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Risk Management and Corporate Governance Failure in Islamic Banks: A Case Study

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Abstract

Purpose – The aim of this paper is to show how the choice and ongoing evaluation of a firm's business model, as a matter of strategic guidance, are key aspects of corporate governance, with particular reference to risk management in Islamic banks.

Design/methodology/approach – This research uses a case study approach, with a single case which was chosen as it fits very well the purpose of this research. The data collection was based largely on documentary evidence. Company data was collected from company annual reports, press releases, and legitimate web sites. The ORBIS Bank Focus database was also used to produce a comparative financial analysis.

Findings – The study findings illustrate how an apparently successful business model may fail due to an inherent instability that could have been identified through the application of careful risk analysis (including stress testing) in the choice and ongoing evaluation of the business model, which robust corporate governance and strategic guidance require. In particular, Arcapita's problems illustrate the dangers to Islamic financial institutions from business models that involve undue exposure to liquidity risk.

Practical implications – The issues raised in the paper are important in that Islamic banking and finance is an integral part of the global banking and finance industry. Investors and regulators are now requesting corporate management to provide improved service to shareholders and other stakeholders alike. Islamic financial institutions rely on the confidence of investors and market participants, just like conventional institutions, and when this confidence erodes, it may prove difficult to regain.

Social implications – The global credit crisis of 2008 caused significant difficulties to firms, especially financial institutions, even with substantial government intervention in the economy, which raised some issues of corporate governance and ethics.

Originality/value – This paper extends the knowledge of the potential effects of weaknesses in corporate governance and risk management, with specific reference to strategic guidance in the choice and ongoing evaluation of a firm's business model, especially in relation to the Islamic banking sector. It also provides a telling illustration of the need for the enhancements of the Basel Committee's prudential requirements set out in the various Basel III documents.

Keywords: Corporate Governance, Strategic Guidance, Islamic banks, Risk Management, Arcapita

1. Introduction

The global credit crisis of 2008 caused major frustration to firms, even with significant government intervention in the economy, which raised some issues of corporate governance (CG) and ethics. People and governments around the world are demanding that corporate management provide improved service to shareholders and other stakeholders alike. Islamic financial institutions (IFI) rely on the confidence of investors and market participants, just like conventional institutions, and when this confidence erodes, it may prove challenging to regain. Financial success is based on different elements, such as opportunity, management strategy and trust.

This paper aims to examine the relationships between CG, risk management (RM), strategic guidance and the choice of a business model, in the context of Islamic banking where the constraints of compliance with the Shari'ah raise specific issues. CG was defined by the OECD (1999) as "a set of relationships between a company's management, its board, its shareholders and other stakeholders. [CG] also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined….". Subsequently, an alternative definition was proposed (OECD, 2004), as "procedures and processes according to which an organisation is directed and controlled. The CG structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making."

With respect to the responsibilities of the Board of Directors (BOD), the Organisation for Economic Co-operation and Development (OECD) Principles (OECD, 2015, OECD, 2004) state that "The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders". A key aspect of the strategic guidance is the choice of a business model and the ongoing evaluation of the adequacy of that model, taking into account the exposure to risk and risk appetite of key stakeholders, and the requirements of effective RM. It is this aspect which is the focus of this paper. The context of Shari'ah compliance presents particular issues with respect to RM, precisely that of liquidity risk, and to the potential role of Shari'ah governance due to the presence of a specific organ of governance, namely a Shari'ah Board with responsibility for monitoring the company's compliance with applicable Shari'ah rules and principles. As argued by AlAbbad et al. (2019), a Shari'ah board at the institution level constitutes an important feature to differentiate IB governance from that of conventional institutions.

Arcapita IB is used as a single case study in order to examine the relationships between CG, strategic guidance, RM and the choice of a business model. Arcapita's business model, as an Islamic investment bank, is of particular interest as it highlights the relationship between RM and strategic guidance in the choice of a business model which involved significant exposure to liquidity risk, and on paper Arcapita appeared to have a robust system of RM (as described in Section 4 below). According to Arcapita's annual reports, Arcapita attempts to achieve sustainable growth through maintaining a sturdy capital base and fit RM processes. For example, Arcapita embraces an enterprise-wide approach to RM, with practical identification and mitigation of the risks embedded in the company's balance sheet and business activities. The main objective of RM is to be consistent with the maximisation of investor returns. At the same time, RM aims to maintain the bank's risk exposure within self-imposed parameters defined within the Board's approved risk policy documents. The overall responsibility for the implementation of a sound RM framework lies with firm's top management and the BOD, through establishing an independent RM team. For example, in Arcapita's case, the bank has established a RM Department that works in coordination with the RM Committee, which is a management level committee to provide a platform for senior management input, review and approval of critical aspects relating to RM. However, this did not prevent it from being forced to apply for protection under Chapter 11 of the US Bankruptcy Act (see Subsection 4.4 below). As stated in the OECD/G20 Principles of Corporate Governance (OECD, 2015) "An area of increasing importance for boards and which is closely related to corporate strategy is oversight of the company's risk management. This risk management oversight will involve oversight of the accountabilities and responsibilities for managing risks, specifying the types and degree of risk that a company is prepared to accept in pursuit of its goals, and how it will manage the risks that it creates through its operations and relationships." It is noteworthy that no such emphasis on RM appeared in the section on board responsibilities (pp.24-25) of the OECD's earlier 2005 version of its Principles of CG. This change may reflect an increased awareness of the importance of RM in general, and liquidity risk in particular, following the 2007-8 financial crisis

It is not our purpose to criticise the Board or the management of Arcapita; it is indeed easy to be wise after the event. Rather, we believe that the case of Arcapita provides an excellent illustration of how the financial crisis of 2007-8, of which Arcapita was a victim, showed up the lacunae in the Basel II Accords and the need for the subsequent provisions of Basel III with respect not just to liquidity RM but also to stress testing. A similar observation may be made regarding the revision of the section on board responsibilities in the OECD Principles of CG.

With respect to our use of a single case study, we are not aiming to test a theory but rather to provide a micro-level illustration of a historical process, namely the shock of the 2007-8 financial crisis, the need for the development of thinking on CG and RM stimulated by that shock, and the response to that need in Basel III and the revision of the OECD Principles of CG This illustration provides answers to "how and why" questions regarding that historical process of the financial crisis. As Yin (2018) notes the need to use case studies arises whenever "an empirical method that investigates a contemporary phenomenon (the "case") in depth and within its real-world context, especially when the boundaries between phenomenon and context may not be clearly evident." Given the time that has passed since the events covered in the case study, we have relied on documentary sources of information and did not conduct interviews with members of Arcapita's Board or Senior Management.

According to the research background above, this research seeks to discuss the CG framework, the need for strategic guidance by the board and ongoing appraisal of the firm's business model in the light of the risk exposures and risk appetite of key stakeholders, not only shareholders. Strategic guidance regarding the choice and ongoing evaluation of the firm's business model is thus a key issue for CG. The context of Shari'ah compliance presents particular issues concerning RM, specifically that of liquidity risk (because of certain Shari'ah restrictions), and the potential role of Shari'ah governance due to the presence of a particular organ of governance, namely a Shari'ah Board with responsibility for monitoring the company's compliance with applicable Shari'ah rules and principles. For example, the Shari'ah board can create pressures on the BOD and management by restricting risky investments (Mollah and Zaman, 2015).

2. Review of Theoretical Considerations

2.1 Risks faced by Islamic Banks

IFIs, like other financial institutions, are not immune to failure (DeLorenzo, 2000). For example, Ali (2007) highlighted that a number of IBs in practice have experienced financial distress which forced them to close their operations, such as the case of Ihlas Finans in Turkey. Thus, it has been shown that, while the global financial crisis negatively impacted conventional banks, it also adversely affected the performance of Islamic banks (Zarrouk, 2012). Importantly, Zarrouk (2012) indicated how weaknesses in RM practices in some Islamic banks, alongside a weak regulatory framework, contributed to the decline in their performance during the period.

Unlike conventional institutions, IFIs have as their *raison d'être* compliance with the Shari'ah (Islamic law), which imposes various prohibitions, including *riba*, i.e. the use of interest-based transactions central to conventional banking. Shari'ah-compliant banking thus prohibits interest, which is deemed unethical according to the Shari'ah, being considered a 'pure rent on money' which allows the financier to receive a return without undertaking either risk (apart from credit risk) or effort. Where the wealthy lend to the poor at high rates of interest, poverty is aggravated, which can cause severe financial distress and social problems.[1] As an alternative, Islamic-compliant banking allows credit or financing to be provided by various means which do not involve interest, such as through sales on credit with a profit mark-up (provided the goods are not considered prohibited, such as pork or alcohol). The religious nature of IBF has led to conjecture that Islamic banks (IBs) possess inherent attributes that enhance their ability to withstand economic shocks (Pappas et al., 2017, Hasan and Dridi, 2011). However, individual banks are typically subject to different kinds of risks, including credit risk, liquidity risk, market risk, interest rate risk, and operational risk. On the other hand, IBs face rate-of-return risk rather than interest rate risk, plus another specific kind of risk, such as Shari'ah non-compliance risk (a type of operational risk) and fiduciary risks in respect of profit-sharing investment accounts. IBs also deal with traditional risks (such as liquidity) differently compared to conventional banks. Even though there are two types of liquidity risk (market and funding), IBs are subject to an additional element in liquidity risks, due to the existence of Shari'ah constraints on the types of high-quality liquid instruments that they may hold, especially the lack of short-term sovereign instruments utilised in conventional sectors (Archer et al., 2010, Archer, 2011). This restricts market liquidity and forces IBs to hold cash, which yields no return. Regarding funding liquidity, in most jurisdictions, IBs lack both a Shari'ah-compliant interbank market and a Shari'ah-compliant lender of last resort (LOLR) facility.

The banking system by its nature is highly sensitive to the management and control of risks. For example, Čihák and Hesse (2010) found that small IBs tend to be more financially stronger than a larger one, as IBs tend to loosen their credit risk monitoring system as they become bigger. IBs are also exposed to credit risk through clients who default via Murabahah, Salam or Istinsna'a (forms of working capital financing), Musharakah or Mudarabah (forms of partnership-based financing) or other financing contracts (Archer and Karim, 2013). Credit risk in respect of Ijarah (leasing) is mitigated by the financier's ownership of the leased asset. On the other hand, liquidity risk can be caused by market disruptions, which may impact certain sources of funding. Liquidity risk is crucial to Islamic banking owing to the exposure to risk being aggravated by Shari'ah constraints. One form of funding liquidity risk is refinancing or roll-over risk, i.e. the risk of not being able to refinance liabilities when they fall due. This risk is particularly relevant in the case study analysed in this paper.

2.2 Corporate Governance Practice

In order to achieve the objectives of Al-Shari'ah, good CG practices are needed to ensure the sustainability of IBs, which then leads to promote people's well-being (Asutay, 2012). For example, applying good CG will lead to safeguarding the stakeholders' interests and facilitates effective monitoring to utilise an IBs resources efficiently; as a result, the preservation of wealth is more likely to be achieved (Ginena and Hamid, 2015). Therefore, CG and RM are critical to the success of any firm, and weakness in these will prove problematic for companies, as Bhagat and Bolton (2008) pointed out in their examination of the relationship between CG and firm performance. For macro-level risk, as Platonova et al. (2018) stated, the stability of the financial system can be negatively affected by poor CG. Furthermore, inadequate RM or the lack thereof can be financially catastrophic not just for companies, their employees, their suppliers and customers, but for the whole economy, as evidenced by the infamous 2007 subprime mortgage meltdown that contributed to the 2008-2009 global financial crisis.

Even though according to some views, CG practice in the context of commercial entities is considered to be a product of the western capitalist system (Ertuna and Ertuna, 2016, Aras, 2009: 164, Nakpodia et al., 2018), yet CG applies to non-commercial corporate bodies, such as universities and may well be older than the western capitalist system. As such, it is variously described as, for example, "the system of laws, rules, and factors that control operations in a company" (Gillan and Starks, 1998: 10, Okeahalam and Akinboade, 2003) or "a set of relationships between a company's management, its

[1] While this type of exploitation might be thought of as a problem of developing economies, recent scandals involving so-called 'payday lenders' in the UK show that it can also occur in developed economies.

board, its shareholders and its other stakeholders" (OECD, 2015). However, CG in Islam differs from the conventional side, in that Islamic institutions have a structure of Shari'ah governance and must obey the Shari'ah law as well as meeting other requirements (Nomran and Haron, 2020). According to Mergaliyev et al. (2019), IFI is considered to be a value-oriented financial institution that is affected by the ethical norms, morals, and principles of Islam.

CG may be considered from the theoretical standpoints of Agency Theory (Jensen and Meckling, 1976) and Transactions Costs Theory (Williamson, 1996). From an Agency Theory (AT) perspective, CG aims to ensure the accountability of specific individuals within a corporation, using mechanisms that can mitigate or prevent the principal-agent problem, which involves resolving the issues that exist in the agency relationships between stakeholders in a corporation (principals) on one hand and those managing the corporation (agents) on the other hand. Where the corporation is a business firm with shareholders, in Jensen and Meckling's formulation of AT the latter are the principals, and the firm's executives are the agents. AT applies to relations between the principals and the agents involving conflicts of interests, where there is asymmetry of information and misalignment of incentives between the agents (who are better informed about the firm's day to day activities) and the principals. Such a situation arises, in particular, when the agents and principals have different attitudes towards risk.

Jensen and Meckling (1976) developed the theory of the ownership structure of the firm, where they highlighted the concept of agency costs and the relationship to separation and control. This issue may affect the value of the firm. Thus, the principal engages the agent to perform services on his/her behalf that typically involve decision-making to maximise the value of the firm in the principal's interest. However, the agent might have a different strategy and may not maximise value for the principal but might instead focus more on optimising his/her own personal welfare, for example through taking perquisites or non-pecuniary benefits. This situation creates agency costs, such as the costs of monitoring, a form of transactions cost or a reduction in the value of the firm (Williamson, 1996).

Thus, the principal may reduce the effects of such a conflict of interests through imposing monitoring by having a BOD that acts on the principal's behalf to monitor and control the agent's activities. On the other hand, the principal may also develop appropriate incentives for the agent by contracting the agent to undertake actions in the interest of the principal or to avoid specific activities that conflict with the principal's interests. Also, Fama and Jensen (1983b) argue that the agency problem is a consequence of not conducting a costlessly and enforceable contract. However, these problems could be reduced by developing a controlling or monitoring process (carried out by a Board of Directors) that ensures that the decisions taken by the agents are in the best interests of the principal. Williamson (1996) points out that this monitoring process (the governance mechanism of equity) is relatively costly.

Part of this controlling process (to be conducted by the board) is concerned with the effectiveness of the performed by the agents, i.e. senior management. in this context is defined as the process of identifying potential risks, analysing the identified risks, evaluating or ranking them in terms of seriousness, taking precautionary measures aimed at avoiding or mitigating the risks, and monitoring and reviewing the management of the risks (Merna and Al-Thani, 2011, Srinivas, 2019): As well as micro-level risks such as credit, market, liquidity and operational risk, these risks include macro-level elements associated with economic cycles, including inflation, capital market volatility, commodity price volatility, recession, and so on. Thus, with respect to micro-level risk, for example, the management a company would conduct due diligence regarding a supplier before engaging the latter or perform a credit check on a prospective customer before granting a credit facility.

Consequently, the focus of this paper is on the situation that ended in Arcapita filing for bankruptcy protection, which requires an examination of the CG and RM issues arising from this case study. A key question would be: *to what extent are failures in RM the result of inadequate CG?*

3. Methodology

This research is an exploratory study, focusing on CG and RM. A critical aspect of the strategic guidance in CG is the choice of a business model and the evaluation of the adequacy of that model from the standpoint of risk appetite and RM. We use a case study as an exploratory method, where a case study approach is an empirical inquiry that investigates a contemporary phenomenon with more intensity, as highlighted by Yin (2018). A case study approach involves in-depth and detailed investigation that can be suitable for explaining a specific problem by using 'how' and 'why' questions to examine a subject. The examination can be conducted in the form of qualitative or quantitative research. Additionally, it allows a researcher to explore the main topics which would not easily be covered by a different method. There are different types of case study designs; however, this research uses an embedded case study design, including quantitative analyses, to illustrate and analyse the issues of CG and RM.

The study focuses on the first Islamic investment bank known as "Arcapita". It used as a single case study to illustrate and analyse the relationships between CG, strategic guidance, RM, and the choice and ongoing evaluation of a business model. In particular, the case study highlights the relationship between RM and strategic guidance in the choice and operation of a business model which involved significant exposure to both market and funding liquidity risk. Thus, while Arcapita appeared to have a well-developed system of RM, this failed to prevent them from having to file for bankruptcy protection under Chapter 11 of the US Bankruptcy Act.

4. The case of Arcapita

4.1 Background

Founded in 1996, and formerly known as the First Islamic Bank, Arcapita is based in Manama, Bahrain. It also maintains offices in London, Atlanta, and Singapore. The bank is licensed by the Central Bank of Bahrain (CBB), which is the financial and monetary regulator. Bahrain, together with the other Gulf Cooperation Council (GCC) countries, holds about 70% of Islamic banking assets (Alhammadi et al., 2018). The name and logo of the company, along with those of its subsidiaries, was changed to Arcapita in 2005 (Mostafa Khan and Jamal Uddin, 2013). Together with its subsidiaries, the bank is wholly owned by Arcapita Group Holdings Limited (AGHL) which operates under the laws of the Cayman Islands (Arcapita, 2017). Under contractual arrangements, AGHL and Arcapita Bahrain currently are owned by the same shareholders applying the same shareholding ratios entitling them to appoint identical members to the BOD in both entities. Arcapita offers investors diversified alternative Shari'ah-compliant investments in private equity and real estate with long-term returns that claim to exceed those of conventional equity markets (Bank Focus, 2019, Karry and Sharif, 2012, Atlanta Business Chronicle, 2005). Arcapita co-invests with investors in its sponsored investment products and provides investment management and administration services (Arcapita, 2017: 11). The company's key milestones from inception to date are stated below in **Table 1** to avoid a lengthy historical account:

Table 1: Key Milestones from Inception to Date

Year	Activities
1996	Established in December
1997	Commenced business after raising $100 million in equity capital from the GCC and Southeast Asia investors
1998	First investment in a US-based private equity deal: Perception Group, Inc., a manufacturer of canoes and kayaks; Opens its Atlanta office in the US.
1999	Launches asset management operations
2000	First real estate investment: First Multifamily Properties LLC, a portfolio of properties in the US multifamily real estate sector
2004	Opens a London office
2005	The name and logo of the company and those of its subsidiaries were changed to Arcapita

2007	Opens a Singapore office
2010	Arcapita Bahrain moves to its new location in Bahrain Bay, where Arcapita Headquarters are based
2012	Files for Chapter 11 protection in the US.
2013	Emerges from Chapter 11 protection
2014	Raises new equity capital of $100 million
2015	Acquires its first real estate investment since restructuring in the GCC
2017	Acquires its first private equity investment since restructuring in the GCC

Source: Author using Arcapita's website: https://www.arcapita.com/, and annual report.

4.2 Organisational Structure and Corporate Governance

Arcapita's BOD is responsible for the firm's overall strategy, oversight, and monitoring. It supervises senior management who engage in day-to-day management. The BOD is assisted by the three Board Committees: Executive Investment Committee (EIC), Executive Administration and Corporate Governance Committee (EAC), and Audit and Risk Management Committee (ARC).

According to Arcapita's annual report (2011), sound CG is fundamental to the success of the organisation. In addition, it is stated that the structure of the CG system at Arcapita complies with Shari'ah principles throughout the bank's business operations. It is worth mentioning that the Shari'ah Supervisory Board (SSB) was not mentioned initially as being a component of CG, although it existed. Moreover, in 2011 Arcapita implemented a CG code to comply with Bahrain Central Bank guidelines. However, this did not protect the bank from the problems that led to it filing for bankruptcy protection under Chapter 11 of the US Bankruptcy Code in 2012.

With regard to Shari'ah governance, we may note that Arcapita states that it complies with Shari'ah rules and principles following the standards of the Auditing Organization of Islamic Financial Institutions (AAOIFI), and it is overseen by an external and independent Shari'ah Board that is supported by its internal Shari'ah department. However, the Shari'ah Board implicitly approved a leveraged business model, with leverage being provided through *Murabahah* facilities.

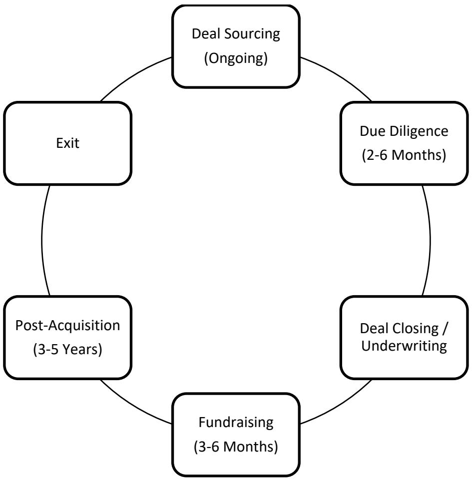
Thus, Arcapita's CG and RM systems, notwithstanding their apparent merits, proved inadequate to prevent the bank from incurring the financial distress which led to its filing for bankruptcy protection under Chapter 11, as it was unable to withstand the challenge posed by the global crisis of 2007-8. This can be attributed to the vulnerability of the bank's business model to both market and funding liquidity risk.

4.3 Arcapita's Business Model

4.3.1 Investment Process

The investment process at Arcapita involves a six-stage investment decision-making process. It starts with deal sourcing secured by Arcapita's professionals, including private equity, real estate and infrastructure. Venture capital professionals are sought through their networks. Due diligence is the second stage of the investment process whereby the proposed investment is assessed to determine, among other things, compliance with Islamic law and ethics, alignment with the preference and needs of the investors; and the expected returns on investment. The help of consultants, financial and management experts, as well as legal teams, is required to undertake in-depth due diligence. The third stage involves deal closure/underwriting. Here, if Arcapita decides to pursue investments by funding the purchase via its balance sheet, Arcapita self-funds the investment. For example, Arcapita initially owns 100% of the investment and then sells most of the investment on to clients as described later (for more information, see Arcapita annual report 2017). The fundraising or investment placement phase (fourth stage) involves Arcapita presenting the investment opportunity to a select clientele and inviting them to invest. At the conclusion of the fundraising stage, the investment (or most of it) is placed with investors (private equity or venture capital) for a holding period of 3-5 years. The fifth stage (post-acquisition) is a holding phase that requires Arcapita's portfolio management team to start monitoring the investment's performance aimed at ensuring eventual investment realisation. The team manages the investment and its operations. In the exit stage (last phase) by securing a sale, recapitalisation or public offering. An early exit is possible if an attractive opportunity emerges, while an eventual exit may be prolonged to improve its investor's value. Thus, Arcapita "follows a clearly defined investment process for its acquisitions and exits" (Mostafa Khan and Jamal Uddin, 2013).

Figure 2: Arcapita's Investment Process



Source: Authors' own figure based on Arcapita, Annual Report 2017: 14.

As shown in Figure 2 above, Arcapita's business model, developed and refined over time, commences with project sourcing and ends with project divestment. It is primarily focused on using the bank's balance sheet in the first instance to fund deals in private equity, infrastructure, venture capital, and the real estate sectors, which are then syndicated out to investors that include high net worth individuals with investable assets over USD 1 million, family offices, institutions, and sovereign wealth funds. For instance, Arcapita acquires controlling interests in companies with large growth potential with the intention to divest at a profit. For example, a going concern bought for US$1 million is nurtured for 3-5 years assisted by Arcapita's investment and management team and then sold to investors via a special purpose vehicle (SPV) for US$ 1.2 million, thereby, making a small premium on the deal, plus fees.

Arcapita's business model is summed up by El-Hage and Pierson (2009: 1) as follows: "Arcapita's business model had been developed to provide several revenue-generation opportunities for the bank as it conducted its business: acquisition fees levied on each new investment; placement fees charged as new investments were placed with investors; asset management fees charged during the holding period; performance fees payable upon exiting a transaction, which would be triggered at certain agreed performance thresholds; and proprietary investment gains through the bank's investments alongside its investors. This business model **required ready liquidity** to allow the bank to underwrite transactions, to take full advantage of its balance sheet, to support portfolio companies with their ongoing capital requirements, and to cover the bank's operating expenses through the investment cycle" (emphasis added). In particular, the model required markets to be receptive to the sale or IPO of the investments at the end of a holding period normally not exceeding 5 years, and, insofar as the investments were financed by borrowed funds (such as *Murabahah* financing), that any resulting liquidity risk be carefully managed.

4.3.2 Capital Structure

Mostafa Khan and Jamal Uddin (2013) state that Arcapita, a relatively young Shari'ah-compliant financial institution, has become internationally successful by raising funds from the Middle East and then investing in the US, Europe, the Middle East, and Asia. For the financial year 2019 (twelve-month period ending June 30 2019) Arcapita reported revenue of US$ 54.6 million, net income of US$ 21.9 million and total equity of US$ 237.9 million. It held a paid-up capital of 7.6% in dividend, retained earnings worth US$ 41.6 million and US$ 7.46 million in proposed dividends (Arcapita, 2019). Table 2 below shows the key financial highlights for Arcapita in the financial years 2014 – 2019, post the bankruptcy.

Table 2: Key Financial Highlights for 2014 – 2019

Key Financial Indicators/Year	2019	2018	2017	2016	2015	2014
Total Revenue	54.6	37.9	33.5	36.2	35.5	29.3
Net Income	21.9	12.4	8.1	12.2	11.4	10.1
Total Assets	291.1	340.3	198.7	144.5	144.5	59.1
Total Liabilities	66	134	65	13	57	10
Total Equity	237.9	219.7	132.3	130.2	86.1	50.5
Net Income Margin (percentage)	40	33	24	34	32	35
Dividend	7.6	7.1	7	7	7	5
Return on Assets (percentage)	7.5	3.6	4.2	8.5	8.3	17.6
Return of Equity (percentage)	9.7	6	6.5	9.5	13.3	21.4
Debt to Equity ratio	29.4	64.5	52.5	10.3	66	21.6
Equity Multiplier	129	165	153	111	160	122

Source: Arcapita, Annual Report (in US$ Millions). Also, authors calculation from Arcapita annual reports, ROE = net income/total equity, ROA = Net Income/ total assets, Debt to Equity ratio = total Liabilities/Total equity, Equity Multiplier = Total Assets/total Equity. Dividend as a percentage of paid-up Capital (percentage). The numbers here suggest that Arcapita had changed its business model to be less risky because less reliant on borrowings compared to the period prior to the bankruptcy.

Arcapita's "international success" is not new to analysts as the bank previously recorded growth and profitability prior to filing for bankruptcy protection in 2012 (as highlighted in Table 1). Preceding its bankruptcy restructuring, the bank had completed 74 transactions worth $28.1 billion across its four lines of business – private equity, real estate, infrastructure, and venture capital. The bank had created investor returns and a net income at a cumulative 40% annual growth rate (Arcapita, 2008) and had a balance sheet total of US$3.7 billion and an equity capital base of US$1.1 billion (Arcapita, 2011). However, the global financial crisis of 2008-2009 together with the Eurozone crisis had a negative impact on Arcapita's financial performance, with losses in 2009 and 2010 amounting to $87.9 million and $559.4 million, respectively (see Table 3 below). As reported in the Financial Times, the bank lost its Standard & Poor's (S&P) rating affirming S&P's negative outlook (Lidstone, 2009). Table 3 shows that the leverage ratio was 2.6/3.7 or just over 70%, and a debt/equity ratio of 2.36 or 236%, which was much higher than later, as shown in Table 2. Thus, Arcapita has a high degree of leverage before the chapter 11 filing. The numbers in Table 3 suggest that Arcapita had a risky business model because more reliant on borrowings.

Table 3: Key Financial Highlights for 2007 – 2011

Key Financial Indicators	2011	2010	2009	2008	2007*
Total Revenue	398	-235	424	624	286
Net Income (loss)	50.2	-559.4	-87.9	362.5	190.5
Total Assets	3718.2	3457.1	4372.3	5137.4	3805.5
Total Liabilities	2601.0	2397.0	2774.0	3708.0	2738.0
Total Equity	1118.0	1060.0	1599.0	1340.0	955.0
Net Income Margin (%)	12.6	-682.0	-26.0	58.0	51.0
Operating Income	211.3	88.3	338.5	618.4	373.4
Dividend (%)	Nil	Nil	Nil	40.0	50.0
ROE (%)	4.5	-52.8	-5.5	27.0	19.9
ROA (%)	1.3	-16.2	-2.0	7.1	5.0
Debt to Equity ratio (%)	232.7	226.1	173.5	276.8	286.7
Equity Multiplier (%)	333.0	326.0	274.0	384.0	398.0

*Note 1: Financial Year (FY) 2007 was a transitional 18-month period. Source: Arcapita, Annual Report (in US$ Millions). Also, authors calculation from Arcapita annual reports, ROE = net income/total equity, ROA = Net Income/ total assets, Debt to Equity ratio = total Liabilities/Total equity, Equity Multiplier = Total Assets/total Equity. Dividend as a percentage of paid-up Capital (percentage).

According to Arcapita, its ownership structure aligns interests between Arcapita and its shareholders, which gives Arcapita the flexibility and independence to conduct its business strategies, and Arcapita stated that its shareholder base is well diversified, with no one shareholder having a majority stake. However, a report by the Financial Times, stated that the CBB granted Arcapita a $250m Murabahah facility, "in line with the policy of directing deposits to local banks. This makes the CBB the biggest stakeholder (Kerr and Hall, 2012).

It is noteworthy that following its emergence from chapter. 11, Arcapita modified its business model to reduce reliance on leverage. Debt/equity ratios of 200% or more were replaced by debt/equity ratios of between 21.6% and 64.5%, with the ratio for 2019 being a modest 29.4%. The fact that a much less leveraged business model was found to be viable following emergence from ch.11 raises the question of why such a highly leveraged model was adopted initially. This points to a lack of strategic guidance at this earlier stage.

4.3.3 Management failures

Arcapita's organisational structure appears from the above to provide for sound CG. The three board committees, EIC, EAC and ARC, together with the SSB, should between them prevent Arcapita from incurring excessive risk exposures. However, this does not seem to have been the case. It was noted in Subsection 4.3.1 above that Arcapita's business model requires ready liquidity. What appears to have been lacking, therefore, is strategic guidance (or perhaps strategic awareness) with respect to this riskiness of Arcapita's business model, namely its exposure to both market and funding liquidity risk together with its use of leverage to enhance returns to equity. But such lack of awareness was far from unusual until the shock of the financial crisis of 2007-8, which led to the reinforcement of the Basel Committee's prudential requirements in Basel III. Hence, to roll-over financing a possible solution that Arcapita would use was Murabahah-based funding. But in the credit crunch following the 2007-8 financial crisis, it became impossible to refinance the US$1.1bn syndicated Murabahah financing.

4.4 Liquidity Risk Crisis, Bankruptcy Protection and Reorganization Plan

As already noted, Arcapita operates across private equity, infrastructure, venture capital and real estate businesses, and the bank's business model involves making investments subsequently placed with wealthy clients usually drawn from the GCC states. However, owing to the global financial collapse of 2008, the bank faced a liquidity risk management crisis, becoming unable to refinance a syndicated *Murabahah* financing of US$ 1.1bn. Therefore, in 2012 Arcapita became the first Arab Gulf firm to file in the US seeking Chapter 11 protection under American bankruptcy laws to protect its assets and investments from any legal challenge, thus allowing the bank to continue talks with its lenders (French, 2012). It was able to do this due to its presence in the US market. The bank had been unable to reach an agreement with its creditors to refinance a US$1.1 billion Islamic (*Murabahah*) syndicated finance facility due in April 2012, under pressure from hedge funds that were members of the syndicate insistent on full repayment. Although some of its creditors were prepared to support the bank, this was not effective because certain non-bank creditors (hedge funds) withheld their agreement. Shari'ah constraints, in particular the prohibition of the trading of liabilities, further complicated the situation. In such circumstances, Arcapita, having sought and obtained protection under Chapter 11 of the US bankruptcy code, subsequently sold off most investments to meet its obligations to creditors. According to the Arcapita CEO, the firm managed about US$7.4bn of assets, while the reorganisation plan represented the most effective way to implement a comprehensive restructuring of Arcapita, in order to maximise recoveries to creditors and other stakeholders.

While the bank's voluntary case under Chapter 11 aimed to protect its assets and develop plans to refinance the US$1.1bn debt, in the context of the negative impact of the global credit and Eurozone crises, its ability to secure funds, to dispose of investments and to extend the facility was restricted. However, under Chapter 11 provisions, Arcapita continued operations and managed its properties under the direction and control of its board and management. The reorganisation plan was submitted to creditors to vote on; and, subject to the US court for confirmation, while proceeds from asset sales were repaid to creditors, who were also given equity in companies holding Arcapita's assets.

Alternatives to Chapter 11 protection involved liquidation, which would have required the entire sale of Arcapita's assets, preventing Arcapita from securing new investments. This would have meant the liquidation of assets worth US$7.4bn under its management, including real estate, infrastructure, venture capital and private equity stakes in companies, ranging from an insulation maker in Massachusetts to a French logistics firm. Arcapita had stated its determination to work with advisors during the exclusivity period if this was granted by the court. The reorganisation plan envisioned a new $550 million *Sukuk* (Islamic security) to be issued to the unsecured creditors. The *Sukuk* would come with a 12% annual profit rate. They would be unsecured and perpetual, meaning they would have no fixed redemption date. Arcapita also proposed to secure a $185 million Shari'ah-compliant exit facility to provide working capital and payback financing used to tide it over during the bankruptcy process (Fitch, 2013). Although the reorganisation plan was opposed by some creditors, the court finally approved Arcapita's reorganisation plan under Chapter 11 protection. Arcapita, thereby, avoided liquidation and has remained in business to date. Therefore, the question raised here is: what are the circumstances that led Arcapita to file for bankruptcy protection, which requires an examination of the CG and RM issues arising from this case study.

5. Challenges and Failure of Risk Management

Arcapita was initially successful in constructing a business model that, at the time, took advantage of the benefits of the global business environment. With respect to the BOD's attitude toward risk, it ensured that a RM framework was in place that was thought to be effective in the circumstances. The Basel III requirements for liquidity RM and stress testing had not yet been developed. Nevertheless, the bank faced some challenges posed by globalisation. Different cultures and political systems fused together as new challenges.

According to Bedicks; and Arruda (2005), globalisation and concentration of ownership are primary influences on the development of CG; however, certain activities by Arcapita's management raised questions about the company's ethical judgment, particularly as regards conflicts of interest in the conduct of business. For example, two weeks before the decision was taken to file for Chapter 11 protection, Arcapita's BOD agreed to lease back the Lusail property project to Qatar Islamic Bank (QIB) for US$200 million. Even though the son of Qatar's prime minister (chair of QIB) and member of the Arcapita board, did not attend the meeting that approved the sale and leaseback, some governance issues around conflict of interest may be raised, and questions surrounding the timing and the necessity of the deal that was given to QIB but not to other potential lenders could arise. In this connection, it is relevant that Arcapita was faced with a vast amount of debt claims, over and above its US$1.1 billion *Murabahah* liability, before filing for bankruptcy protection. For example, the second-largest creditor to Arcapita, Germany's Commerzbank, requested to be paid a guarantee of about US$165 million for HT Troplast (plastics manufacturer), one of Arcapita's subsidiaries based in Berlin.

Another issue with Arcapita's RM that resulted in Chapter 11 protection concerned various activities of non-bank creditors, which raised an ethical issue, regarding how Shari'ah-compliant liabilities are traded, as trading of liabilities. This is not Shari'ah-compliant, and the 'vulture funds' were not bound by Shari'ah rules and principles. According to Arcapita CEO, the reason for reliance on Chapter 11 was the precipitous action threatened by hedge funds that had purchased some of Arcapita's liabilities at a discount (so-called 'vulture funds') and were seeking to leverage their opposition to a restructuring to obtain a buyout at par.

The potential fragility of Arcapita's business model can be seen through one of the major failures of RM that troubled the bank, namely its strategy for refinancing its liabilities, which involved exposure to both market liquidity and funding liquidity risks. Arcapita used to refinance its liabilities by paying back a portion of the liability using the cash obtained through disposals of investments and using this new facility to refinance the balance of the liability. Thus, Arcapita was exposed to market liquidity risk with respect to the disposal, leading to funding (refinancing) liquidity risk when the global market crisis slowed down the refinancing process. Hence, the bank found itself obliged to raise US$1.1 billion, which it did by entering into a relatively short-term syndicated *Murabahah* financing agreement with more than 50 creditors. It was subsequently unable to repay this liability at maturity, a default that led to its filing for Chapter 11 protection. Furthermore, as a result of the global economic crisis and the failure to refinance its debt of US$1.1 billion, Arcapita started to sell off most of its investments such as the fast-food chain, Church's Chicken, to repay their debt (Griffith, 2009, Arnold and Kerr, 2009).

In addition to the 2008 global financial crisis that affected most industries and banks including Arcapita, the slowdown of businesses worldwide, and the hedge funds' tactics of putting pressure on Arcapita led to the bank seeking Chapter 11 protection, the firm faced the specific problems mentioned above, which contributed to its financial difficulties. These notably included the maturity mismatch between its assets and the $1.1 billion *Murabahah* payable that was due in March 2012 and which it was unable to refinance. In the event, Arcapita was willing to take the reputational risk resulting from filing for bankruptcy under Chapter 11; this allowed it to realise its investments in an orderly manner. It was thus protecting them from the hedge funds which had hoped to acquire them at 'fire sale' prices in case of default.

Arcapita's syndicated *Murabahah* Islamic financing of US$1.1 billion involved more than 50 creditors. At the same time, hedge funds held around 25 per cent of the debt, and their attitude subsequently made it impossible to reach a deal to restructure the financing and led to filing under Chapter 11. The decision of the CBB to support Arcapita raises additional questions about the prudence of the country's regulator (Kerr, 2012), and may create a precedent placing pressure on the regulator to intervene in the future. The CBB was the largest of around 50 unsecured lenders, being owed $255m, and stated that the *Murabahah* facility had been extended to Arcapita. This was in line with CBB policy of directing deposits to local banks to support the banking sector in the Kingdom of Bahrain in light of the global financial crisis by the end of 2008 (Kerr, 2012). The regulator's reputation constitutes one of the selling points of the country's financial services sector. The financial support of Arcapita by the CBB arguably compromised its independence and impartiality in regulating the sector and was also criticised as an imprudent use of state resources (Kerr, 2012).

Two further reasons have been proposed to explain Arcapita's inability to reach an agreement with its creditors. One of these relates to creditors' concerns about the political and financial context of the GCC countries. It has been suggested that the creditors, especially those in Europe, were concerned about political instability in the region at the time of the negotiations. In particular, Bahrain faced escalating problems concerning political upheaval, including sustained pro-democracy protests that threatened the country's financial sector and caused foreign bankers and offshore banking assets to exit. Moreover, the past history of other GCC companies in rescheduling their debt and failure to pay such creditors, as with Gulf Financial House which tried to reschedule its debt several times already, created a fear of dealing with GCC companies.

Secondly, but less plausibly, the terrorist attacks on the USA on September 11, 2001, have been cited as a possible source of difficulties for Arcapita. While these were probably a reason for the change of name from 'First Islamic' in 2005, it is doubtful whether the attacks led to difficulties for Arcapita. There were some objections at the time to businesses with Muslim ownership, and Caribou Coffee, the second-largest speciality chain retailer of premium brewed and roasted whole bean coffee, which had been acquired in 2000 by Crescent Capital, one of Arcapita's subsidiaries, became a target of calls for a boycott. However, it has been noted that the boycott may, in fact, have had minimal growth impact on the chain, which nevertheless increased the number of its stores (Paul and Poole, 2006).

In addition, there were some difficulties related explicitly to restrictions imposed by the need for Shari'ah compliance, which aggravated the problems of funding and market liquidity. Arcapita, as an Islamic investment bank, faces constraints regarding the availability of Shari'ah-compliant liquid assets and LOLR facilities, as well as the lack of a Shari'ah-compliant interbank market, which created a scarcity in terms of funding liquidity. Therefore, this affected the growth of the business, as well as contributing to difficulties in refinancing its liabilities, which propelled its subsequent bankruptcy. The global recession hampered the bank's ability to obtain liquidity from the capital markets, especially Shari'ah-compliant funds. The global recession mainly affected Arcapita's ability to offload its investments at reasonable prices to clients as required by its business model (market liquidity). It also resulted in a reduction in asset values, as it negatively impacted the process of placing investments with customers.

Correspondingly, both market liquidity risk and funding liquidity risk (aggravated by Shari'ah non-compliance risk) are major components of Arcapita's profile that are difficult to manage, given the lack of Shari'ah-compliant funding. The bank seeks to manage its investment risks through each stage of the investment process, including investment funding, sourcing, and the investment holding period. Prior to funding investment, and regardless of its size, the SSB and the Shari'ah department provide an independent assessment of the opportunity to make sure their investment and funding are Shari'ah-compliant, highlighting key risks before commitment. All Arcapita business lines use a private equity risk model to manage their investment portfolio. The RM Committee ensures that Arcapita maintains appropriate asset diversification by geography, industry and investment type, and seeks Shari'ah-compliant funding (Arcapita, 2011).

Thus, while in theory, Arcapita had solid CG and RM structures, these were insufficient in practice to prevent the liquidity crisis into which it fell in the wake of the 2007-8 financial crisis. The business model was inherently vulnerable to both funding and market liquidity risk. Stress tests might have revealed this vulnerability and led Arcapita to increase its own funds and reduce its reliance on non-equity funds such as *Murabahah*, but they were not required at the time.

As a result, to answer the key question: *to what extent are failures in RM the result of inadequate CG?* In the case of Arcapita, it may be argued that the failure in RM was basically due to a governance (i.e. strategic guidance) problem involving the design of the business model. As noted above, the business model was potentially unstable as it entailed exposures to both funding and market liquidity risk as well as the use of a high degree of leverage (debt/equity ratios of over 200%). Given the business model, could Arcapita really have managed these risks much better? For example, the liquidity mismatch between the investment assets and the liabilities could have been mitigated by matching more closely the maturities of the latter to the likely exit dates of the former, thus reducing the refinancing risk. Shari'ah constraints on funding might, however, have made this more difficult. The use of Sukuk for bank funding was not developed at the time. On the other hand, the very much lower degree of leverage used by Arcapita following its exit from ch. 11 protection suggests that the extent of its reliance on leverage in its original business model involved an unnecessary risk, and hence inadequacy in CG.

In defence of Arcapita, however, it is worth reiterating that prior to the 2007-8 financial crisis the dangers of liquidity risk in banking did not initially receive the emphasis that was subsequently provided, for example, by the Basel Committee on Banking Supervision (BCBS) in its Basel III guidelines. In Basel II, the emphasis had been on capital adequacy and credit risk rather than liquidity risk. The BCBS *Principles for Sound Liquidity Risk Management* was issued in September 2008, but the more detailed guidelines on the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) were not published until January 2013 and October 2014, respectively. The Islamic Financial Services Board (IFSB) issued its *Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services* in March 2012 and its more detailed guidelines on the LCR and NSFR in April 2015. Moreover, in addition to the increased concern for liquidity risk management, there was a growing emphasis on stress tests. In May 2009, the BCBS published its *Principles for Sound Stress Testing Practices and Supervision*. This was followed by the IFSB's *Guiding Principles on Stress Testing for Institutions Offering Islamic Financial Services* in March 2012. Had the guidance in these publications, with the greater awareness of the dangers of liquidity risk and the need for stress testing, been available at an earlier stage of Arcapita's history, its board and senior management might have exhibited greater prudence and built more resilience into the business model.

Thus, awareness of the dangers of liquidity risk was less developed before the crisis and the attention given to such dangers in Basel III. It is said that it is easy to be wise after the event, with the benefit of hindsight. The same applies to the need for stress testing, which would probably have revealed the problems of the business model. The use of more equity capital and less reliance on borrowing to finance acquisitions would have mitigated the liquidity risk. However, it would have diluted the return on shareholders' equity and would effectively have constituted a change to the business model (in fact, such a change was indeed made following Arcapita's emergence from chapter 11 protection in 2013). Longer-term non-equity funds for banks in the form of Sukuk, which would have provided the more stable funding to match the maturities of Arcapita's assets, were developed in later years, but were not available prior to 2012 when the first issuance of such Sukuk was made by Abu Dhabi Islamic Bank.

6. Conclusions and Lessons

We may conclude that more effective oversight and strategic guidance from CG could have led to a more prudent strategy, involving a combination of better maturity matching and reduced reliance on borrowing, while retaining the essentials of the business model. However, the replacement of financing by equity capital would have reduced the returns on equity, thus making the business model less attractive for shareholders.

This paper has used the case of Arcapita to illustrate and analyse the relationship between CG and RM in the choice and ongoing evaluation of a firm's business model. As a Shari'ah-compliant Islamic investment bank, Arcapita had a particular vulnerability to liquidity risk, yet its business model in some ways aggravated this risk.

From the descriptions in Arcapita's annual reports, it would appear that the bank had instituted well-developed CG and RM systems. Yet these failed in the stressed conditions following the 2007-8 financial crisis. This implies that Arcapita's business model was basically fragile, owing to the combined exposures to market liquidity and funding liquidity risks, aggravated by the use of a high degree of leverage and a concentration of asset risks in the US. Arcapita's solvency was critically dependent on its ability to sell on a significant proportion of its acquisitions in a relatively short time. When it was unable to do so, it was faced with the impossibility of plugging the resulting liquidity gap, given its inability to refinance its $1.1 billion *Murabahah* liability.

Failing to reach a deal with its creditors to refinance a $ 1.1 billion *Murabahah* liability that was due on March 28, 2012, following the global financial crisis, Arcapita was driven to seek Chapter 11 redress in the US to protect its assets and investment from any legal challenge. The business model required a ready market liquidity that was not available in the stressed circumstances following the 2007-8 financial crisis, in order to exit from its investments and to cover its operating expenses through the investment cycle. The same circumstances left the bank unable to overcome the refinancing risk in respect of its 1.1 billion US$ *Murabahah* liability. The combination of exposure to market liquidity risk (aggravated by risk concentration) and funding liquidity risk resulted in Arcapita's insolvency.

Although Arcapita blamed both the global financial and Eurozone crises for its financial mess and inability to refinance its $1.1 billion *Murabahah* facility, it is clear an internal problem existed and not simply an external one. The CG and RM practices of the bank were not robust enough to overcome the inherent riskiness of its business model, which was mainly responsible for the failure leading to bankruptcy protection proceedings in the US.

To conclude, that the governance structure of Arcapita was not exactly weak, but in retrospect it was clearly not strong enough. Probably the main weakness was the failure to stress-test the business model's vulnerability to liquidity risk, which means that there was a failure of strategic guidance.

Hence, the alternative solution to the problem facing Arcapita was limited during the immediate aftermath of the 2007-8 financial crisis. For example, could Arcapita have done anything to prevent the debts (part of the syndicated Murababah) such as being sold to the hedge funds, which could result in acquiring them at 'fire sale' prices?. One needs to bear in mind that the options to avoid holding cash were few. The use of short-term Murabahah assets with other banks was one option. More recently, short-term Sukuk have become available through the International Islamic Liquidity Management (IILM) but did not exist at the time.

However, Arcapita's main problem was a dual squeeze: funding liquidity difficulties in having to refinance a high level of liabilities at a time when it was being squeezed by a lack of market liquidity for disposing of its investments, in the adverse conditions following the 2007-8 financial crisis. The syndicated Murabahah facility had a relatively short tenor, which meant a significant roll-over risk. Holding more liquid assets would not have helped. The answer would have been more stable funding. The Basel Committee on Banking Supervision, net stable funding ratio treats as 'stable' any financing with a residual maturity of at least one year, which may not be long enough to refinance a significant liability. Islamic finance has become more sophisticated in the last 10 years, with greater use by banks of Sukuk for financing. Typically these Sukuk are based on a form of Mudarabah with the Sukuk-holders claims on the underlying assets being subordinated to those of general creditors, as in the issuances of Abu Dhabi Islamic Bank and Dubai Islamic bank in 2012 and 2013.

In the absence of such solutions, to roll-over its existing Murabahah-based financing, Arcapita would have to rely on more Murabahah-based financing. But in the credit crunch following the 2007-8 financial crisis, it became impossible to refinance the US$1.1bn syndicated Murabahah financing. However, this is being said with the benefit of hindsight. The paper thus makes the further point that the innovations in prudential requirements introduced in Basel III, as regards liquidity RM, leverage and stress testing, met needs that were present but not met during the financial crisis of 2007-8 and the ensuing economic crisis. Moreover, developments in Islamic forms of non-equity funding, namely Sukuk, were not available prior to 2012. Thus, Arcapita's CG prior to its filing for chapter 11 protection displayed weaknesses and lacks that Basel III and subsequent developments were designed to address. From this perspective, arguably the main CG weakness of Arcapita was the failure of the Board to require the stress-testing of the business model's vulnerability to liquidity risk, which can be described as a failure of strategic guidance.

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