3,586	353,020	1.02%	2.60%
2004	75,262	1,163,188	6.61%	0.70%	-26,302	498,147	-6.18%	2.47%
2005	-507,807	730,181	-53.64%	2.53%	32,328	523,683	6.33%	2.31%
2006	-1,296,789	-277,840	-573.37%	2.76%	72,520	713,126	11.73%	3.08%
2007	232,460	1,014,212	63.14%	3.50%	48,138	737,331	6.64%	3.69%
2008	384,117	1,308,950	33.07%	2.80%	31,951	702,640	4.44%	3.24%
2009	160,607	1,519,553	11.36%	2.20%	82,273	1,312,782	8.16%	2.58%
2010	411,778	2,526,968	20.35%	3.37%	97,528	1,318,454	7.41%	2.45%
2011	376,333	2,800,957	14.13%	2.34%	134,014	1,361,287	10.00%	2.16%
2012	430,785	3,099,615	14.60%	2.73%	84,370	1,428,993	6.05%	2.50%
2013	491,645	3,329,374	15.29%	3.00%	167,186	1,596,372	6.05%	2.58%
		Number (N)	12	12			12	12
		Mean	-36.49%	2.48%			5.37%	2.71%
		Standard Deviation	171.10%	0.92%			4.64%	0.43%
		Coefficient of Variation	-468.85%	37.18%			86.56%	15.98%

Currency is presented in thousands Malaysian Ringgit.

Table H-11 the calculation of ROAE and UIAHs return for Malaysia Islamic bank (C)

Malaysia IBs	*Hong Leong Islamic Bank Berhad*				*MAYBANK ISLAMIC BERHAD*			
Year	Net Profit	Equity Return	ROAE	UIAHs	Net Profit	Equity Return	ROAE	UIAHs
2002	NA	NA	NA	NA	NA	NA	NA	NA
2003	NA	NA	NA	NA	NA	NA	NA	NA
2004	NA	NA	NA	NA	NA	NA	NA	NA
2005	NA	NA	NA	NA	NA	NA	NA	NA
2006	43,096	541,283	7.96%	3.38%	NA	NA	NA	NA
2007	56,811	600,135	9.95%	4.10%	NA	NA	NA	NA
2008	64,156	664,732	10.14%	3.14%	115,966	1,684,840	6.88%	1.41%
2009	74,353	740,031	10.59%	2.84%	357,419	2,558,461	16.85%	4.86%
2010	84,188	818,810	10.80%	2.13%	297,958	3,633,674	9.62%	2.02%
2011	67,478	883,246	7.93%	2.91%	388,508	4,111,483	10.03%	1.92%
2012	112,238	1,165,803	10.96%	3.54%	886,327	4,545,371	20.48%	2.82%
2013	226,655	1,352,741	18.00%	3.48%	1,049,337	6,435,555	19.11%	2.93%
		Number (N)	8	8			6	6
		Mean	10.79%	3.19%			13.83%	2.66%
		Standard Deviation	3.15%	0.59%			5.68%	1.22%
		Coefficient of Variation	29.16%	18.35%			41.10%	45.84%

Currency is presented in thousands Malaysian Ringgit.

Table H-12: the calculation of ROAE and UIAHs return for Malaysia Islamic bank (D)

Malaysia IBs	*OCBC AL-AMIN BANK BERHAD*				*PUBLIC ISLAMIC BANK BERHAD*			
Year	Net Profit	Equity Return	ROAE	UIAHs	Net Profit	Equity Return	ROAE	UIAHs
2002	NA	NA	NA	NA	NA	NA	NA	NA
2003	NA	NA	NA	NA	NA	NA	NA	NA
2004	NA	NA	NA	NA	NA	NA	NA	NA
2005	NA	NA	NA	NA	NA	NA	NA	NA
2006	NA	NA	NA	NA	NA	NA	NA	NA
2007	NA	NA	NA	NA	-286	131,453	NA	NA
2008	-1,762	196,548	-0.90%	0.42%	47,638	984,432	8.54%	0.36%
2009	17,319	210,287	8.51%	3.34%	346,640	1,505,887	27.84%	1.88%
2010	23,844	294,504	9.45%	3.68%	395,301	1,815,388	23.80%	2.55%
2011	20,028	318,731	6.53%	3.88%	456,547	2,116,926	23.22%	3.57%
2012	46,094	471,751	11.66%	4.76%	410,966	2,287,279	18.66%	1.87%
2013	107,493	595,167	20.15%	3.47%	357,040	2,591,446	14.64%	2.71%
		Number (N)	6	6			6	6
		Mean	9.23%	3.26%			19.45%	2.16%
		Standard Deviation	6.86%	1.48%			7.02%	1.08%
		Coefficient of Variation	74.32%	45.35%			36.09%	50.11%

Currency is presented in thousands Malaysian Ringgit.

Table H-13: the calculation of ROAE and UIAHs return for Malaysia Islamic bank (E)

Malaysia IBs	*RHB Islamic Bank Berhad*				*Standard Chartered Saadiq Berhad*			
Year	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**
2002	NA	NA	NA	NA	NA	NA	NA	NA
2003	NA	NA	NA	NA	NA	NA	NA	NA
2004	NA	NA	NA	NA	NA	NA	NA	NA
2005	41,484	565,154	7.34%	3.73%	NA	NA	NA	NA
2006	86,362	651,674	14.19%	3.44%	NA	NA	NA	NA
2007	118,278	739,434	17.00%	3.30%	NA	NA	NA	NA
2008	85,886	843,396	10.85%	2.95%	3,078	202,177	1.52%	1.24%
2009	63,469	895,462	7.30%	2.22%	12,843	316,492	4.95%	2.85%
2010	67,489	984,665	7.18%	2.88%	47,491	442,130	12.52%	5.07%
2011	97,854	1,332,236	8.45%	4.12%	56,437	498,571	12.00%	4.61%
2012	155,896	1,693,673	10.30%	3.79%	65,846	501,322	13.17%	4.98%
2013	166,500	2,027,132	8.95%	3.74%	48,294	549,680	9.19%	4.46%
		Number (N)	9	9			6	6
		Mean	10.17%	3.35%			8.89%	3.87%
		Standard Deviation	3.41%	0.59%			4.71%	1.52%
		Coefficient of Variation	33.52%	17.49%			53.00%	39.28%

Currency is presented in thousands Malaysian Ringgit.

Table H-14: the calculation of ROAE and UIAHs return for Malaysia Islamic bank (F)

Malaysia IBs	*CIMB Islamic Bank Berhad*				*KFH Malaysia*	
Year	**Net Profit**	**Equity Return**	**ROAE**	**UIAHs**	**ROAE**	**UIAHs**
2002	NA	NA	NA	NA	NA	NA
2003	NA	NA	NA	NA	NA	NA
2004	NA	NA	NA	NA	NA	NA
2005	-16,405	84,217	-19.48%	0.19%	0.11%	0.22%
2006	5,921	601,622	1.73%	4.24%	2.03%	0.99%
2007	64,743	672,241	10.16%	4.46%	4.72%	2.29%
2008	73,319	745,403	10.34%	3.73%	4.46%	3.08%
2009	123,742	871,058	15.31%	2.45%	-1.52%	2.46%
2010	301,122	1,338,667	27.25%	3.69%	-3.48%	2.56%
2011	335,732	1,928,550	20.55%	3.63%	-33.84%	2.97%
2012	401,070	2,343,444	18.78%	3.45%	4.07%	3.20%
2013	365,560	2,670,902	14.58%	3.13%	6.29%	2.77%
		Number (N)	9	9	9	9
		Mean	11.03%	3.22%	-1.91%	2.28%
		Standard Deviation	13.53%	1.28%	12.39%	1.01%
		Coefficient of Variation	122.67%	39.75%	-649.62%	44.38%

Currency is presented in thousands Malaysian Ringgit.

Appendix I List of banks

I.1 Name of the sample banks used in the model

I.2 GCC countries

Bahrain

1. AL Baraka Bank
2. Al Salam Bank
3. Bahrain Islamic Bank
4. Ithmaar Bank
5. Khaleeji Commercial
6. KFH Bahrain

Kuwait

7. Ahli United Bank
8. Boubyan Bank
9. Kuwait Finance House
10. Kuwait International Bank

Qatar

11. Masraf Al Rayan
12. Qatar Islamic Bank

UAE

13. Abu Dhabi Islamic Bank
14. Dubai Islamic Bank
15. Emirates Islamic Bank
16. Sharjah Islamic bank

I.3 Malaysia

Malaysia

17. Affin Islamic Bank
18. Alliance Islamic bank Berhad
19. Bank Islam Malaysia Berhad
20. Bank Muamalat Malaysia Berhad
21. CIMB Islamic Bank Berhad
22. Hong Leong Islamic Bank Berhad
23. KFH Malaysia
24. Maybank Islamic Berhad
25. OCBC Al-Amin Bank Berhad
26. Public Islamic Bank
27. RHB Islamic Bank Berhad
28. Standard Chartered Bank Malaysia Berhad

I.4 Special case study for RPSIA in Saudi Arabia

29. Albilad Bank
30. Alinma Bank
31. Aljazira Bank
32. Alrajhi Bank

I.5 Bank abbreviations

BARK	AL Baraka Islamic Bank	EMIT	Emirates Islamic Bank
SALM	AL Salam Bank	SHAJ	Sharjah Islamic Bank
BAHN	Bahrain Islamic Bank	AFFN	Affin Islamic Bank Berhad
ITHM	Ithmaar Bank	ALLN	Alliance Islamic Bank Berhad
KHAJ	Khaleeji Commercial	ISLM	Bank Islam Malaysia Berhad
KFHB	Kuwait Finance House Bahrain	MUAT	Bank Muamalat Malaysia Berhad
AHLI	Ahli United	CIMB	CIMB Islamic Bank Berhad
BOU	Boubyan	HONG	Hong Leong Islamic Bank Berhad
KFH	Kuwait Finance House	KFHM	Kuwait Finance House Malaysia
KIB	Kuwait International Bank	MAY	Maybank Islamic Berhad
MASF	Masraf Al Rayan	OCBC	OCBC Al-Amin Bank Berhad
QATR	Qatar Islamic Bank	PUBC	Public Islamic Bank Berhad
DHABI	Abu Dhabi Islamic	RHB	RHB Islamic Bank Berhad
DUBAI	Dubai Islamic Bank	STAD	Standard Chartered Saadiq Berhad

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