1.1. The features of corporate governance

1.1.1. Definitions of corporate governance

Corporate governance in the academic literature seems to have been first used by Eells [EEL 60] to denote “the structure and functioning of the corporate polity”. The most quoted definition of corporate governance is the one given by Shleifer and Vishny [SHL 97]: “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. Corporate governance deals with the agency problem: the separation of management and finance, the fundamental question of corporate governance is how to assure financiers that they get a return on their financial investment”.

In their survey, Shleifer and Vishny [SHL 97] account for different governance models, especially those of the United States, UK, Germany and Japan. They conclude that the United States and the United Kingdom have a governance system characterized by a strong legal protection of investors and a lack of large investors, except when ownership is concentrated temporarily during the takeover process. However, in continental Europe as well as in Japan, the system is characterized by a weak legal protection of minorities and the presence of large investors.
According to Braendle and Kostyuk [BRA 07], the term “corporate governance” is susceptible to both narrow and broad definitions, related to the two perspectives of shareholder and stakeholder orientation. It therefore revolves around the debate on whether management should run the corporation solely in the interests of shareholders (shareholder perspective) or whether it should take account of other constituencies (stakeholder perspective).

Narrowly defined corporate governance concerns the relationships between corporate managers, the board of directors and shareholders, but it might as well encompass the relationship of the corporation to stakeholders and society. More broadly defined, corporate governance can encompass the combination of laws, regulations, listing rules and practices that enable the corporation to attract capital, perform efficiently, generate profit and meet both, legal obligations and general societal expectations.

Lipton and Lorsch [LIP 92] give a definition in favor of a shareholder perspective as follows: the approach of corporate governance that social, moral and political questions are proper concerns of corporate governance is fundamentally misconceived. If we expand corporate governance to encompass society, as a whole it benefits neither corporations nor society, because management is ill-equipped to deal with questions of general public interest.

Hess [HES 96] mentioned that “corporate governance is the process of control and administration of the company’s capital and human resources in the interest of the owners of a company”. In the same sense, Sternberg [STE 98] considered that “corporate governance describes ways of ensuring that corporate actions, assets and agents are directed at achieving the corporate objectives established by the corporation’s shareholders”.

The OECD\(^1\) principles of corporate governance (2004, 2015\(^2\)) tried to give a very broad definition, as it should serve as a basis for all OECD countries:

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\(^1\) The Organization for Economic Co-operation and Development (OECD) is an international economic organization of 34 countries founded in 1961 to promote policies that will improve the economic and social well-being of people around the world.

\(^2\) “The G20/OECD principles of corporate governance help policy makers evaluate and improve the legal, regulatory and institutional framework for corporate governance. They also
“Corporate governance defines a set of relationships between a company’s management, its board, its shareholders and other stakeholders”. An even broader definition is to define a governance system as “the complex set of constraints that shape the ex-post bargaining over the quasi rents generated by the firm” [ZIN 98].

This definition focuses on the division of claims and can be somewhat expanded to define corporate governance as “the complex set of constraints that determine the quasi-rents (profits) generated by the firm in the course of relationships and shape the ex-post bargaining over them”. This definition refers to both the determination of value added by firms and the allocation of it among stakeholders that have relationships with the firm. It can be referred to a set of rules and principles, as well as to institutions.

Du Plessis et al. [DU 05] define corporate governance as: “The process of controlling management and of balancing the interests of all internal stakeholders and other parties (external stakeholders, governments and local communities, etc.) who can be affected by the corporation’s conduct in order to ensure responsible behavior by corporations and to achieve the maximum level of efficiency and profitability for a corporation”. Under a definition more specific to corporate governance, the focus would be on how outside investors protect themselves against expropriation by the insiders (large investors). This would include minorities’ protection and the strength of creditor rights, as reflected in collateral and bankruptcy laws, and their enforcement. It could also include such issues as requirements on the composition and the rights of the executive directors and the ability to pursue class-action suits [CLA 12].

Although there are a myriad of definitions on corporate governance and they vary between narrow and broad perspectives, governance may be defined as a set of internal and external mechanisms working together to obtain an efficient and an optimal alignment of all parties’ interests, and provide guidance for stock exchanges, investors, corporations and others that have a role in the process of developing good corporate governance. First issued in 1999, the principles have become the international benchmark in corporate governance. They have been adopted as one of the Financial Stability Board’s Key Standards for Sound Financial Systems and endorsed by the G20. This 2015 edition takes into account developments in both the financial and corporate sectors that may influence the efficiency and relevance of corporate governance policies and practices. http://www.amazon.fr/G20-Oecd-Principles-Corporate-Governance/dp/9264236872/ref=sr_1_4?ie=UTF8&qid=1459015809&sr=1-4&keywords=governance.
getting a win–win relationship. In a subjective conception of the term *corporate governance*, “banking governance is defined as a set of internal and external mechanisms, which aims optimal harmonization between shareholders, directors and stakeholders. It is based on the safe cooperation between management and control in order to obtain a win–win relationship in which interests are aligned and goals are achieved”.

### 1.1.2. Nature of the agency problem

The problem of corporate governance is rooted in the Berle–Means [BER 32] paradigm of the separation of shareholders’ ownership and management’s control in the modern corporation. The agency problem occurs when the principal (shareholders) lacks the necessary power or information to monitor and control the agent (managers) and when the compensation of the principal and the agent is not aligned. The separation of ownership and control results in information asymmetry, thus potentially leading to two types of agency problems: (1) one agency problem is between outside investors and managers (“principal-agent” agency problem) and (2) the other one is between controlling shareholders and minority shareholders (“principal–principal” agency problem) [JEN 76]. Moreover, La Porta et al.’s [LA 99] research of corporate governance patterns in 27 countries concludes that “the principal agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by the controlling shareholders”.

Shleifer and Veshny [SHL 97] consider that contracts between financiers and manager are the source of the first agency problem because they lead to management discretion. Then, the existence of large investors, which causes expropriation of minorities, is the second source of the agency problem. Hence, to mitigate the conflict between all the parties (managers and shareholders, large and minority shareholders), the literature offers several solutions, such as monitoring by the board of directors, incentive contracts and protection of minorities.

### 1.1.3. Origins of the agency problem

#### 1.1.3.1. Contracts

The substratum of the agency problem is the separation of management and finance, or ownership and control. A manager raises funds from
investors either to put them to productive use or to cash out his holdings in the firm. The financiers need the manager’s specialized human capital to generate returns on their funds [SHL 97].

As Hart [HAR 89] observes, every business organization, including the corporation, “represents nothing more than a particular ‘standard form’ contract”. The very justification for having different types of business organizations is to permit investors, entrepreneurs and other participants in the corporate enterprise to select the organizational design they prefer from a menu of standard-form contracts.

So there is a contract signed between owners (financiers) and managers that specifies what the manager does with the funds, and how the returns are divided between him and the financiers. The problem is that the manager is motivated to raise as much funds as he can, and so tries hard to accommodate the financiers by developing a complete contract. And the manager and the financier have to allocate residual control rights not fully foreseen by the contract [GRO 86, HAR 90].

The effect of this is that managers end up with significant control rights (discretion) over how to allocate investors’ funds. To begin, they can expropriate them, which Shleifer and Vishny [SHI 97] refer to as management discretion.

A vast amount of literature explains how managers use their effective control rights to pursue projects that benefit them rather than investors. Grossman and Hart [GRO 88] describe these benefits as the private benefits of control.

Moreover, managers can expropriate shareholders by entrenching themselves and staying on the job even if they are no longer competent or qualified to run the firm [SHL 89]. As argued in [JEN 83], poor managers who resist being replaced might be the costliest manifestation of the agency problem.

1.1.3.2. Large investors

When control rights are concentrated in the hands of a small number of investors, this can lead to the expropriation of minorities. In their survey,

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3 See, for example, [BAU 59], [MAR 64], [WIL 64] and [JEN 86].
Shleifer and Vishny [SHL 97] discussed the forms of concentrating ownership, and how they address the agency problem. Hence, they subdivided large investors as follows:

– Large shareholders:

Their control rights give them the power to put pressure on the management, or in some cases to oust the management through a proxy fight or a takeover [SHL 86b].

In the United States, large share holdings, and especially majority ownership, are relatively uncommon probably because of legal restrictions on high ownership and exercise of control by banks, mutual funds, insurance companies and other institutions [ROE 94]. Even in the United States, however, ownership is not completely dispersed, and concentrated holdings by families and wealthy investors are more common than is often believed⁴.

In Germany, large commercial banks often control over a quarter of the votes in major companies through proxy voting arrangements, and also have smaller but significant cash stakes as direct shareholders or creditors⁵. In addition, one study estimates that about 80% of the large German companies have an over 25% non-bank large shareholder [GOR 98]. In smaller German companies, the principle is family control through majority ownership or pyramids, in which the owner controls 51% of a company, which in turn controls 51% of its subsidiaries and so on [FRA 94]. In France, cross-ownership and the so-called core investors are common [OEC 95].

In Britain and the United States, two of the countries where large shareholders are less common, a particular mechanism for consolidating ownership has emerged, namely the hostile takeover [JEN 83, FRA 90].

– Large creditors:

Like the large shareholders, they have large investments and want to see the returns on their investments materialize. The effectiveness of large creditors, such as the effectiveness of large shareholders, depends on the legal rights they have. In Germany and Japan, the powers of the banks

⁴ See [EIS 76, DEM 83, SHL 86b].
⁵ See [FRA 94, OEC 95].
vis-à-vis companies are very significant because banks vote on significant blocks of shares, sit on boards of directors, play a dominant role in lending and operate in a legal environment favorable to creditors. In other countries, especially where procedures for turning control over to the banks are not well established, bank governance is likely to be less effective.

### 1.1.4. Solutions

#### 1.1.4.1. Incentive contracts

The agency problem arises when contracts are incomplete and managers possess more expertise than shareholders, such that managers typically end up with the residual rights of control, giving them enormous latitude for self-interested behavior. So the better solution is the “incentive contract” to align his interests with those of investors. In this way, incentive contracts can induce the manager to act in investors’ interest without encouraging blackmail [SHL 97].

Incentive contracts can take a variety of forms, including share ownership, stock options or a threat of dismissal if income is low [JEN 76, FAM 80]. The optimal incentive contract is determined by the manager’s risk aversion, the importance of his/her decisions and his/her ability to pay for the cash flow ownership up front⁶.

#### 1.1.4.2. Monitoring by board of directors

The board of directors is presumed to carry out the monitoring function on behalf of shareholders, because the shareholders themselves would find it difficult to exercise control due to wide dispersion of ownership of common stocks. Therefore, the board’s effectiveness in its monitoring function is determined by its independence, size and composition. The bulk of the literature is empirical, which takes as given the current structure of board governance and studies its impact on firm performance [JOH 98].

However, monitoring by the board of directors is not the best option for minimizing the agency problem, because the agency problem, sometimes, can come from the directors themselves.

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⁶ See, for instance, [ROS 73, STI 75, MIR 76, HOL 79, HOL 82].
Adams [ADA 01] focuses on the conflict between the monitoring and advisory functions of the board of directors: the board’s monitoring role can restrict its ability to extract information from management that is needed for its advisory role. Thus, the model gives insight into the possible benefits of instituting a dual-board system, as in Germany.

The literature has mainly focused on issues relating to board composition, board size and the selection of directors. However, issues relating to the functioning of the board, their dependence from what and from who and how board meetings can be structured to ensure more effective monitoring of management, are equally important. This is a particularly fruitful area for future research.

1.1.4.3. Minority protection

The minority shareholder problem maintains that both the controlling shareholders [SHL 88, GAD 06] and managers [JEN 86, LAN 89, PEA 03] have the power to extract private benefits at the cost of minority shareholders. However, legal regimes, if such exist, may give minority shareholders enough power to extract cash dividends [LA 00].

Corporate and other law gives outside investors, including shareholders, certain powers to protect their investments against expropriation by insiders. For shareholders, these powers range from the right to receive the same per share dividend as the insiders, to the right to vote on important matters, including the election of directors, and to the right to sue the company for damages. The very fact that legal protection exists probably explains why becoming a minority shareholder is a viable investment strategy, as opposed to just being an outright gift of money to strangers who are under few, if any, obligations to give it back [LA 00]. The extent of legal protection of outside investors differs enormously across countries and according to La Porta et al. [LA 98] in common law countries compared to civil law countries, there is better minority protection.

Djankov et al. [DJA 08] discuss and reject two extreme approaches to resolve the principal–principal agency problem. First, they argue that the exclusive reliance on market forces will not solve the problem because, in the absence of regulations, and thus of risks, the temptation for controlling shareholders to engage in opportunistic behavior is too high. Second,
because certain related-party transactions, such as propping, may benefit a firm and all its shareholders, governments or regulators cannot legally restrict all of them. Hence, most countries adopt a middle of the road approach, enacting laws that do offer minority shareholders any rights to monitor controlling shareholders and that provide governance mechanisms that restrict private control rights. Accordingly, in countries with better legal protection, investors believe that they are more likely to receive their fair share of their investment’s profits as controlling shareholders are less likely to divert corporate resources away.

1.1.4.4. General actions

Becht et al. [BEC 02] proposed five main ways to mitigate shareholders’ collective action problems:

1) election of a board of directors representing shareholders’ interests, to which the chief executive officer (CEO) is accountable;

2) when the need arises, a takeover or proxy fight launched by a corporate raider who temporarily concentrates voting power (and/or ownership) in his/her hands to resolve a crisis, reach an important decision or remove an inefficient manager;

3) active and continuous monitoring by a large blockholder, who could be a wealthy investor or a financial intermediary, such as a bank, a holding company or a pension fund;

4) alignment of managerial interests with investors through executive compensation contracts;

5) clearly defined fiduciary duties for CEOs and the threat of class-action suits that either blocks corporate decisions that go against investors’ interests, or seek compensation for past actions that have harmed their interests.

They explained that there is potential difficulty with the first three approaches, which is the old problem of who monitors the monitor and the risk of collusion between management (the agent) and the delegated monitor (director, raider, blockholder). It might appear that corporate raiders, who concentrate ownership directly in their hands, are not susceptible to this delegated monitoring problem. This is only partially true since the raiders
themselves have to raise funds to finance the takeover. Typically, firms that
are taken over through a hostile bid end up being substantially more highly
levered. They may have resolved the shareholder collective action problem,
but at the cost of significantly increasing the expected cost of financial
distress.

1.2. Fundamental theories of corporate governance

1.2.1. Transaction cost theory

Transaction cost theory was first initiated in Coase’s [COA 37] paper and
later theoretical described and exposed by Williamson [WIL 96].
Transaction cost theory was an interdisciplinary alliance of law, economics
and organizations. This theory attempts to view the firm as an organization
comprising people with different views and objectives. The underlying
assumption of transaction theory is that firms have become so large they in
effect substitute for the market in determining the allocation of resources. In
other words, the organization and structure of a firm can determine price and
production. The unit of analysis in transaction cost theory is the transaction.
Therefore, the combination of people with transaction suggests that
transaction cost theory managers are opportunists and arrange firms’
transactions to their interests [WIL 96].

The essential element of transaction costs, that property rights must be
protected, is found in most fields of economics and throughout the
discipline’s history. Adam Smith, in discussing foreign trade, endowments,
corporate ownership structure and non-profit organizations, repeatedly
exploits concepts of costly information and the ability of individuals to
exploit others’ ignorance to their own advantage [WES 90].

In his study about “the transaction costs”, Allen [ALL 99] mentioned that
in macroeconomics the notion of costly information lead to the rational
expectations revolution and subsequent real business cycle models based on
search and the disincentives found in unemployment insurance programs.
Public choice models are founded on the premise that individuals can use the
state as a mechanism to transfer wealth to themselves. In game theory, the
prisoner’s dilemma and other non-cooperative games are essentially
transaction cost problems. And other fields like industrial organization,
international trade, development and labor, all contain ideas that hinge on the protection of property rights.

This connection between transaction costs and property rights is summarized in the Coase theorem, which is defined as:

\[
\text{In the absence of transaction costs, the allocation of resources is independent of the distribution of property rights.}
\]

There are many attacks and defenses of the Coase theorem, none of which are dealt with here\(^7\). The point is that for all property right approaches to transaction costs, the two concepts of property rights and transaction costs are fundamentally interlinked. The neoclassical literature on transaction costs begins in the early 1950s; this literature defines transaction costs more narrowly and models them more explicitly. The definition of transaction costs found in the neoclassical approaches is as follows:

“In general, transaction costs are ubiquitous in market economies and can arise from the transfer of any property right because parties to exchanges must find one another, communicate and exchange information. There may be a necessity to inspect and measure goods to be transferred, draw up contracts, consult with lawyers or other experts and transfer title. Depending upon who provides these services, transaction costs can take one of two forms, inputs or resources – including time – by a buyer and/or a seller or a margin between the buying and selling price of a commodity in a given market” [STA 95].

1.2.2. **Agency theory**

The phenomena of corporate governance are linked directly to the agency theory, or agency relationships, which focuses on the relationship and goal incongruence between managers and stockholders [JEN 86, JEN 76]. Managers are considered as shareholder agents. There are potential conflicts of interest between the management, ownerships and shareholders due to the delegation of decision-making authority from shareholders to managers. Shareholders and ownerships cannot perfectly and costlessly, monitor the

\(^7\) See [SHA 74, ALL 97, ZER 80].
managers, but they are in a position to monitor and acquire the available information possessed by managers otherwise risk information asymmetry.

Agency theory was exposited by Alchian and Demsetz [ALC 72] and further developed by Jensen and Meckling [JEN 76]. Agency theory is defined as “the relationship between the principals, such as shareholders and agents, and the company executives and managers”. In this theory, shareholders, who are the owners or principals of the company, hire agents. Principals delegate the running of business to the directors or managers, who are the shareholder’s agents [CLA 04].

Daily et al. [DAI 03] argued that two factors could influence the prominence of agency theory. First, that the theory is conceptual and simple, reducing the corporation to two participants of managers and shareholders. Second, agency theory suggests that employees or managers in organizations can be self-interested. Agency theory shareholders expect the agents to act and make decisions in the principal’s interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals. Such a problem was first highlighted by Adam Smith in the 18th Century and subsequently explored by Ross [ROS 73] and the first detailed description of agency theory was presented by Jensen and Meckling [JEN 76]. Indeed, the notion of problems arising from the separation of ownership and control in agency theory has been confirmed by Davis et al. [DAV 97].

In agency theory, the agent may succumb to self-interest, opportunistic behavior and thus fall short of congruence between the aspirations of the principal and the agent’s pursuits. Even the understanding of risk defers in its approach. Although with such setbacks, agency theory was introduced simply as a separation of ownership and control [BHI 08]. Holmstrom and Milgrom [HOL 94] argued that instead of providing fluctuating incentive payments, the agents should only focus on projects that have a high return and have a fixed wage without any incentive component. Although this will provide a fair assessment, it does not eradicate or even minimize corporate misconduct. Here, the positivist approach is used where the agents are controlled by principal-made rules, with the aim of maximizing shareholder value, hence a more individualistic view is applied [CLA 04]. Indeed,
agency theory can be employed to explore the relationship between the ownership and management structure.

Where there is a separation, however, the agency model can be applied to align the goals of the management with that of the owners. Due to the fact that in a family-run firm the management comprises family members, the agency cost would be minimal as any firm’s performance does not really affect the firm performance. The model of an employee portrayed in agency theory is more of a self-interested individual with bounded rationality where rewards and punishments seem to take priority [JEN 76]. This theory prescribes that people or employees are held accountable in their tasks and responsibilities. Employees must constitute a good governance structure rather than just providing the need of shareholders, which maybe challenging the governance structure.

![Figure 1.1. The agency model](image)

The goal of corporate governance is to engender the successful operation of organizations [KEA 93], to minimize agency problem related costs and to create harmony and synchronization between all parties. Corporate governance includes employing thorough contracts that specifically and in detail denote managements’ duties and freedom as well as the profit sharing [SHL 97].

**1.2.3. Stewardship theory**

Stewardship theory has its roots in psychology and sociology and is defined by Davis *et al.* [DAV 97]: “A steward protects and maximizes
shareholders wealth through firm performance, because by so doing, the steward’s utility functions are maximized”. In this perspective, stewards are company executives and managers working, protecting and making money for the shareholders. Unlike agency theory, stewardship theory stresses not on the perspective of individualism [DON 91], but rather on the role of top management as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained.

Agyris [AGY 73] argues that agency theory looks at an employee or people as an economic being, which suppresses an individual’s own aspirations. However, stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust [DON 91]. It stresses on the position of employees or executives to act more autonomously so that the shareholders’ returns are maximized. Indeed, this can minimize the costs aimed at monitoring and controlling behaviors.

On the other end, Daly et al. [DAL] argue that in order to protect their reputations as decision makers in organizations, executives and directors are inclined to operate the firm to maximize financial performance as well as shareholders’ profits. In this sense, it is believed that the firm’s performance can directly impact perceptions of their individual performance. Indeed, Fama [FAM 80] contends that executives and directors are also managing their careers in order to be seen as effective stewards of their organization, while Shleifer and Vishny [SHL 97] insist that managers return finance to investors to establish a good reputation so that they can re-enter the market for future finance. Stewardship model can have linking or resemblance in countries like Japan, where the Japanese worker assumes the role of stewards and takes ownership of their jobs and work diligently.

Moreover, stewardship theory suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have a greater role as stewards in the organization. It was evident that there would be better safeguarding of the interest of the shareholders. It was empirically found that the returns have improved by having both these theories combined rather than applied separately [DON 91].
1.2.4. Stakeholder theory

Stakeholder theory was embedded in the discipline of management in 1970 and gradually developed by Freeman [FRE 84] incorporating corporate accountability to a broad range of stakeholders. Wheeler et al. [WHE 03] argued that stakeholder theory derived from a combination of the sociological and organizational disciplines.

Indeed, stakeholder theory is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science. Stakeholder theory can be defined as “any group or individual who can affect or is affected by the achievement of the organization’s objectives”. Unlike agency theory in which the managers are working and serving for the stakeholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve – this includes the suppliers, employees and business partners. It has been argued that this group is more important than other owner–manager–employee relationships as in agency theory [FRE 99].

On the other end, Sundaram and Inkpen [SUN 04] contend that stakeholder theory attempts to address the group of stakeholders deserving and requiring management’s attention, while Donaldson and Preston [DON 95] claimed that all groups participate in a business to obtain benefits.
Nevertheless, Clarkson [CLA 95] suggested that the firm is a system, where there are stakeholders and the purpose of the organization is to create wealth for its stakeholders.

Freeman [FRE 84] contends that the network of relationships with many groups can affect decision-making processes as stakeholder theory is concerned with the nature of these relationships in terms of both processes and outcomes for the firm and its stakeholders. Donaldson and Preston [DON 95] argued that this theory focuses on managerial decision-making and interests of all stakeholders have intrinsic value, and no set of interests is assumed to overpower the others.

We should note immediately that in the context of Islamic banks, depositors are the main financiers of the bank and that these stakeholders have a notable and notorious influence on profitability (return on equity) and the risks of these banks (Bale II) [LEV 12].

![Figure 1.3. The stakeholder model [DON 95]](image)

1.2.5. Resource dependency theory

While stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm. Hillman et al. [HIL 00] contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their links with the external environment. Indeed,
Johnson et al. [JOH 96] concur that resource dependency theorists provide focus on the appointment of representatives of independent organizations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communications with firm executives that may otherwise be more costly for the firm to secure. It has been argued that the provision of resources enhances organizational functioning, firm’s performance and its survival.

According to Hillman et al. [HIL 00], directors bring resources to the firm, such as information, skills and access to key constituents such as suppliers, buyers, public policy makers, social groups, and legitimacy. Directors can be classified into four categories of insiders, business experts, support specialists and community influential. First, the insiders are current and former executives of the firm and they provide expertise in specific areas such as finance and law on the firm itself as well as general strategy and direction. Second, the business experts are current or former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision making and problem solving. Third, the support specialists are lawyers, bankers, insurance company representatives and public relations experts and these specialists provide support in their individual specialized field. Finally, the community influential are the political leaders, university faculty, members of clergy and leaders of social or community organizations.

1.2.6. Political theory

Political theory considers the approach of developing voting support from shareholders, rather by purchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision-making, taking into consideration cultural challenges [POU 93]. The political model highlights the allocation of corporate power; profits and privileges are determined via the governments’ favor. The political model of corporate governance can have an immense influence on governance developments. Over the past decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms’ mechanism [HAW 96].
1.3. Corporate governance and ethics

Corporate governance is not only the process of control and administration of a company’s capital and human resources in the interest of the owners of a company, but also the whole system of rights where social, moral and political questions are legitimate concerns. It deals with questions of general public interest.

Under this definition, corporate governance would include the relationship between shareholders, creditors and corporations, between financial markets, institutions and corporations and between employees and corporations. Corporate governance would also encompass the issue of corporate social responsibility, including such aspects as the dealings of the firm with respect to culture and the environment. Giving the example of the loyalty that is an important virtue, many works in empirical social psychology suggests that loyalty is hardwired into human behavior. Milgram [MIL 63, MIL 74] shows that a human subject suppresses internal ethical standards surprisingly readily if these conflict with loyalty to an authority figure. This accords well with officers and directors’ stalwart loyalty to misguided or errant CEOs, even under clear signs of impending financial doom. Milgram argues that loyal behavior stimulates feelings of well-being, and that this reflects evolutionary pressure on early human societies, when obedience to authority wrought social organization that raised survival odds [HOB 52].

Milgram [MIL 74] posits what he calls an agentic shift, whereby individuals forsake rational reasoning for loyalty. Milgram [MIL 74] states, “the most far-reaching consequence of the agentic shift is that a man feels responsibility to the authority directing him, but feels no responsibility for the content of the actions that the authority prescribes”. Directors enchanted by a powerful CEO feel a profound duty to live up to the CEO’s expectations, but none at all for how their actions affect shareholders, or other stakeholders for that matter.

Human nature changes slowly, if at all, and terms like loyalty and duty are laden with moral charge. Milgram [MIL 74] despair that “the virtues of loyalty, discipline, and self-sacrifice that we value so highly in the individual are the very properties that create destructive engines of war and bind men to malevolent systems of authority”. Corporate governance
scandals seem anticlimactic to this, but arise from the same weakness in human nature.

One hope whenever behavioral biases induce irrational or unethical behavior is that informing people about those biases can help them correct their errors and induce appropriate behavior. Gergen [GER 73] argues that sophistication as to psychological principles liberates one from their behavioral implications.

There is far more to a job than just showing up and completing your work. You need to understand very well your social environment. Employers expect you to show up every day on time, looking good, enthused and focused on the job at hand. As basic as these expectations sound, it is not easy for many people to show up consistently in this manner. The people who do, however, have an advantage which is basically their knowledge of others and their behaviors.

We have never heard of anyone criticized for being too positive or too professional, but we have heard a lot of criticism about people who are negative, unreliable and difficult to get along with. You will have an advantage in the workplace and in life if you are dependable, professional, flexible and likeable. Doing a job well is a key factor for success, but your ability to succeed encompasses much more. Do not overlook the importance of your attitude and demeanor; picking up after yourself, pitching in without being asked, and being consistent in all of your behaviors toward other people.

1.3.1. Ethics in Islamic finance

Islam as a way of life has, in some verses of the Koran [LEV 13], promoted good ethics, strong morals, unshakeable integrity and honesty of the highest order positive values and high ethical conduct should be integrated and inherent in the Muslim community. Therefore, the issue of corporate governance is not foreign to Islamic financial institutions. As organizations governed by the principles laid out in the Koran, Islamic financial institutions must strictly observe and fulfill their obligations as prescribed by the Islamic Law of Shariah [DUS 06].

Hence, Islamic finance has to put Islamic principles about the economy into practice. Attempts have been undertaken specifically to develop an
Islamic type of economy, based upon the precepts of the holy book of Muslims, the Koran, and on Islamic religious law, the principles of Shariah. The tenets of Islamic finance are the avoidance of riba (fixed and predetermined interest), gharar (uncertainty, risk and speculation), and haram (religiously prohibited) activities. Therefore, Islamic finance strictly prohibits fixed and predetermined interest-based transactions, but it embraces the sharing of profit and loss or, in other words, sharing of the risk in the real economy by the provider and the user of the funds invested. The ownership and trading of a physical good or service is a critical element in structuring Islamic financial products. Islamic finance encourages, but without obligation, active participation of financial institutions and investors in achieving the goals and objectives of an Islamic economy. It merges the ethical teachings of Islam with finance as a means to meet the needs of society and encourage socioeconomic justice.

According to McMillen [MCM 08], the Shariah which is the Islamic finance law is composed of and embodies religion, ethics, morality and behavioral admonitions as well as those that are more customarily recognized as legal requirements: it is the Whole Duty of Man’s moral and pastoral theology and ethics, high spiritual aspiration and the detailed ritualistic and formal observance which to some minds is a vehicle for such aspiration and to others a substitute for it in all aspects of law.

The prohibition of interest plays a key role in Islamic finance. But this ban is not the Koran. It was not born with Islam but dates back to the Jewish worship which passages from Deuteronomy and Exode5 mention that a Jew cannot lend with interest to a non-Jew:

“From abroad you may charge interest, but to your brother you shall lend on the point, that the Lord thy God may bless you in all that you undertake in the land where you’ll regain possession […]. If you lend money to my people that is poor by thee, thou shalt not behave with him in usurer; you put over him wear”8.

In Ancient Greece, there are also traces of a disdain for any form of remuneration of the money lent. Indeed, Aristotle (Greek philosopher who lived in the fifth Century before Christ) already evokes in its policies:

8 Deuteronomy, 23 :19, 20; Exodus, 22:25.
“It is quite normal to hate the profession of usurer that his wealth comes from his money himself and that it was not invented for it. It was made for the exchange, while the interest only multiplies. And this is where it got its name: small, in fact, are similar to their parents, and the interest is money born of money. So this is the way to gain more unnatural.”

Christianity, through the Gospels, also prohibited interest, but this time implicitly:

“If you lend to those from whom you hope to receive, what credit is that for you? Even sinners lend to sinners so that they may receive back an equal amount. But love your enemies, and do good, and lend, do not despair nobody.”

It was not until 1515 that the Catholic religion allowed interest through Concil Lateran V10. At this time, reformers such as Calvin authorized interest, without allowing wear. Calvin opposed the loan resulting in a depletion of the debtor, but was favorable to the enrichment of the latter. He defended the loan to non-usury when applied to the rich.

The following passage is taken from the Koran and is the basis of the interpretation of the prohibition of interest in Islam:

“Those who feed on usury shall rise up in the judgment that stands as one the demon violently struck. This will be so because they say the sale is like usury. But God allowed the sales and forbid usury. He who renounces the benefit of wear, from an admonition from his Lord will keep reaches him what he has earned. His case comes from God. But those returning to wear the Fire will host where they will remain immortal. (...) O you who believe! Fear God! Give up if you believe in what you have profits from wear. If you do not expect to war from God and his prophet.”

In fact, money is only potential capital and becomes capital only after its association with another tangible resource to undertake a productive activity.

9 Aristotle, Politics, Book 1, Chapter 3.
11 Sura II, verse 275 to verse 281.
1.4. Corporate governance and psychological biases

Behavioral finance is a very important field, because it has explained the behavior of managers and shareholders in their decision-making relying on psychological biases, such as the over confidence kink. A vast amount of literature shows that people tend to be overconfident. De Bondt and Thaler [DE 95] said that the most robust finding in the psychology of judgment is that people are overconfident. People tend to be too optimistic about outcomes they believe they control and to take too much credit for success while blaming other factors for failure or underperformance. Not surprisingly, people tend to believe that they exert more control over results than they actually do, discounting the role of luck and chance.

Shiller [SHI 03] mentions that “the collaboration between finance and other social sciences that has become known as behavioral finance has led to a profound deepening of our knowledge of financial markets”. Moreover, “behavioral finance is the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on markets” [SEW 05].

Shleifer and Vishny [SHL 97] argue that corporate governance problems often involve corporate insiders failing to act as agents of the firm’s shareholders and other providers of capital. This view derives from the agency problem model of Jensen and Meckling [JEN 76], in which corporate officers and directors have a duty as agents of shareholders, but act for themselves.

Adams et al. [ADA 05] argue that the CEO can manipulate agendas to frame issues most easily if he is the only insider on the board, and that boards entirely composed of independent directors actually strengthen the CEO’s power. Ocasio [OCA 94] argues that other corporate insiders on boards can emerge as alternative “leaders” if they feel they can usurp the CEO’s position.

In a recent study, Hirshleifer et al. [HIR 12] investigate how managers’ psychological biases, especially overconfidence, affect firm decisions. They note that Steve Jobs, former CEO of Apple Computers, was ranked by Business Week as one of the greatest innovators of the last 75 years in a 2004 article written before Apple’s introduction of the path-breaking iPhone and iPad, because “more than anyone else, Apple’s co-founder has brought
digital technology to the masses”. They confirm that Jobs is almost as famous for his self-confidence.

This study also found that over the 1993–2003 period, firms with overconfident CEOs have greater return volatility, invest more in innovation, obtain more patents and patent citations, and achieve greater innovative success for given research and development expenditures. However, overconfident managers achieve greater innovation only in innovative industries. Their findings suggest that overconfidence helps CEOs exploit innovative growth opportunities.

Recent empirical studies document the presence of managerial overconfidence and its effects on corporate policies. For example, Malmendier and Tate [MAL 05, MAL 08] use the tendency of CEOs to delay the exercise of their stock options to proxy for overconfidence, and show that this measure correlates with the intensity of firm investments.

Liu and Taffler [LIU 08] use formal content analysis of CEO statements to measure CEO overconfidence, and find that high ratings of this measure correlate with investment activity.

For instance, Gervais et al. [GER 11] studied overconfidence, compensation contracts and capital budgeting. They investigated the effects that overconfident managers have on corporate policies and firm value. How does overconfidence affect the investment decisions that managers make on behalf of shareholders? Do firms benefit from managerial overconfidence? Thus, they studied the interaction of managerial overconfidence and compensation in the context of a firm’s investment policy. To do so, they developed a simple capital budgeting problem in which a manager, using his information about the prospects of a risky project, must decide whether his firm should undertake the project or drop it in favor of a safer investment alternative. Their model shows that a manager’s overconfidence creates two potential sources of value for him and the firm. First, the manager’s overconfidence commits him to follow an optimal risky investment policy with a flatter compensation schedule. Second, the manager’s overconfidence commits him to exert effort to gather information that improves the success rate and value of the firm’s investment policy. They conclude that overconfident managers are also more attractive to firms than their rational
counterparts because overconfidence commits them to exert effort to learn about projects. But too much overconfidence is detrimental to the manager since it leads him to accept highly convex compensation contracts that expose him to excessive risk.

In a world where agents make decisions based on their subjective probabilities, psychological factors can play an important role in explaining investor behavior. Different experimental settings can lead to under- or overreliance on new signals; people seem to make judgments differently in different situations. A large amount of literature shows that real-world decision makers do not predict outcomes as well as mechanical decision rules based on simple linear combinations of objective input measures [BEN 15].

Overall, the structure of corporate boards creates strong pressures on directors to fall into line behind the CEO. Fama [FAM 80] and Fama and Jensen [FAM 83] argue that directors seek to build reputations as effective monitors. However, such reputations may not be the key to successful careers as directors. A reputation as a “loose cannon” or a “troublemaker” may be a bigger impediment than a reputation as a “yes man” [MAC 71, WES 06, WES 07].

De Waal [DE 05] describes apes as organized into hierarchical social structures under alpha males (e.g. chimpanzees) or alpha females (e.g. bonobos), who command the obedience of other apes in the troop.

In corporate governance, obedience in corporate boardrooms might thus reflect behavioral biases, rational information cascades or some interaction of the two. Regardless, popular attention to recent corporate governance scandals is inducing major institutional reforms aimed at altering the dynamics of board decision making. Adams et al. [ADA 05] show that powerful CEOs raise the variance in firm performance: some firms with powerful CEOs do much better than firms with constrained CEOs, others do much worse. Simply constraining the CEO thus probably confers no clear advantage. Good corporate governance requires constraints that fall into place when the CEO is making an obvious mistake, but not when he is enacting a visionary strategy. In practice, this distinction may be difficult for independent observers to draw.
As Aristotle famously noted, humans are social animals, so perhaps fund managers also trade stocks that they learn about from other managers [POO 15]. Informing people about behavioral biases can help them correct their errors and induce appropriate and rational behavior. Gergen [GER 73] argues in this vein that sophistication as to psychological principles liberates one from their behavioral implications. Corporate governance reforms and director education programs are now providing a natural experiment that holds the promise of greatly advancing our understanding of these issues [MOR 07]. To summarize, behavioral arguments, up to now restricted within finance to explaining asset-pricing anomalies\textsuperscript{12}, may shed light on issues in other branches of financial economics, such as corporate governance.

1.4.1. Transnational governance

Transnational governance suggests that territorial grounds and national autonomy or sovereignty cannot be taken for granted. It also implies, however, that governance activity is embedded in particular geopolitical structures and hence enveloped in multiple and interacting institutional webs. Kobrin [KOB 02] saw parallels between present governance structures and medieval states:

“Although medieval ‘states’ occupied geographic space, politics was not organized in terms of unambiguous geography… Borders were diffuse, representing a projection of power rather than a limit of sovereignty. In the context, power and authority could not be based on mutually exclusive geography”.

With reference to Ruggie [RUG 83], Kobrin [KOB 02] characterized such political structures as “patchwork”, meaning interdependence and entanglement. Interdependence and entanglement reflect in part regulation while driving it even further. Greater interdependence and entanglement foster the need for systematic comparisons and benchmarks and thus make it necessary to increase coordination across countries and regions. This in turn generates even more regulatory activity.

\textsuperscript{12} See [SHL 99, BAK 07].
Transnational regulation is not new but has changed and expanded, with diffusing logic moving from economic to social spheres [JOR 04]. Transnational regulation is a mode of governance in the sense that it structures, guides and controls human and social activities and interactions beyond, across and within national territories. As is shown throughout this book, however, transnational regulations are embedded in and supported by other modes of governance. As a concept, therefore, governance captures the re-ordering patterns of our contemporary world better than regulation [DJE 06].