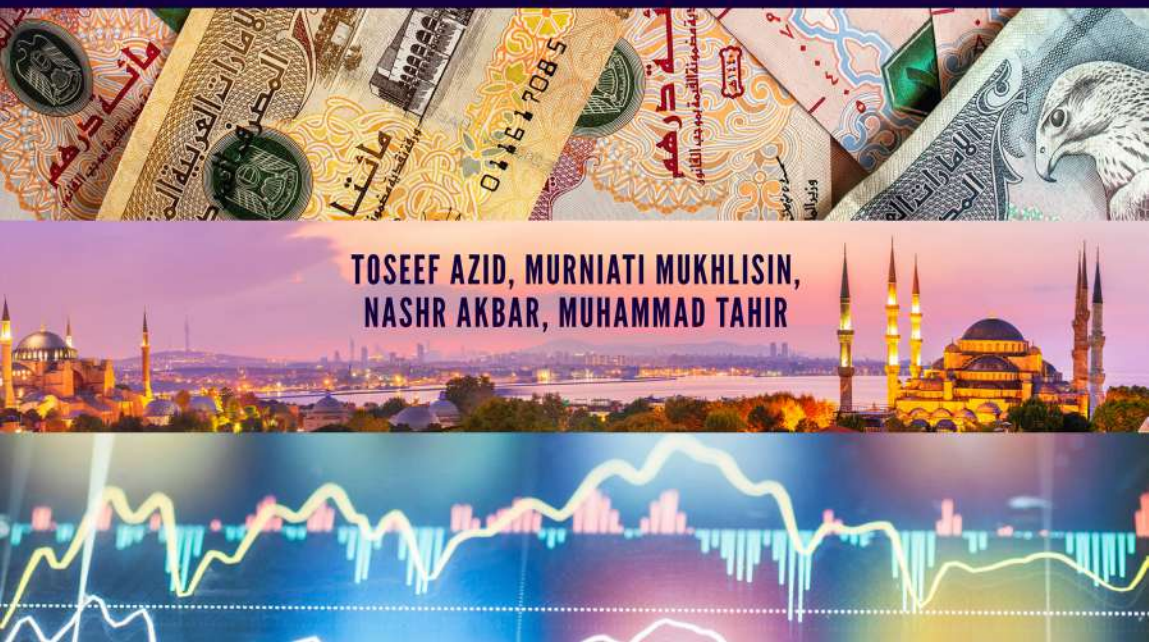
MONETARY POLICY, ISLAMIC FINANCE, AND ISLAMIC CORPORATE GOVERNANCE

An International Overview



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Monetary Policy, Islamic Finance, and Islamic Corporate Governance

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Monetary Policy, Islamic Finance, and Islamic Corporate Governance: An International Overview

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Preface

In a typical literature, one can see that monetary transmission works through the channel of interest rate, and policy analyst are observing its impact on inflation, for example, if nominal interest rate increases it leads to incremental change in the user cost of capital, therefore, leading to an overall decrease in general prices level. Because higher interest rate has a negative impact on consumption (postponement) and also on desired investment due to which prices are going down. Another important channel of monetary transmission is the exchange rate. It is observed that an increase in the domestic interest rate has positive impact on the strength of currency which ultimately leads to downward pressure on the prices of tradable goods. A stronger exchange rate has a negative impact on net exports and aggregate demand. It is also an undeniable fact that appreciating currency increases the activities of the economy. Likewise, financial market development or institutional policy frameworks, and other country characteristics have impact on the transmission of monetary policy. Generally, in developing countries, majority of the households and firms are dependent on the bank lending.

On the contrary, the management of the corporations are always keeping their eyes on the amount of leverage. In this respect, financial stability has a strong relationship with the corporate governance. There is a strong consensus among the policy makers that financial stability increases the confidence of all stakeholders in the business sector. Financial stability reflects the overall stability and consequently if provides an effective platform to all stakeholders to perform their functions efficiently. Consequently, it leads to an effective corporate governance.

However, there is no room for the interest rate in the system of Islam, therefore, its monetary policy and the way it is transmitting should be different. Consequently, the impact of Islamic monetary policy on corporate governance should be different than the conventional monetary policy. Moreover, those corporations offering the *Shari'ah* compliance products and services are also behaving in a different way. It is witnessed that during the financial crises of 2007–2008, Islamic financial institutions (IFIs) showed more resilience than their conventional counterparts.

With this standpoint, the current volume argues that monetary policy based on moral and religious values plays a different role in building the confidence of the business sector in attaining its objectives, and the necessary outcomes under the umbrella of *Shari'ah*. Therefore, a humble effort is made to integrate the three dimensions of the subject together in one volume, that is, monetary policy, corporate governance and financial sector under the umbrella of *Shari'ah*. We hope our humble effort would provide better understanding in developing a substantial research in future. In this volume, we followed two assumptions. The first is, that Islamic monetary policy approximately has the same targets but works with the different instruments, this fulfills the necessary condition. Whereas the second assumption is that moral and religious values are basic foundations of human behavior, this fulfills the sufficient condition.

Keeping these assumptions, the scholars are invited for their contributions. Therefore, as editors of this current volume, we provide a platform to our readers to start a discussion on the above mentioned three dimensions. We invited scholars to contribute their theoretical discourse, empirical investigations and relevant analysis. The contributors put a lot of efforts to discuss their arguments by following the above assumptions and provide a new path for the further research. However, the credit goes to the contributors for their discussion, analysis, and filling the gap in the current literature of monetary policy and corporate governance under the moral and religious environment with special reference to Islamic jurisprudence. In this environment, 2Rs (responsibility and resilience) are in front of the actors of policy makers and corporate governance.

The current volume has three parts, after introductory chapter, we presented theoretical underpinning in Part I, while in Part II, the association between governance and monetary policy is discussed. Finally, in Part III we shed light on corporate governance by focusing on IFIs.

Chapter 2 insinuates that CG can probably be improved by applying Islamic Moral Economy principles from Islamic economics. However, Abdullah and Asutay argued that for the achievement of this objective a strong political ground is required, that is, Islamic political economy to help with setting up laws and regulations to operationalize Islamic Economy.

Chapter 3 is based on the analytical study of the available material on features of Islamic finance and the applicable regulations, evaluates the effectiveness of the governance framework and steps taken for evolving the systems, Ayub argues, in order to align the business of the IBFIs (Islamic Banking and Financial Institutions) with the Divine objectives of *Shari'ah* and the value-based and corporate social responsibility (CSR) related functions, the governance framework must provide for the focus of financial institutions on the value based direct and indirect intermediation. In Chapter 4, Harahap discusses the implementation of Zakat through CSR partnership in overcoming poverty. In her opinion, this principle of social concern is realized through the concept of zakat. And the people living in the same jurisdiction, must be materially responsible for the poverty in their environment. Furthermore, the concept of zakat is aimed at maintaining religion, mind, soul, descent and wealth. Akbar and Amijaya, in Chapter 5, review the stock *waqf* product of Indonesian securities company. They suggested the capital gain or dividend will be distributed to the beneficiaries according to the demand of waqif (investors). In Akbar's view, there are five categories of benefits stipulated in the waqf statement form: (a) economic empowerment, (b) public welfare, (c) scholarship, (d) health services, and (e) Islamic preaching.

Choudhury, in Chapter 6, explains the complementary use of monetary and fiscal regimes although much desired for economic expansion, this phenomenon remains plagued with uncertainty, unpredictability, and subject to perturbations that adversely affect stable price and output relations. Throughout this chapter, fiscalism is equated with spending (aggregate demand stimulation) rather than with government spending only. In Chapter 7, Uddin et al. explore the suitability of interest rate as monetary policy instrument for OIC countries. In their findings, interest rates have lost its edge significantly as a monetary policy instrument after the global financial crisis in Muslim countries. They suggested that in this changing macroeconomic condition, Muslim countries need to explore the alternative policy instruments for maintaining stable economy and sustainable development. Bayuni and Srisusilawati describe the contribution of *Shari'ah* monetary instrument to control inflation in an Islamic country like Indonesia in Chapter 8. They suggested that *Shari'ah* monetary instruments applied in Muslim countries might be applied in Indonesia such as Modharabha Certificate, COM, Commercial Papers-i, and Promissory FX Contract-i. Kiaee and Mahabadi elucidate the effects of monetary policy on the stability of Islamic banks with different governance models in Chapter 9. They carry out comprehensive empirical investigations by focusing on the economy of Iran. They endorsed that for Iranian Islamic banks, institutional investors and large investors, are those corporate governance characteristics which could bring stability to the banks. Also, the cost–deposit ratio is the only bank's stability variable which is affected by both monetary and corporate governance variables. In Chapter 10, Ahmad and Siddiqua find that through using transaction cost theory, Islamic finance institutions can ensure that they do not make money against money, rather make asset against money through their transactions applying ethical values. So far, the theoretical analysis of the study is concerned, the "Ronald Coase" model has been taken into consideration.

Marie et al. examine whether culture moderates the relation between AAOIFI adoption and earnings management (EM). Using Gray and Hofstede culture framework a sample of 122 Islamic banks across 24 countries for the period 2010–2017 is utilized in Chapter 11. Their analysis shows that cultural values of individualism; masculinity and UA positively strength the AAOIFI-EM association. Abdullah and Asutay, in Chapter 12, explore the corporate governance and risk management disclosure performance nexus in Islamic banks of Malaysia. They documented that one of the most profound traits of Islamic banks is its ethical foundation, and ethicality in contemporary times is not limited to the ethical nature of businesses but also the disclosure of activities as stipulated by international agencies. In Chapter 13, Rashedul Hasan et al. highlight the importance of appointing an appropriate number of independent members on the board and strengthening the internal control system as part of the efficient governance framework for IFIs. This chapter also contributes to addressing areas of improvement required in the Malaysian Code of Governance which will be helpful for regulators, market analysts, investors and financial institutions. Tanin et al. investigate how different variables drive the profitability of Turkish banks, conventional and Islamic in Chapter 14. Their findings show that non-fund-based income (and conventional bank's non-interest income) noticeably affects profitability. However, Islamic banks appear to be more profitable, which is in line with their initial expectation. Kasri and Kamal explore the application of integrated reporting (IR) in annual reports of two Malaysian Islamic banks namely Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad in Chapter 15. Their chapter contributes to the dearth of literature on IR particularly on Malaysian IFIs as the existing literature focus more on the application of IR in conventional commercial institutions.

In Chapter 16, Rahman and Ahmad indicated that how corporate governance of IFIs can play their role in the context of a developing country. They found that the governance of IFIs in Bangladesh is an excellent blend of CG and IG. Several indicators demonstrate that the performance of IFIs is superior compared to their conventional counterparts. Given that, effective governance of IFIs can lead them toward achieving excellence in their respective businesses. Furthermore, such achievements of IFIs will ultimately contribute to society and Bangladesh's economy enormously. Musari and Fathorrazi, in Chapter 17, describe some of the practices of the Islamic social finance partnership model for micro-small-medium enterprises in Indonesia. They discuss five partnership models. Then, they explain the relationship between each stakeholder of the five partnership models by the Helix Approach. In the last chapter, editors present the summary and their suggestions for the further future research.

Foreword

This edited volume is a welcome addition to the literature on Islamic finance. It covers two important areas, hitherto not treated together, namely monetary policy and corporate governance. Monetary policy is in the realm of macroeconomics, whereas corporate governance choices are at the institutional level, and, therefore, can be classified as microeconomic. There have been considerable advances in developing models of corporate governance that adequately serve Islamic financial institutions. Unfortunately, the same cannot be said for monetary policy, where there remains confusion about how *Shari'ah* law can be applied.

From an Islamic perspective, conventional monetary policy is, at best problematic, as interest rates are the most important policy tool. Manipulation of interest by central banks and monetary authorities to stimulate or restrain economic activity all too often has unjust consequences and is socially divisive. An increase in interest rates will not only result in the costs of financing new debt rising, but may also adversely affect existing borrowers. Those with variable rate contracts linked to interest rate proxies will have to immediately pay more, irrespective of whether they can afford the increased premiums. Of course, some may argue that borrowers were foolish in signing variable rate contracts. Many have taken on these contracts, however, because they are cheaper than fixed rate agreements.

Even those with fixed rate contracts will be exposed to higher rates when they re-finance. Banks are increasingly unwilling to provide fixed rate contracts for longer than 3–5 years, despite long-term residential mortgages often not repaid until 20 or even 30 years have elapsed. At present with negative interest in many economies to avoid Covid-19 having a recessionary effect, the only direction for interest rates is up. Consequently borrowers should beware.

Given the amoral financial consequences of relying on interest rates as the main determinant of monetary policy, economists committed to Islamic finance have sought alternative instruments. The authors of three of the chapters in this volume have addressed this issue. Md. Akther Uddin, Abu Umar Faruq Ahmad, and Fatima El Morabit ask if interest rates are an appropriate monetary policy instrument for OIC countries. The simple answer is undoubtedly no, but they describe themselves as on a quest. Their efforts represent a preliminary investigation which has considerable promise. A major strength of this book is the country experiences outlined. Hasan Kiaee and Samaneh Eftekhari examine the effects of monetary policy on Islamic banking in Iran. This is of particular interest as Iran portrays itself as having a *Shari'ah* compliant financial system with all its banks designated as Islamic. However, as the researchers report, the banks have adopted different governance systems. Does this make a difference? Read the chapter and find the answer! At the macroeconomic level, the chapter by Eva Misfah Bayuni and Popon Srisusilawati on Indonesia is especially interesting. There, as in Malaysia, *Shari'ah* complaint monetary instruments have been introduced to control inflation. How do these work, and how successful have they been? Again, read the chapter and find out!

Ten of the eighteen chapters are focused on corporate governance issues in Islamic financial institutions. Hanimon Abdullah and Mehmet Asutay contribute two of these chapters, one which is categorized as theoretical and a second which focuses on the critical areas of risk management and financial disclosure. Again much of the strength of the corporate governance chapters is the country case studies covering Pakistan, Malaysia, Turkey, Bangladesh, and Indonesia. There is a wealth of material in these country studies that will be invaluable to future researchers, especially as the experiences have been so variable. Nevertheless, the advances in introducing appropriate corporate government structures for Islamic financial institutions is a story of success. It is a pity that this has been much less the case for monetary policy in spite of the efforts of some countries, notably Indonesia.

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