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Financial Contracting, Governance Structures and the Accounting Regulation of Islamic Banks: An Analysis in Terms of Agency Theory and Transaction Cost Economics

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Abstract

Because Islamic banks are prohibited from entering into transactions based on riba (interest), they mobilise funds mainly on the basis of the mudaraba (profit-sharing) form of contract. Thus, in the place of interest-bearing customer deposits, Islamic banks offer investment accounts the return on which depends on the return on the pool of assets in which the customers' funds are invested by the bank. In contrast to conventional deposits, such investment accounts therefore yield a variable periodic return which may be negative (a loss). Islamic investment accounts are thus a form of limited-duration equity investment.

This type of investment account raises a set of issues concerning the contractual relations between the bank and the holders of such investment accounts. These

issues may be addressed from the perspectives of both Agency Theory (principal-agent and principal-principal relations) and Transaction Cost Economics (contractual forms and governance structures), and it is the purpose of this paper to do so. In particular, we focus on governance issues such as the monitoring possibilities which may or may not be contractually available to investment account holders. We conclude that, under present contractual arrangements, investment account holders depend unduly upon 'vicarious' monitoring by or on behalf of shareholders, a situation aggravated by current shortcomings in financial reporting and limitations of the scope of external auditing. The latter have implications for accounting regulation as applied to Islamic banks. The paper concludes with some suggestions as to how this situation could be ameliorated.

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