

Agency Theory in Explaining Islamic Financial Contracts

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Abstract: In this paper, we explore the concept of agency theory in a conventional perspective, to understand the types of agency problems emerging in the contractual relationship context. However, many agency contracts that have been observed are incomplete. Completeness in the contractual agency relationship contributes to the reduction of the monitoring cost of contracting parties and there is a scarcity of literature which has fueled the effort to discuss agency relationship in Islamic financial contracts and agency problems. For such contract to succeed, the paper provides an initial baseline to understand how *Tawhid* epistemology elements can be used to facilitate and deter different goals, different levels of information, also the opportunism behavior in Islamic financial contracts.

Key words: Agency theory % Principal-agent relationship % Contract % Tawhidi epistemology

INTRODUCTION

From the very beginning, Islam stresses on the importance of relationship. It is mentioned in the Quran, a Verse in Al-Imran: 173, '*Behold, a host of gathered against you, so beware of them!-whereupon this only increased their faith, so that they answered, "God is enough for us; and how excellent a guardian is He"*'. This verse provides an understanding that any given relationship in this world, especially for Muslim people, should begin with the relationship with Allah. Relying on faith through building a concrete relationship with Allah, would also determine a good relationship with other humans and other living things in this world. Verse in Al-Imran: 112, is one of the many verses in the Holy Book that place such an emphasis on the relationship with Allah and also on the relationship among human beings. As in the Islamic economics field, the relationships with others may exist between, for example, the capital provider (*rabbul mal*) and entrepreneur (*mudarib*), among capital providers or partners, buyer and seller, agent (*wakeel*) and principal (*muwakkel*), contributor (*wakif*) and

beneficiaries (*muawikif*), pledgee (*marhun*) and assets owner (*murtahin*). This relationship, generally, creates a principal-agent relationship.

The discussion on this relationship has taken place as early as during the era of the Prophet (pbuh). Nonetheless, no one seemed to have attempted to coin it as principal-agent relationship¹. It only happens later, after the Islamic economics appears as a new field in economics [1]. Then, several researchers try to explore the Islamic economics as a field, in relation to the principal-agent relationship. For example [2] dedicate ample time to examine the link between capital structure and Islamic bank performance; [3] study the Islamic law origin and finance [4] discusses Islamic business contract and theory of firms and [5] explains the need to harmonize Islamic banking and finance that consolidates *shariah* principles in their operations. They realize that the principal-agent relationship also exists in the Islamic economic field.

However, this relationship does not expand much. It is due to the fact that it is either too much clouded by the conventional view (which normally refers to [6] or

¹ We refer financial transaction relationship between principal (owner of the firm or capital provider) and his agent (who performs the job).

too much empirical works have been tested on various disciplines in economics and finance such as corporate social disclosure [7], legal analysis [8], capital structure and firm performance [9], managerial ownership [10], franchising [11], economics and politics [12], entrepreneurial businesses [13] and corporate governance [14].

Conventionally, the agency theory was pioneered [6] but it lacks the idea of shaping the behaviour and ethical codes of the contractual parties. His contribution verifies that organizations do not operate to maximize the benefit of the principal due to factors concerning their self-interest. The relationship of principal-agent is translated through the metaphor of the contract. Traditionally, contract is written, legally binding formal agreements between two or more parties. The incomplete contract has led to the asymmetric information theory which becomes the main ingredient in contracts that create agency conflict. Later, this contract was applied very extensively in conventional financial institutions where the contract provides a binding interaction between parties involved in financial institutions to stipulate the roles and responsibilities of each party to establish the goals of the contract. Therefore, the enforcement of contract in business and banking transaction is important to indicate an evidence of the ownership of a product and also the rights of the parties involved in the transaction, particularly when there is an array of lending and borrowing activities. Two studies, which is by [15, 16] document the importance of the institution of contract and property rights to ensure proper growth of the organization. As for the financial institution, the important aspects of contract terms include law, interest rates, maturity, ownership and collateral and creditor protection.

A number of studies have shown the importance of law and ownership [17, 18] in the financial contract. For instance, [18] show that different legal and institution variables do influence the term of contract. They use the legal protection of creditors as one of the main component variables in the determination of contract environment quality. Their empirical result shows that the stronger the creditor's rights, the stronger loan availability would be offered, the longer the maturity, the more asset will serve as the collateral and the more heightened protection there will be. Therefore, good enforcement of contract in financial institutions would reduce the potential risk to creditors and this would lead to better outcomes. However, the study of the contract lacks the human aspect in the economic transactions, particularly in terms of the behavior of individuals and the development of ethics [19]. A contract is regarded as a governance

mechanism to show the contracting parties' promises and obligations. The individual parties or financial institutions have a private knowledge; personal values and behavior that should be in alliance with the ethical conduct determined in the contract. The misbehavior and unethical conduct by the agency's contracting parties are represented as factors that contribute to agency problems and also to the instability and growth of the financial industry.

Although we cannot deny that the conventional agency theory has contributed to a better understanding of the contractual relationship by emphasizing the existence of agency problems, it appears that the standard agency models lack practical relevance to different organizations and epistemology. Therefore, it cannot derive appropriate economic policy conclusions with regards to the agency problems that have emerged. Hence, the aim of this paper is to provide an overview of the agency theory which specifically looks into the form of contract that can mitigate a lot of agency problems happening today. By doing so, we intend to fill the gap of the agency issues in Islamic financial contracts. This paper would also discuss the elements of the agency in Islamic contracts, in Islamic financial institutions. Hence, we suggest an insight from the Islamic perspective that is to employ the concept of *Tawhid* epistemology in the Islamic agency (*wakalah*) relationship, namely the relationship between agent-manager (*mudarib*) and investors or borrowers in conducting the Islamic contract, where it would enhance the moral features of one's obedience to Allah in Islamic financial institutions.

This paper is structured as follows. The paper is organized in five sections additional to this introduction. Next section reviews the conventional agency theory, section two presents the conventional contract theory and section three explains the form of Islamic contract under focus. Section four attempts to highlight the divergence between the conventional agency contract and Islamic agency contract and section five concludes the discussion.

A Presentation About The Agency Theory: As highlighted by many researchers, the agency theory deals with problems such as conflicts of goals and conflicts of behaviour. The agency theory is concerned with how these problems affect the form of the contract and how they can be minimized, in particular, when contracting parties are variously informed (or when they are uncertain). It shows that the agency theory which has an important place in the economic theory depends on the

nature of the contractual relationship. Therefore, the discussion in this section will be directed towards: what is the agency theory, the identification of those problems and the form of the contract which can minimize those problems.

What is Agency Theory?: Agency theory, or known as the principal-agent relationship [6], is a theory in which a contract allows one or more persons (the principal (s) to engage another person the agent), to perform some services on their behalf which involve delegating some decision-making to the agent. The principal is the owner or managers of the organization who delegate and transfer responsibilities or capital to the agent. The agent is the managers/employees of an organization who manage the firm's business transactions for the owner/principal. Theoretically, the agency relationship is commonplace in our lives, for example, a homeowner (principal) would appoint a contractor (agent) to build a dream house according to the plan, with the cost agreed by both parties.

In an organization, it also involves a principal-agent relationship in each stage of the organization hierarchy [20]. For examples, a relationship between the board of directors (principal) and the chief executive officer (agent), the relationship between the finance manager (principal) and the finance officer (agent), who delegates job accordingly to achieve the organization's objectives. The employer (principal) has to make some efforts or execute a control mechanism to make the employee (agent) to do his or her work to achieve the organizational goal. Therefore, it entails a set of agreement between different parties in an organization.

Similar to Jensen and [6, 20] verifies that the managers (agent) may not operate according to the best interest of the owners (principal) of the firm because of the conflicting objectives between the governing parties, which would create agency problems. Thus, it is an agreement or contract between these two parties that the agent subsequently has to choose actions that lead to outcomes desired by the principals [21]. The agent should act and perform within the interest of the principal rather than satisfying the agent's own interest [22]. Therefore, the agency relationship is governed by a contract that is designed by the principal to the agent, specifying the agent's obligations and duty, also the monetary payoff to the agent being assigned.

The Agency Conflicts: Following the work [6,23], we find that two main problems can arise from the agency relationship. Firstly, it is when the principal and agent have different goals or objectives. Secondly, when it difficult for the principal to access accurate information and behavior of the agent. The agency theory assumes that the role and function of the agency relationship is asymmetric because the principal is only concerned about profit or return as the job is done by the agent. Meanwhile, the agent agrees on his own benefit in terms of the compensation rather than the interest of the principal or organization. There is a potential of lack of addresses by the agency theory in the alignment of goals, preferences and action between the principal and the agent. In the case of public-owned organizations, the separation of ownership and control would create agency conflicts between the shareholders (principal) and the interests of the managers or CEOs (agent), [24]. The shareholders (principal) are normally interested in maximizing the value of the organization through maximizing the share prices or dividends, where the managers or CEO are more interested in having high compensations and perks.

The complicated conflict of the agency in agency relationships, has brought [25] to further divide the agency conflicts into two types (i) Type I agency conflict happens between managers and shareholders where the ownership is widely dispersed and no single owner or dominant shareholders have the right to control the organization. Particularly, it is hard for shareholders to have a direct control in the management. Developed western countries like the United States and the United Kingdom are more related to this type of agency [26]. (ii) Type II agency conflict happens in concentrated ownership firms, where there is an owner or several owners with large block shares who use their authority in reducing agency problems through their high incentives to monitor management behavior [27]. Type II agency conflicts happens in European and East Asia countries where the ownership of the listed company is quite highly concentrated [26].

However, our paper emphasizes on the theoretical refinement of agency conflicts done by prior studies. Prior studies have predominantly explained that principals tend to take full control and enforcement approach in the agency contract as governance mechanism through compensation and incentives but the stress is lacking on individual behavior and development of ethics [19].

The misbehavior and unethical conduct by agency parties (either the agent or principal) can represent themselves as factors that contribute to agency conflicts. Therefore, the agency conflicts such as different goals between the agent and the principal, the conflict of agent behavior and conflict of information asymmetry still exist in this relationship. These three types of agency conflicts would further be discussed below.

Conflict of Goals: The first problem arises due to the conflict of objectives between the contracting parties, which would create agency problems. The conflicts such as below: The goal conflicts happen when the agent wants to, for example, have high income and the principal would want to maximize his profit. The principal assumes that the agent has to work to maximize the benefits of the principal. Here, each party is assumed to perform with their own self-interest in mind [28] in which the agent's preferences lie only in the optimization of rewards given to him. However, the best effort by the agent will contribute to greater income, but it only benefits the principal. Greater effort by the agent can cause greater disutility by the agent [29]. The agent might have a chance to use his or her position to increase personal wealth and job security. As a result, the agent may want to maximize his income and minimize his effort in performing in his or her work due to different working motivations in the relationships.

Another problem relating to different objectives is when the agent makes actions or decisions that can affect the principal's revenue and welfare as the agent can pursue any action which does not coincide with the principal's objectives [30]. In this case, the principal has no idea on what the agent has done due to his lack of knowledge, lack of communication between parties, which contribute to the conflict of behavior and conflict of information asymmetry. Therefore the divergence of goals in agency relationships, exists when the principal is not sure whether or not the agent is acting in his best interest.

This situation can lead to the agent's misbehavior that only works to benefit him or her, without any intention to benefit the principal or the organization. The misbehavior can leave a significant impact to moral hazard that again, contributes risk and cost to the principal; this would be discussed further in the next point.

Conflict of Behavior: The agency theory is said to be too narrow a contract because this theory emphasizes the contract between a principal and agent and the contract

tends to weigh more on the principal [23,31]. It is also one-way by nature, where only the behavior of the agent is analyzed and not of the principal as well [32]. Consequently, it is also possible for the principal to closely monitor the agent's behavior and effort. Thus, the conflict of behavior arises when the principal cannot perfectly monitor the agent's action, effort and behavior [23]. The opportunistic situations by the agent such as the chance of earning more than stated in the contract, doing actions that do not comply with the contract and being negligent, create moral problems to the principal which would create related risk of loss in the capital invested.

Conflict of Information Asymmetry: Problems also occur in principal-agent relationships when the principal does not have access to all available information at the time a decision is made by the agent. The existence of information asymmetry conflicts, normally occurs because the agent has better information, effort and work than the principal [23, 33]. In this situation, the principal does not know whether the agent's actions are in the best interest of the principal [23, 34]. The agents might take different actions when they are being monitored by the principal. [35]. Related to this, the principal may find some difficulties to address the information asymmetry problem when it is hard to address and it is costly to observe, monitor and measure the behavior of the agent [36, 37] Refers to this situation as a moral hazard where there is an opportunity for the agent to act against the interests of the owners of the firm, which is labelled as shirking, or hidden actions [38]. For example, they can act responsible and in align with the contract of employment to grab a chance of having pre-requisite consumption.

Standard Agency Model: The above conflicts lead to the construction of several standard agency models. We are now going to discuss each one of them.

The Moral Hazard with Incentives: The self interest, negative effect, fraud, opportunistic and shirking behavior of an agent is called moral hazard. In the case of an agent who performs negligence in decisions that impose negative consequences and he or she do not want to be responsible for the action made, this can be labeled as moral hazard. An agent does not perform his action and task properly or according to the agency contract, because his goal does not converge with the principal's, particularly when his actions are flawed, as monitored and

controlled by the principal [23, 39]. This is the ex-post result of the self interest and opportunistic behavior by the agent; occurring when contract has been signed. In this situation, the principal may not have full information whether or not the agent has attended to every part of the contract, or whether or not the agent is fully satisfied with the compensation.

Therefore, in the moral hazard with incentives model, a principal can establish a monitoring system and behaviour-based contract². A system for monitoring includes hourly work schedule, observation by the supervisors and complaint records. The behaviour-contract is designed to evaluate the agent's behaviour and reward is given according to his actual behaviour. [23] states that the behaviour-based contract is represented as a salary-based compensation contract, where the behaviour of the agents engaged in programmed jobs is easier to observe and evaluate. For example, a cashier in a retail store will be paid by hourly wages through the behaviour-based contract.

On the other hand, the outcome-based contract specifies a clear performance standard or outcomes that clarify the principal expectations from the agent's actions in the contract³. Studies applied to a retail salesperson have been done by [23], where it is concluded that the outcome-based contract or represented as commission-based compensation is suitable when monitoring the agent's behavior is difficult and expensive. So, the reward is only delivered to the agent when his outcomes meet the performance standard. This type of contract can be more effective to motivate agents to pursue actions which are consistent with the principal's objectives when appropriate incentives are included [38, 40]. The incentives can be in the form of financial incentives and non financial incentives, for example: holiday trips. The contract is designed in such a way that the agent's actions serve to act in the principal's interest and benefit and with the most appropriate cost incurred by the principal. Therefore, this model ties the compensation to observe agent's performance and motivate them to behave properly in favour of the principal's benefits.

Adverse Selection with Signaling and Screening: As explained in section 1.2(c), the adverse selection problems in the agency relationship exist when the principal cannot observe the agent's characteristics due

to the occurrence of information asymmetric before entering the contract. The principal has very limited information of the agent and he or she does not know whether or not the agent has potential characteristics to perform at the principal's expense. In the adverse selection model, researcher identifies two possible solutions to overcome the problems, which include examining the agent's signals and screening the agent's information⁴

In this model, it is not the informed party (agent) that moves first, but the uninformed party (principal) makes the first step. An example of the adverse selection with signals is when the agent states that he has enrolled into a weekend degree program; this signals that he has the requirement that the principal is looking for. In fact, the action of the agent (enrolling in the weekend degree program), is a signal to the principal that the agent has a motivation. The given signal allows the principal to evaluate and distinguish the characteristics of the agent from other groups of agent. Another solution is screening, where the principal makes a strategy to obtain all information about the agent to determine accurate characteristics of the agent. For example, the observation on the agent's characteristics can be done through interviews, personal contact and referees, aptitude test and IQ test. It may be costly to the principal but better information can be retrieved, hence reducing the problem of hidden information. [33,41,42] also recognize screening and selecting the right party control as the most important control methods to mediate the agency problem.

The Form of Contract: As we have previously discussed in Section 1.2, the agency theory is not without criticism. So far, we have discussed how principal-agent studies, as a branch of agency theory, deal with agency problems by proposing standard agency models that integrate informational aspects of these problems with a contract. However, the agency theory and in particular, its branch, the theory of contract, do not deal exclusively with the form of contracts that would help minimize the costs associated with agency problems. However, it does demonstrate the existence of various mechanisms that "back up" the contract to counteract agency problems.

Several researchers argue that the features of the contract are not enough to monitor and screen the contracting parties and suggest other governance mechanisms that can be added into the contract. For

² Behaviour-based contract and outcome-based contracts was originally and extensively discussed by Eisenhardt (1989).

³ Previous works related to outcome-based contract includes Ross (1973), Eisenhardt (1989), Grossman and Hart (1983).

⁴ See Kreps (1990), chapter 17.

example, [43] proposes a contract that provides a binding interaction between parties involved in any transaction to stipulate: the roles and responsibilities of each party to establish the goals of the contract as governance mechanism. A contract is designed for the agent so that they know the set of obligations and duties to perform, job procedures, policy and expectations. However, the features regarding the authority and responsibility of the agent vary according to the kind of agency to which they commit. In the case of the organization, an agency relationship is involved in each stage of the organizational hierarchy [20]. For example, a relationship between the board of directors (principal) and the chief executive officer (agent), the relationship between the finance manager (principal) and the finance officer (agent), those who delegate tasks accordingly to achieve the organization's objectives.

To understand who the agent and the principal are, we must define the structure of the agency relationship. A point made earlier states that agency relationship arises when the agent enters into a contract to act on behalf of his principal. In the context of the relationship of employment in a firm, the agency relationship exists when the organization's superior (principal) appoints a board of directors or managers (agent) to act on behalf of the organization. This kind of relationship normally arises from the consent of both parties and [44] this is explicit through the creation of the contract. The agency theory involves employment which concerns with whether a corporation (principal) uses straight salary, stock options or others to compensate what the manager (agent) has undertaken to do. Normally, the salary, responsibility, rules and authority of the agent are defined in the contract.

The types of agent verified by [44] can be divided into general and special agent. Both agents are very much related to the organization. General agent acts for the principal in the ordinary course of the agent's business, profession, or to act for his principal in all matters of a particular trade or business. For example, a director of a limited company is a general agent of the company. Law regards the director of the corporation as the agent rather than the shareholder (s), who in turn, regard an employee subject to the rights and duties under the contract of employment and relevant statutes. Referring to [45, 6] they have stated that the principal in the agency relationships is the shareholders. However, according to [46], they argue that the principal is not the shareholder (s) but rather the corporation. They also contend that the

board of directors is not the agent of the corporation but the autonomous fiduciary who acts to benefit the beneficiary.

On the other hand, a special agent has the authority only for a particular purpose that is not part of the ordinary course of business, or to represent his principal in some particular transactions, not being in the ordinary course of his trade, profession or business as an agent. The degree of importance that differentiates between these two classes of agent, may not vary greatly because it depends upon the express or implied terms of the agreement that the agent has made with the principal, with regards to the kind of job in which the agent normally, in the ordinary course of his business or profession, is responsible.

Thus, an agency contract is designed according to the types of agency relationship that the parties are involved in. However, in real situations the explicit contracts tend to be incomplete, even though it is mutually agreed by the contracting parties and hazard problems remain [47,48]. In short, the principal-agent relationship is a 'self-enforcing' contract whereby economically, a rational agent will perform in the best interests of the principal. Nevertheless, in real practices it is hard to find an agent that performs exactly for the best interest of the principal. Hence, it is critical for the contractual agency parties to understand the contract and fulfill their obligations.

The Theory of Contract in Islam with Respect to Agency

Theory: The formation of the contract is essential in transactions so that it has legal significance. Moreover, the contract is created to ensure the existence of a guideline to parties involved, the condition, transaction and all standing points involved, either in conventional or Islamic financial contracts. Therefore, formal contracts in written and legally binding agreement are essential between two or more parties. They provide an important instrument that represents the premises, responsibility and obligations that each party has to fulfill. However, this nature of the contractual relationship creates asymmetric information, where some of the parties may hide their private information regarding future terms or transactions of the relationship. Therefore, in real situations, the explicit contracts may tend to be incomplete, even though it is mutually agreed by the contracting parties and in effect, hazard problems remain [47]. In contrast, the theory of contract in Islam provides full fundamental procedures in a contractual transaction between parties; and this will be explained below.

Epistemological Aspects of Islamic Contract: In the Islamic perspective, the source of Islamic law of contract is stated in the Quranic verse Al-Maidah 5:1, 'O you believe, fulfill all obligations'. A contract ('aqd) in Islamic law is a promise or consent between parties to fulfill their obligations as mentioned in the above verse. To form a lawful Islamic contract, two elements must exist, namely (a) voluntary consent from competent contracting parties and (b) the consent is for a lawful object or aim. In the Quran, through the verse of An Nisa: 30, it is dictated: 'O ye who believe, squander not your wealth among yourselves in vanity, except it be a trade my mutual consent'. The first part of the verse forbids any agreement based on vanity (batil), whereas the second part enjoins that every agreement should be based on mutual consent. Thus, Aqd is in a form which binds two intentions expressed through words or otherwise and produces obligations of the two parties. Contract Act 1972 in English law, defines contract as: 'when one person signifies to another his willingness to do or to abstain from doing anything, with a view to obtaining the assent of that other person to such an act or abstinence, he is said to make a proposal'. The definition conforms that a contract is an instrument or mechanism used, to make a transaction between parties become lawful. Therefore, every condition, obligation, or objective of the transaction is subject to the responsibility of the parties involved in the contract.

The Islamic term of contract 'aqd' seems equivalent to the term 'contract' among western jurists, which consists of two essential elements of agreement and consideration⁵. However, the Islamic concept of 'aqd' would require an intention of performing obligation and transfer of ownership to the other person. It is normally used in the Muamalat transactions to transfer ownership or belonging of one person to another.

The Islamic Agency Contract: This section provides explanation on the condition of an agency, the subject-matter of an agency and the rights of an agent on the principal.

Legal texts permitted for the agency contract during the reign of the Prophet Muhammad are as below:

- C In a Hadith narrated by Uqbah ibn Amir: Prophet Muhammad (S.A.W.) gave me some sheep to distribute among my companions in order to sacrifice

them and a male kid was left after distribution. I informed Prophet (S.A.W.) about it and the Prophet (S.A.W.) said 'sacrifice it on my behalf'⁶.

- C Urwah al-Bariqi narrated that the Prophet gave him a dinar to buy a sacrifice sheep. He bought two sheep by it and sold one of them for one dinar on the way. He said: When I brought a dinar and a sheep to the Prophet he said to me 'May Allah bless the bargain of your right hand'⁷

Both hadiths prove that a person can assign his business to an agent, for the latter to perform and act on his behalf. However, the agency contract is subject to regulations where the essential elements of the agency contract are the same as the general Islamic contract, except the nature and scope of the authority are subject to certain conditions. As a principal (*muwakeel*), he is obligated to give his full authority to an appointed agent. An insane and minor principal cannot be part of any agency contract. However, a minor person can appoint an agent for the performance that can benefit the minor but not so for transactions that entail loss for the minor.

On the other hand, an agent can perform his actions but he is restricted to the general rule laid down by the principal. Hanafi, Hambali and Shafi'i Sectarrians further explained that an agent does not have an authority to dispose the principal's asset (subject matter) and a minor is not eligible to act as an agent for others⁸. The position for the agency contract's subject matter is the act for the performance of which the agent is appointed. The agent should be informed about the limitations of his performance. In the case of disposition, it must be lawful and permissible by the principal and it is also required that the action is witnessed. The agent duties include: (a) exercising care and skills, (b) not permitting the appointment of another person to do his job, (c) not allowing the buying of property for himself, which he is able to be engaged in without fully disclosing the facts and (d) not misusing confidential information for his own benefit [49].

Agency Relationship and Islamic Financial Contract:

In this section, we will discuss the main elements contributing to the Islamic financial contract in general and how it could create a relationship that will be used to establish Islamic financial institutions.

⁵ Coulson N. J. Commercial Law in the Gulf States, The Islamic Legal Tradition, Graham & Tronman, London, 1984, p.18

⁶ Sahih Bukhari, Book 47, No. 17

⁷ Kitab Al-Buyu, Sunan Abu Dawud, retrieved from: www.ahadith.co.uk

⁸ Zuhayli, al-Fiqh al-Islami wa Adillahtu, vol. 4 in Islamic Law of Contracts and Business Transaction by Mansuri, M. T. (2006).

Elements in Contract: The majority of the Islamic Jurists of Maliki, Syafi'i and Hambali agree that there are three basic elements of a contract, which are quite similar to English common law, namely: *Offer and acceptance*: a contract must consist of an offer (*ijab*) and acceptance (*qabul*). An offer (*ijab*) is a proposal by the first party to make a transaction with the other party/second party, where an acceptance is the statement or acknowledgment made by the second party to reply and accept the offer. The parties of the contract must be capable to perform tasks and they must be reasonable persons to make the decisions or pass judgements.

Secondly, as for the subject matter, a contract must consist of the subject matter; namely, the object of the contract, things, performance, commodity and consideration (money, goods or services), which should be lawful. The subject matter of the value, quantity, quality, types, etc must be determined at the time of the contract. In fact, it must be owned by the contracting party of the contract (seller) and must be able to be delivered to the buyer. The object must be in existence at the time of the contract.

Thirdly, the Contracting Capacity of Contracting Parties: The parties entering into a contract must be legally qualified and competent. The word 'capacity' here means the capacity of a human to express words/communication and performance/task. A minor, a persons without a sound mind, persons falling into insolvency, persons suffering from an illness which leads to death cannot enter into the binding contract.

The above mentioned elements of contracts constitute the basic observation about the Islamic contract law in general. The Islamic law requires the fulfillment of these elements to decide that the contract is valid and permissible under *Shariah*. The importance of these elements further illustrates the classification of the contract based on the nature of the contract. Conceptually, the nature of the contract is classified into three categories [50] namely: (i) Unilateral contract: Unilateral binding contract is between one person who makes an offer and another person (an identified person), who accepted the offer; hence both parties are equally bound to promises. Unilateral contract is normally attached to favour the recipient as a gift (*hibah*), rebate of debt (*ibra*), will (*wasiyat*) and *qardh hassan* loan; (ii) Bilateral contract: Bilateral contract is a contract that acquires one party to offer to the party if the latter wishes to accept the intention and subject matter of the contract. It is recognized as a legal relationship to promote the mutual consent of both parties, as well as to perform each

right and obligation; (iii) Quasi contract: A quasi contract is a contract that does not originate from a proper verbal agreement as in the law of contract, but the obligation is enforceable using the *Shariah* principle. For example, an action to recover the money paid by mistakes to the other party which one does not owe will require the wrongful recipient of the money to restore it [51].

According to the explanation above, it can be concluded that a contract must have a lawful aim and voluntary consent from the contracting parties. Both parties in the contract must recognize their consent and fulfill the obligations. It is stated directly in the Quran regarding the observation of these important requirements. In Quran, An Nisa' verse 30, 'O ye who believe, squander not your wealth among yourselves in vanity, except it be a trade my mutual consent'.

Contracts and Islamic Financial Institution: The discussions in section 3.1 lead us to think about several relationships that might be created in establishing the Islamic financial institution.

With the existence of the Islamic Financial Institutions which act as financial intermediaries, the movements of deposits and applications of fund are through contracts and they are permissible by *Shariah*. As depositors save money in Islamic financial institutions for investing purposes, Islamic financial institutions make transaction on behalf of the depositors. Therefore, Islamic financial institution staff is required to have, legal capacity and authority to make transactions and decisions on behalf of the depositors. The authority given from the depositors is called agency. The agency contract in Islam is known as *wakalah*, where an agent has taken the place of the principal to perform on behalf of that principal, an act, which admits representation [49]. Zuhayli in his book *Al-Fiqh Al'Islami wa Adillatuh* (Islamic Transaction in Islamic Jurisprudence) defines agency from the views of Imam Hanafi and Imam Shafi'i. According to Hanafi's point of view, *wakalah* (agency) means the one person (principal) who delegates to another person (agent) to take over his place in a known and legally permissible position. Likewise, Shafi'i defines *wakalah* as 'delegation of one living person to another of the performance of an act that permit delegation and that the first person is permitted to perform himself'. Most importantly, these definitions provide us with available evidence that permissible agency contract includes dealing in legal Islamic financial transactions that creates a relationship between two or more persons, one who is supposed to perform the act is called the principal (*asil*) and another

who should act on behalf of the principal is called agent (*wakeel*), where the authority to use another person's asset or property is stated in the collaborations.

Islamic financial institutions play an important role in providing and offering a variety of deposits and financing products with different financial contracts with unique characteristics of *Shariah* compliance. Financing products can both be equity-based and debt-based. Equity-based financing products consist of *mudarabah* (trustee partnership), *musharakah* (joint-venture), *musharahah* (declining joint-venture) and etc. Meanwhile, debt-based financing comprises of *murabahah* (cost-plus sales), *ijara* (leasing), *bai-bithaman-ajil* (deferred payment), *salam* (delivery sale) and others. All these contracts offer *Shariah*-compliant products with varying level of acceptance on the risks, liquidity, maturity and stability. However, the building blocks of Islamic products are based on the partnership between depositors, investors and borrowers. Therefore, Islamic Financial Institutions are positioning themselves as a '*wakeel*' (agent) to perform a financial transaction on behalf of the depositors, investors and borrowers.

Hence, Islamic financial institutions' economic activities are based on a set of contracts that have in-built mechanism and element mentioned above to promote the fairness and justice to the contracting parties. The main rules and principles that cut across the law of all contracts in Islamic are usury (*riba*'), uncertain risk (*gharar*) and gambling. Islamic law is not only expressed as a general theory, but also from various rules and principles in specific contracts such as the law of lease, sales, pledge and etc. A contract that is applied to Islamic transactions is called '*muamalat*' in *Shariah*.

Agency Problem in Islamic Financial Contracts:

Like conventional financial institutions, Islamic financial institutions are also involved with conflicts of goal, behaviour and information asymmetry even though the contract is in terms of joint venture and equity participation. In Islamic financial institution transactions, the misbehaviour can occur due to the irresponsible decisions of the agent (bankers) upon using the account holder's money. The agent or the bank management staff does not perform their fiduciary duty in accordance to the *syariah* principles stated in the contract. The monitoring cost and monitoring problems remain unsolved in the banking industry. On the profit and loss sharing financing, the borrower may not provide full information regarding the proposed projects and profit and thus, the bank cannot directly access the information. The banker

is not invited to join the meeting of the borrower's company and this prevents the banker from understanding and being exposed to all information regarding the proposed project. As a *mudarabah* financing contract to entrepreneurs, it is recommended for the financiers, especially the Islamic banks to offer a capital plus, obtaining some ownership risks in the venture business without placing collateral [3]. This form of collaboration and cooperation would offer sound financial development and robust information asymmetry issues and disclosure requirement during the transaction.

Information asymmetry issues would lead to *ex ante* problems, for example adverse selection problems when an investment or loan is made to high investment risk or poor credit risk. It also raises another issue, when borrower hides the information regarding the proposed project to the Islamic financial institution. Another problem lays in the *ex-post* problems, for example the moral hazard problem when the agents/bankers misuse the depositors' money or when a loan is not used appropriately. This is consistent with earlier explanation on the misbehaviour of the agent during the Islamic financial institution contract transactions. On the other hand, moral hazard exists in all situations, where an individual seeks to maximize his utility function to take advantage of other individuals on which it is dependent [52]. Hence, full information by borrowers and monitoring of the agent's action can be seen as a resolution to adverse selection and moral hazard problems. However, the controlling cost of the agent is high and it is difficult for the principal to measure the agent's action perfectly because the agent action is not tied to its result or performance.

Further Discourse on *Tawhid* as Guiding Principles in the Agency Theory:

Prior research that locates the important contribution of agency conflicts include [20,6,45]. The agency conflicts could be reduced or eliminated if the agency's contracting parties agree to bind the contract, where the enforcement of the agent's action should also be in the best interest of the principal. In general, the contract between agency parties will always be incomplete and it is hardly difficult to specify the agent's goals and a personal incentive due to the fact that the morality of the agent is often discreet [53].

The agency contract should serve as a safeguard to contractual parties from opportunistic behaviour by the agent. However, in fulfilling the agency contract or terms and conditions, such as compensation, incentives or perks, the moral hazard, opportunistic or exploitation from available information about the agent may be exploited by

the principal. This opportunistic behaviour causes the principal to consider various forms of governance, including monitoring, measuring compensation according to performance and re-examining the board of directors' structures but until now the agency problems in the financial contract are still unresolved due to low moral integrity and ethics values among the contractual parties. However, not many studies have looked into the role of religion in Islamic finance, except [17] which only traces back the law origin, in terms of the efficiency of finance. It shows that the religious principle has little influence on the principal-agent relationship.

Recent view by [48] suggests three ways that the principal can use to control agency conflicts: (i) board independence to force and improve the director monitoring of managers, (ii) monitor the market for corporate control, which refers to the merger and acquisition market that improves on the mischievous managers and (iii) equity ownership to agent, that offers managers to share the ownership of the organization. The latter approach is consistent with [45,6], where managers that have an ownership in organization are likely to embrace the interest of other shareholders rather than succumbing to their personal interest. This would also serve as motivation to the managers to put his effort, actions and outcomes that benefit the shareholders and at the same time benefit themselves. However, a mixed result has been reported in studies that examine the relationship between the ownership structure and director's remuneration. [54] have embarked on a study which results establish a negative relationship between executive directors and director's stockholdings in firms controlled by a single individual or family. By contrast, [55], finds out that there is no relationship between the managerial ownership and director's remuneration. A positive relationship is found between managerial ownership and manager's remuneration for equity up to 35 percent in small and family-controlled firms and up 10 percent in large firms. Most of their findings are consistent with [48] which attempt of using CEO compensation as a monitoring solution mechanism to reduce agency problems, remains unsettled. We can say that the main issues of the agency contract relates to the behaviour of agents and tradeoffs between the compensation and incentive mechanism, where there is still a lot to be done to improve the operational system of the agency contract. Thus, this paper seeks to view an Islamic paradigm in the agency relationship which can certainly resolve agency problems as compared to the

conventional agency theory by including *Tawhidi* epistemology as an element in the form of agency contract, particularly with regards to the Islamic financial institution contract.

The nature of the contract in the conventional theory shows that it does not have any aspect of human behaviour with God or faith. For example, the subject matter, the transaction has no relation with religious beliefs and practices. Meanwhile, the Islamic contracts provide a fruitful view on the validity aspect of the contract beginning with normative human behaviour and then its relation to God and faith. In other words, as far as the contract in Islam is concerned, Allah is the witness of all contracts. The subject matter and transaction in the contract must be religiously lawful, indicating that it has to be consistent with the divine law stated in the Quran and Hadith.

Since our lives must be guided by *tawhid*, hence, our suggestion is to use *tawhid* epistemology as the guiding principle in the agency theory. The principles basis of the agency theory in Islam will be discussed below.

Unity: The agency problems can also be reduced through the concept of *Unity*. *Unity* means cooperation and participation in the organization which does not exist in the conventional agency theory. According to [56]; human relationship can be strengthened if you view all people as created by God (Allah). This is a unique feature of Islamic teachings where people are treated fairly without any discrimination against their skin colours, races, religions, gender and age. Our social life or business activities cannot be done without instilling the concept of unity; together with the inherent elements of cooperation and participation. Thus, the players in the Islamic-oriented agency relationship have to obey Islamic principles, rules, laws, regulations that guide them as to utilize the capital the best way possible and as economic agent that serve in respect of the notion of the Oneness of Allah.

Khalifah: Another concept that is directly related to *Tawhid* is the concept of *Khilafah* (vicegerent/stewardship). Quran explicitly states that:

C “Believe in Allah and His messenger and spend freely from what He has bequeathed to you. For those of you who believe and spend freely will have a great wage” (Al-Hadid: 7)

Muslim individuals believe that their existence in the universe is to be a vicegerent to Allah. According to [57], Allah knows every action that Man does as a vicegerent at any time. In the Islamic agency contract, an agent (*wakil*) assumes the role as a trustee not only to the principal (*muwakkel*) but also to the Creator and Controller of the earth; Allah. Along with the concept of *khalifah* is the notion of *ownership in Islam*, where the ultimate owner is Allah, whilst we as humans are an economic agent/*khalifah* permitted to exercise our rights to use economic resources or property with responsibility and not jeopardizing others.

Ihsan: Another concept that is consistent with the concept of *Khilafah* is the concept of *Ihsan*. Quran dictates:

﴿ *Such is the bounty of God – and none has the knowledge which God has. (An-Nisa’: 70)*

The Prophet has this to say, regarding the concept of *Ihsan*:

﴿ *“It is that you worship Allah as if you are seeing Him. For though you see Him not, verily He is seeing you”.*⁹

The cornerstone of this *Hadith* is the requirement to feel the presence of Allah in anything that you do. These two concepts reflect well the agency theory relationship. As information asymmetry becomes one agency problem, where the principal (*muwakkel*) does not have the ability to access the entire agent’s (*wakil*) information, no such information asymmetry is assumed when both parties are engaged in a relationship with Allah. An agent (*wakil*), knows that they have an obligation to provide for the best interest of the principals (*muwakkel*). As both parties believe that Allah has the perfect knowledge and each of their actions will be accountable in the hereafter. Therefore, each of their actions and decisions has to realign with the clearly codified agency contract. They also feel the spiritual bonding with Allah and truly understand the punishment by Allah if they do not perform accordingly. The corporation that practices this concept is believed to have no monitoring cost; hence, the agency cost, in relation to monitoring and controlling is reduced to zero. These two concepts provide a distinctive character and value as compared to the conventional agency theory.

Commit to Fulfill Promise: *Itqan, Ikhlas, Amanah, Taklif:* Parallel with these principles, Islam provides a universal and comprehensive value. This value provides a strong thrust of the contracting parties to commit their promise in the agency contract. Some of this Islamic universal values applicable to the Islamic agency theory are known as *Itqan* (conscientiousness and knowledgeable) and *Ikhlas* (sincerity) and *Amanah* (truthfulness) [58]. These are the most acquired values needed in the Islamic agency contract in order to reduce, or perhaps to eliminate moral hazard problems in the agency relationship. The concept of *Itqan* means that the principal (*muwakkel*) and agent (*wakil*) should be committed, dedicated to perform the task. In order for them to achieve success in the task, they must have been certain to acquire knowledge and skills in their undertakings. Seeking for knowledge and skills is as important to all *Muslims* as recorded in a *Hadith*:

﴿ *“Seeking knowledge is the duty of every Muslim”*¹⁰

A part of that, the concept of *Ikhlas* (sincerity) means the parties in the Islamic agency relationship should be sincere in undertaking the task. The task assigned refers to the ability of the parties to contribute success to the corporation. Sincerity of both parties can forbid negative attitude such as arrogance and selfish.

The value of *amanah* (truthfulness) acquires the agent (*wakil*) to be honest in his/her action, intention, speech, information and solving problems. Trustworthiness is a value than can be exemplified from The Prophet Muhammad which displays ethical discipline in trade. The Prophet is recorded to have said:

﴿ *“The truthful merchant (is rewarded by being ranked) on the Day of Resurrection together with the Prophet, the truthful ones, the martyrs and the pious people”.*¹⁰

The Prophet Also Touched on Dishonest Traders: *“O traders! Surely you will be resurrected on the Day of Judgement as transgressors, except him who is dutiful and sincere”.*

Quran Recorded: *“The truth is from your God. So do not be one of the doubters” (Al-Baqarah: 147)*

This axiom verifies that any person including any party in the agency relationship, especially the agent (*wakil*) is obligated to fulfill his fiduciary duty with truthfulness. For example, do not invest the principal (*muwakkal*) asset in non-*Shariah* compliance investment or in any kind of investment that attributes *gharar* or other factors that would not serve the benefit of the principal, even he has an opportunity to do so. Thus, the agency problems regarding lying, shirking, opportunistic endeavours between the principal and agent could be reduced if the members in that particular relationship believe in faith. A principal (*muwakkal*) needs to deliver the power of administration and trustworthiness to a competent agent (*wakil*) who not only performs well in the task, but also it complements the good deeds of *amanah*. It is about the agent (*wakil*) who believes in faith and practices an Islamic ethics [59], in his study stated that *taklif* (personal accountability) is vital in a corporation. *Taklif* means that each person in the corporation is accountable and responsible to accept the task, that risk is associated to task and also the compensation paid to them. They believe in the final accountability by God. Therefore, if they make decisions just for the benefit of themselves, ignoring the interests of the organization, then they have violated their duties. Unlike the conventional agency contract, the relationship is based on fulfilling the obligation with expectation on human needs, human dignity and human recognition.

In relation to the Islamic agency contract, both parties have to offer the highest effort of participation and cooperation bounded by the *Shariah* rules and principles to pursue the main objectives of the organization. An agent (*wakil*) should not cause harm while performing a task, especially one that can be imposed onto the principal (*muwakkal*). This is recorded in a famous *Hadith*:

C “A Muslim is the one from whose hands and tongue other Muslims are safe”.¹¹

This *Hadith* provides a clear requirement to treat people with fairness, except for those non Muslims who are at war with Muslims. As a Muslim, he/she must not demonstrate carelessness through his or her actions or words that can cause harm or pain on others [60] Relationship in the Islamic agency theory carries the objectives to cooperate, to improve and to strengthen the relationship among members that lean on the main

purpose of building a good relationship with God. Building a relationship with God is the tenet of faith in Islam, as it will guide Muslims on the ways to achieve success and to form a proper long-term agency relationship.

Syura (mutual consultation): Another crucial problem in the agency contract is when there is a divergence of goals between the agent and the principle. Each party tries to maximize their own interests. This condition occurs when an agent is not performing the way it is desired by the principle and when the principle is not paying accordingly as desired by the agent. The distinction of the benefit between parties can be solved through the principles of *Syura*, which means mutual consultation. A principal (*muwakkal*) and agent (*wakil*), should conduct their respective tasks and responsibilities according to the mutual agreement, regarding the task as well as the compensation. Both parties should implement open-mindedness, respect, trust, acceptance of divergent view, freedom to give ideas and expression, etc. [58]. This concept is important to ensure justice, protect the interest of both parties and avoid negative values of arrogance and ego. Any misunderstanding within parties in the agency should closely consult the mutual agreement which adheres to *Shariah* rules. This is clearly stated in the Quran:

C “O believers, obey Allah and obey the Messenger and those in authority among you. Should you quarrel over any matter and then refer it to Allah and the Messenger, if you really believe in Allah and the Last Day. That is far better for you and fairer interpretation”(An-Nisa’:59)

C “Allah enjoins justice, charity and the giving to kindred; He forbids indecency, evil and aggression. He admonishes you that you may take heed” (An-Nahl: 90)

These two verses clearly specify that as a principal (*muwakkal*) in the agency relationship he has to fulfill his obligations by paying an appropriate outcome to his agent (*wakil*). An outcome or compensation should lean on relevant factors such as ability, experience, honesty and performance. On the other hand, an agent (*wakil*) should work not only according to the compensation he or she receives but also work with sincerity to achieve the objectives of the organization and also to achieve the blessings from God. In the *Syura* concept, if an agent

(*wakil*) is not satisfied with the compensation, he or she can negotiate with the principal (*muwakkel*). The Islamic agency theory teaches partnership members to practice respect, gratitude, patience, tolerance and also to believe not only in the economic reward/outcome as in the conventional agency theory but also in spiritual rewards (blessings from God). Each party must learn to avoid lying, shirking, conceit and jealousy. This acquires continuous Islamic teachings and training to the partnership members for them to be educated with this spiritual knowledge. Seeking knowledge is a continuous process in Islam, where Islam recognizes the knowledge process of each individual. Furthermore, the spreading of knowledge has been encouraged by The Prophet *s.a.w.*

C “Allah illuminates a man who hears hadith from me, preserves it carefully and passes it on to others...”

Therefore, it is crucial to implement the Islamic training which emphasizes on the importance of knowledge, individual development and ethical-oriented practices in the organization. Some approaches include continuous *tazkirah* (a talk) or discourse in viewing the *Quran* and *Hadith*, educating each individual in the cooperative organization on the importance of personal obligations, organizational obligations and also societal obligations.

CONCLUSIONS

In this paper, we analyze the conventional agency theory in relation to agency problems in the agency contracts. A contractual agency relationship creates some problems like information asymmetry, adverse selection and moral hazard. Therefore, completeness in the agency contract appears to facilitate the common understanding that the mutual understanding and obligation between agency parties could reduce the agency cost. Hence, we suggesting the applicability of Islamic discourse of *Tawhid* epistemology as principles in the agency contract has a great potential to create a distinctive relationship of parties in the agency contract as governance mechanisms would add significant value to the Islamic Financial Institutions' economic activities. The conventional agency theory dominates the self interest and individualism which try to maximize its own utilities and consequently create agency problems that cannot be resolved. This is the main point of contrast between the

conventional and Islamic agency contract with the special concept of *Tawhid* and *Unity* and also social features of *Ikhlas* (sincerity), *Itqan* (knowledgable), *Amanah* (truthfulness), *Syura* (mutual consultation), justice and implementing activities in accordance with the Islamic way based on the epistemological source of Islam: *Quran and Hadith*. In a way that an individual or a corporation should bring religion to organization, to ensure the business conducted is in compliance with Islamic *Shariah* for the best achievement in the present and hereafter.

We can say that the individual understanding in moral values, belief and religion can be a force that propels an individual to perform good behaviour. The existence of spiritual life and happiness would necessitate one to be sincere, honest, responsible and accountable and also to be good to others. This is consistent with (1) which emphasizes the use of religion to reduce self-interest, to make individual become honest and he states that there is no separation between materialistic and spiritual life. In the Islamic view, the economic relationships must be in writing to protect parties in the relationship and to avoid misunderstanding. The contract is believed to have been written in the sight of God, as evidence, to avoid doubt, to have witnesses and bind the parties to fulfill contracts to which one is committed.

Reflecting the above theoretical divergence, it can be stated that the Islamic agency theory uses the *Quran* and *Hadith* to determine the features and framework of the economic relationship practices in Islamic financial institutions. The successful practices of the Islamic agency theory should contribute to the development of the Islamic economic system. As [61] reported that Islamic economics, “is an approach to and (process of) interpreting and solving the man's economic problems based on values, norms, laws and institution found in and derived from, all sources of knowledge (in Islam)”. This is consistent with Islamic views that it is essential to hold Islamic values and norms at an individual level because the individual will determine the success of his or her economic relationship which enhances the economics system further.

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