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Corporate Governance and Shariah Governance: Assessing from Takaful Operators in Malaysia

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Abstract

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The study reviews the relationship between corporate governance (CG) and Shariah Governance (SG) and examine how the governance concepts are handled in Takaful operators in Malaysia. The main question is how different or similar the governance concept applied in Takaful companies and make comparison between the theory and practises. This research compares studies on corporate governance and shariah governance in Takaful operators using a literature study approach. This research aims to extend the understanding of the roles played by CG and SG in their disclosure and how they contribute to the sustainability of Takaful operators. The analytical findings show that the unique contribution of Shariah governance as an additional governance measure for the purpose of Shariah compliance for the Takaful operators in Malaysia.

Keywords: *Corporate Governance, Shariah Governance, Disclosure, Takaful operators*

Introduction

The Malaysian economy's sustainable growth is significantly influenced by the takaful sector. Because of the increased risk associated with Takaful goods, the Muslim community anticipates that Takaful companies will place a high priority on corporate governance (CG) as Shariah compliant businesses. A higher benchmark of CG, greater transparency and disclosure are now required from takaful companies to strengthen stakeholders' confidence in their institutions which will result in less volatile and better performance. The objective of the paper is to highlight the comparison between corporate governance (CG) and shariah governance in Takaful industry. In addition, it investigates the role of CG and SG on the disclosure . The practices of CG and SG in other Islamic countries with presence of Takaful operators specifically in Southeast Asia (SEA) will be analysed in order to understand the key difference between CG and SG. The expected result is that the CG and SG mechanisms has important influence on the SG and CG disclosures of Takaful operators. This research aims to extend the understanding of the roles played by CG and SG characteristics in the disclosure, and how they contribute to the sustainability of Takaful operators.

Problem Statement

In order to help Malaysia's government achieve its goal of becoming the Islamic finance hub 2.0 under the first main economic growth areas, this research aims to explore the key distinctions between corporate governance and Shariah governance for the takaful industry. There are two main motivations behinds this research. First is the frequent reported financial scandal and fraud which resulted in corporate failures by some high-profile Islamic financial institutions (IFI) within the last two decades. Second, is the scanty research done in Takaful in governance despite its complex business model and Shariah reporting requirements which are different from insurance company which demand for greater transparency and its contribution to the growth of finance.

Islamic financial institutions (IFIs) have collapsed, as evidenced by the failure of Ihlas Finance House in Turkey in 2001, the commercial losses of Bank Islam Malaysia Berhad in 2005 (Parker, 2005), and the numerous fraud cases that resulted in losses for Dubai Islamic Bank between 2004 and 2007 (Abd Razak, 2018). Additionally, IFIs including Kuwait Finance House, Al-Rajhi Bank, Al-Hilal Bank, and Noor Islamic Bank of the United Arab Emirates were significantly impacted by the 2008 global financial crisis (Abd Razak, 2018). According to an analysis of past fraud involving IFIs, worker negligence, a lack of security, lax ethical standards, and, most importantly, failure of the CG and Shariah governance in IFIs which caused the majority of IFIs to fail are the most frequent sources of fraud.

While the above examples are mainly evidence from banking industry, there are several examples in the insurance industry including Islamic insurance industry (Takaful). Example in the insurance industry is the incidence where the U.S government had to bail out the giant American Insurance Group (AIG) due to excessive risk taking (Harrington, 2009). While in the takaful industry, the most recent case is Weqafa Takaful and Reinsurance Co., where some members of board of directors, audit and executive committees were convicted and fined SAR1.3 million in the lawsuit filed by the Capital Market Authority (CMA) in Saudi Arabia (Ramady, 2021). In the case of AIG, issues related to compensation packages for executive, roles and duties of board of directors, the practice of risk management within the company and the regulation impact had emerged following the crisis. The questioning of all these issues consequently lead to a large debate on whether the presence of effective monitoring mechanism could prevent managers from taking an excessive risk behaviour. The magnitude of the crisis added importance to how critical it is in finding an effective monitoring mechanism and implementing such mechanisms (Boubakri, 2011).

Demand for more openness is growing as a result of the takaful industry's quick development. Lack of transparency frequently has a detrimental effect on the share price of high-end takaful markets. Due to this situation, takaful operators are under increased pressure to voluntarily reveal financial information above and above what is necessary. Further, despite its rapid growth and importance, research on Takaful as a segment of Islamic finance is under-investigated.

For example, Khan et al. (2020) found that asymmetric information exists between the relationship between policyholders and takaful operators especially in assessing prices and quality of Takaful products. The implication is that part of current practices of Takaful operators may not be in line with the structure requirement for takaful operators which is different from conventional insurance. Thus, this asymmetric information issue may result in takaful operators are seen as only concern in maximising its own benefit and might damage takaful operator's reputation. Thus, the multi-layer of governance structure in takaful operators, (such as having board of directors, shariah supervisory board and Shariah Audit Committee) are aimed to provide monitoring and approving the operations of Takaful to ensure that the operations are in compliance to Shariah principles. Additionally, they must provide administration, product design, and contract enforcement; in the event of a breach, the entire transaction is donated to charity and maintained apart from other activities (Nasir et al, 2021).

Additionally, a distinct financial division between participant monies and takaful operator funds is one of the key aspects of takaful (Htay et al., 2013). These challenges motivate the researchers to conduct further research in this field of interest. Particularly, this research will investigate the role of corporate governance and Shariah governance in strengthening the Takaful firm's disclosure and performance, bearing in mind that disclosure is a reflection of CG and Shariah governance strength of Islamic financial institutions, including Takaful firms.

Literature Review

Definition of Takaful

Takaful is described as a "process of agreement among a group of persons to handle the injuries resulting from specific risks to which all of them are subject" by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). A process, thus initiated, involves payment of contributions as donations, and leads to the establishment of an insurance fund that enjoys the status of a legal entity and has independent financial liability. The resources of this fund are used to indemnify any participant who encounters injury, subject to a specific set of rules and a given process of documentation. According to AAOIFI (2015), the fund is managed by either a selected group of policyholders, or a joint stock company that manages the insurance operations and invests the assets of the fund, against a specific fee".

While the Islamic Financial Services Board (IFSB) specifies that "Takaful is derived from an Arabic word that means joint guarantee, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specific risks. In a takaful arrangement, the participants contribute a sum of money as a tabarru commitment into a common fund that will be used mutually to assist the members against a specified type of loss or damage" (IFSB, 2009).

According to all of the definitions of takaful, it can be said that it is a business model based on tabarru (donation) and ta'awun (mutual cooperation) in which a group of participants contribute a set amount of money to a pooled fund in order to provide mutual indemnity in the event that any of the participants suffers injuries that are specified in the mutual agreement.

Takaful industry

According to ICD-Thomson Reuters (2020), as at the end of 2019, the top five countries in Takaful assets are Saudi Arabia (USD17 billion), Iran (USD14 billion), Malaysia (USD10 billion), United Arab Emirates (USD3 billion) and Indonesia (USD3 billion). However, in terms of number of Takaful operators, the top five countries are Indonesia (52), Saudi Arabia (37), Iran (26), Pakistan (24) and Malaysia (21). While countries with highest Takaful assets to GDP are Brunei (112%), Iran (0.95%), Bahrain (0.93%), Saudi Arabia (0.87% and Bahrain (0.54%).
Accordingly, total assets of Takaful and Retakaful was USD51 billion which is only 2% of total Islamic finance industry with total 336 Takaful operators (including windows) in 47 countries. In terms of distribution of Takaful contributions by region, GCC contributed USD11.7 billion of Takaful contribution, followed by MENA (USD10.3 billion) and Asia (USD4.1 billion). In relation to Global Takaful Sector, General takaful dominates 73.9 percent (or USD19.3 billion) of the market while family takaful is only 26.05 percent or USD6.8 billions. According to Statista.com, GCC (USD11.7 billion) contributes the highest value of takaful contributions of the global Islamic financial services industry worldwide in 2019. This is followed by Middle East and South Asia (USD11.36 billion). South-East Asia is placed third with USD3.02billion.

Takaful performance

The literature on Takaful operator's performance has been growing for the last decades (for example Al-Amri, 2015; Alshammari et al., 2019;Kantakji et al., 2020).
Al-Amri (2015) investigated takaful technical efficiency in the GCC countries using panel data consisting of 115 firm-year observations between 2004-2009. He found that takaful industry in this region is moderately efficient and suggest further improvement specifically in technical, purely technical, cost and allocative efficiencies. Alshammari et al (2019) investigated the impact of competition on the cost efficiency of conventional insurance and takaful sectors in the GCC countries between 2009 to 2016 using a stochastic frontier cost function. They found that there is a positive relationship between competition and efficiency in overall and Takaful sample which supports Quiet Life hypothesis where managers in a less competitive market may utilise the market power of their firms and reduce their efforts.
A recent study by Kantakji et al. (2020) examines financial performance drivers of Takaful operators in Saudi Arabia, Malaysia, UAE, Qatar and Pakistan. They use two main performance measures which are net investment income and investment yield. They find that company size, GDP per capita, equity returns, and interest rate are positively related to performance. In contrast, liquidity and re-takaful dependence are negatively associated with performance.
The above review of performance of Takaful operators reveals that majority of performance measures that are unique to takaful industry such as various efficiency measures and financial ratios such as premium to surplus ratios, net investment income and investment yield.

Research Methodology

The literature study method is employed in this paper. The information gathered originates from a variety of publications and internet sources, including official websites pertaining to the theoretical and conceptual underpinnings of corporate governance and Shariah governance.

Discussion and Analyses

Corporate Governance (CG)

The problem of CG has gained widespread attention. Academics and business professionals are interested in CG. The system that directs and manages the firm, according to The Institute of Chartered Accountants in England and Wales (ICAEW), is CG. In order to safeguard the interests of several stakeholders, including shareholders, management, customers, and the government, corporate governance (CG) entails a number of procedures, rules, processes, practises, relationships, and regulations that must be in place. Internal and exterior CG mechanisms are included in CG (Wu et al., 2020). The most important internal CG mechanisms are thought to be the board of directors (BOD) (Fernandes et al., 2017). The BOD is in charge of the company's good governance. The Board of Directors serves as a connection in the relationship between managers and shareholders. In addition to limiting managers' opportunistic behaviour, the board protects the rights and interests of shareholders (Upadhyay, Bhargava, Faircloth, & Zeng, 2017).

Corporate Governance (CG) Mechanisms and Firm Performance of Takaful companies

The CG of IFIs should ensure equivalence to all stakeholders using greater transparency and accountability in accordance with the Islamic CG framework. In effect, CG for Islamic Financial Institutions (IFIs) stems from elements which mandate the conduct of business in harmony with the Shariah principles (Elsiddig, 2020). Hence, a central feature of the CG of an IFIs is ensuring Shariah compliance. Effective CG mechanisms may significantly assist in reinforcing IFIs (such as Takaful operators) and in empowering them to grow and play their part in the financial system successfully (Elsiddig, 2020). CG in IFI, specifically Takaful will become more important as their products become more complex.

The CG manages the manner in which firms are overseen, controlled and how accountability is assured. The effectiveness of CG characteristics in IFIs (such as Takaful operators) may assist the company in extending its purposes, and eventually will affect the IFIs' financial performance (Mollah et al., 2017). The CG system is one of the major keys to expanding effectiveness in business monitoring. The execution of the CG components is required to accomplish the parity of numerous interests.

On the other hand, good financial performance is crucial for IFIs (such as Takaful operators) to be able to sustain (Mollah & Zaman, 2015). According to Mollah et al. (2017), the governance structure in IFIs enables them to take more risks because their products are more complicated while still performing better. However, Islamic finance sustains a better capitalisation as compared to conventional ones. Mollah et al., (2017) study whether the distinction in governance structures impacts the risk-taking and execution of IFIs as contrasted with conventional financial institutions. In their study, Mollah et al., (2017) used 104 conventional banks and 52 Islamic banks from 2005 to 2013 in 14 countries. This study reveals that, compared to traditional financial institutions, IFIs' governance structures play a more significant impact on risk-taking and performance.

Haider et al., (2015) examine the various factor (board size, the number of board meeting frequency and AC size) in CG that impact the Islamic banks' firm performance in Punjab, Pakistan. The findings show a strong correlation between CG and the success of Islamic institutions. The performance of Islamic banks in Pakistan is strongly and favourably correlated with the size of the board of directors. The effects of SSB, board size, independence, CEO-chair duality, and internally recruited CEO on the performance of Islamic and conventional banks are examined by Mollah and Zaman (2015). This study used 86 Islamic banks and 86 conventional banks as a sample. The results show that the SSB size positively affects Islamic banks' performance. Li et al. (2014) used meta- analyses in their study. Based on the previous study, Li et al. (2014) conclude that Islamic finance tends to have enhanced financial performance if they are fulfilling the seven CG characteristics that have been measured. Unlike Islamic banking sector, there are limited studies on CG in the Takaful industry sector (examples Alshammari et al., 2019).

Karbhari et al. (2018) look into how efficiency and CG qualities affect international takaful operators. They discovered takaful operations to be ineffective. Among Takaful operators, managerial inefficiency is a common problem. They also claim that product diversification, audit committees, and non-executive directors do not increase technical efficiency. Additionally, they discover that the dual role of the CEO and chair, board size, organisational age, regulatory jurisdiction, and company size all considerably increase scale and technical efficiencies.

Shariah board, product diversification and institutional ownership improve scale efficiency. Alshammari et al (2019) examines the comparison between takaful and conventional insurance operators in terms of the impact of competition on the cost efficiency in GCC countries. They found that there is a positive relationship between competition and efficiency which support quiet life hypothesis. This result suggests that where market is less competitive, managers may use their market power to minimise their efforts in pursuing profitability. However, the results vary across business models, and between takaful and conventional insurance. There is a negative relationship between competition and cost efficiency for conventional insurance and positive for takaful.

Similar to this, Htay et al. (2013) use panel data from 2004 to 2007 to examine the relationship between cost effectiveness and board composition in non-life takaful insurance companies operating in 17 Islamic nations. They discovered that the relationship between board composition and other firm-specific features, such as board size, determines how much of an impact it has on takaful insurers' cost effectiveness. As a result, a number of firm-specific issues may make it more difficult to determine how corporate governance systems affect takaful insurers' ability to operate efficiently.

Financial disclosure transparency plays an important role in strengthening CG. According to Pratama et al. (2017), financial disclosure reduces information asymmetry between management and stakeholders and further increases stakeholders’ confidence towards firms’ operations. Taib et al. (2018) showed that there was a lack of transparency in financial reporting standards and internal control for Takaful operators in Pakistan, which supports the significance of financial disclosures.

In another study, Kasim (2012) found that the disclosures on the Shariah Supervisory Board (SSB) conform with the guidelines, but the practice is merely simple complying to rules rather than following the meaningful spirit of disclosure practices. In the case of Takaful operators in Malaysia, it was reported that the role of SSB is limited and constrained because majority of them are hired on part time basis where they are involved in every stage of product development.

Even though both Takaful and conventional insurance offers the same service (ie risk management) takaful business is more susceptible to agency issues. This is due to the fact that the design of Takaful products is more complex and the contractual relationships among the parties in the Takaful operations (policyholders and takaful operator). Due to these two issues, Khan (2020) argues in terms of incentives received by the takaful operators should also include surplus sharing (a share in the takaful surplus).

Thus, the most distinctive CG mechanism of IFIs including Takaful companies which sets it apart from conventional ones is the Shariah Supervisory Board (SSB). Three key functions of this system are counselling, controlling, and assuring. The first duty involves certifying financial items that are legal as well as explaining how to calculate the required Zakah (Islamic tax) (Htay et al. 2013). The SSB also has key responsibilities as an internal control mechanism, including assessing and monitoring IFIs' actions (Taib et al. 2018).

Thus, the SSB has generally been viewed as a generator of stakeholders' confidence and hence a possible booster of performance and market development. Mollah and Zaman (2015) also noted that there was a gap in the literature examining the effect of SSB on the performance of IFIs. Considering this brief review, it can be assumed that the SSB is one of the main CG mechanisms that increase the stability and as a consequence, the profitability of the IFI.

The AAOIFI standards recommended at least three SSB members, one of whom should have sufficient knowledge in understanding the issues in Islamic economics (AAOIFI, 2015). In addition, Farook et al. (2011) reported that scholars with a doctorate in business and economics were arguably better informed of the current implications of the economy on IFIs. Hence, this study combines the three SSB characteristics (SSB size, cross- membership of SSB and expertise of SSB members) into an index to measure its effectiveness. A higher SSB score would indicate that SSB is more objective, competent and effective. Therefore, Takaful operators with a higher SSB score would lead to better monitoring and control of the activities of the Takaful operators and consequently improves the financial performance. However, while the existence of an SSB may lead to greater monitoring, the financial performance may also depend on the effectiveness of the overall CG mechanism.

The literature on CG in Takaful is limited to theoretical perspective, with a number of empirical studies which are inconclusive (for example Karbhari et al., 2018; Abd Razak., 2018). Studies by Karbhari et al. (2018) and Abd Razak (2018) investigate if SSB enhances Takaful operator performance. However, it is not clear if the presence of SSB as an additional layer of CG has an impact to Takaful operator's profitability. Future studies are critical to investigate the structure of SSB and if additional governance layer improves performance of
Takaful compared to conventional insurance operator. The role of SSB is vital to ensure the risk-taking behaviour of Takaful operator is not excessive and negatively affect the policyholders. While there are studies on the impact of SSB on performance and risk taking behaviour of Islamic banks (Mollah and Zaman, 2015), similar studies in Takaful is critical and timely.

Corporate Governance and Disclosure

Multiple rules have been used to ensure that all information disclosed has to meet the criteria expressed (Fernandes et al., 2017). Since the IFIs were introduced, there have been many reforms in accounting, auditing, ethics, government and Shariah standards. IFIs around the world commonly use international standards such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which is responsible for the preparation of accounting standards and auditing standards (AAOIFI, 2015). The AAOIFI standards aim to promote transparency and comparability of financial statements to improve public confidence in Shariah's investment vehicles. Standards include the objectives, concepts and general presentation and disclosure in the financial report of IFIs including Takaful operators.

The following paragraphs will analyse the relationships between the characteristics of the CG (i.e., the size of the board, the board independence, the diligence of the board of directors, the size of the AC, the independence of AC, AC expertise and finally, the diligence of the AC) and disclosure. For board size, it is important to establish a rule that board size should be within a specific range, but not the exact number. Beasley (1996) and Dechow et al. (1996), find that the likelihood of a false statement occurring in the financial statement is greater when the board size is large. The large size of the board could cause problems of correspondence and coordination. However, in another study, Kent and Stewart (2008) find that the large board provides a higher level of disclosure information in the annual report. It is argued that larger boards possess more specialised skills and are better equipped to monitor management. Furthermore, Samaha, Khlif and Hussainey (2015) find that there is a significant positive association between board size and voluntary disclosure of the company. The large board size allows diverse experiences and opinions which potentially increase a supervisory board capacity, thus implying more voluntary disclosure. However, due to concerns about the role of the administration of Takaful operators in protecting the rights of stakeholders, this study argues that size of the board must be large as suggested by Samaha et al. (2015).

In relation to board independence, most of the studies (on the associations between board independence and disclosure are found to be positive. The results indicate that the increase in the independence of the board leads to the increased awareness to disclose more CG information to stakeholders or the public. An increase in board independence could accomplish a better controlling and monitoring of the activities of the management (Fuzi et al., 2016). While for board diligence, measured by frequent board meetings, has a positive relationship with transparency (Laksmana, 2008). Frequent board meetings would encourage greater information sharing among them.

Many researchers (Allegrini & Greco, 2013; Li, Mangena, & Pike, 2012) argued that AC diligence (frequency of meeting) has a positive relationship with the disclosure in the annual reports. Li et al. (2012) and Allegrini and Greco (2013) found that AC that conducts at least four meeting a year has a significant positive impact on the level of voluntary disclosure and intellectual capital disclosure. O'Sullivan, Percy, and Stewart (2008) state that the frequency of meeting can measure the audit quality. They also find that meeting frequency has a positive relationship with the decision to disclose information in the annual reports. Accordingly, this study argues that AC diligence has a positive influence on the disclosure of the Takaful operators. Hence, based on the above arguments, it is expected that a combination of good CG characteristics can lead to an increase in disclosures.

Disclosure in Takaful Companies

As for Takaful companies, we found that there are significantly lack of studies that examine CG and disclosures. The questions that arise here is whether Takaful operators behave similar to Islamic banks in respect of the behaviour towards both disclosures since both institutions are regarded as IFIs.

CG promote on the quantity of disclosure in the annual reports (Haniffa & Cooke, 2002). The board of directors in a company play an important role to release the information on time and to ensure the quality of data. Considering the importance of transparency factor (Haniffa & Cooke, 2002) which could affect the performance of the company, this study attempts to examine whether CG characteristics can predict the level of CG disclosure in the annual reports of the Takaful companies. In turn, good disclosure in the annual report may be able to positively influence the company's performance on the assumption that better disclosure, as well as timely information, can reduce the cost of capital and mitigate the information asymmetry as discussed by Lang and Lundholm (2000). There is limited study that examine CG disclosure. According to Zain et al. (2015), the strongest combination of CG characteristics in Islamic banks is correlated with a higher level of voluntary disclosure of CG. Another study by Srairi (2015) found that Islamic banks with a higher level of CG disclosure could lead to better performance as measured by ROA and ROE. Therefore, based on the above arguments, it is expected that Takaful companies with good CG characteristics will lead to increased disclosure and in turn, will achieve better company performance.

Shariah Governance (SG) Disclosure

The principles of Islamic finance place great emphasis on solid values and the structure of the CG, transparency of information and strict compliance with the principles of Shariah. The Shariah governance framework is a set of organisational mechanisms through which the IFIs ensure oversight, accountability and actual responsibility via the board, management and SSB (Shariah governance is a mechanism at the institutional, industrial and national levels that ensures an IFI is only involved in the Shariah- compliant activities, products and services (Chowdhury and Shanker, 2015). Shariah governance is equally important to CG since Shariah governance plays a significant role in ensuring the IFI's observance with the Shariah principles (Haqqi, 2014). To make sure that IFIs products and operations comply with Shariah principles, SSB plays an important role as a Shariah governance mechanism by advising and supervising the product and operation of the IFIs. The Shariah governance is important to ensure that IFIs follow the Shariah principles because not only it is demanded by the customers but also by other stakeholders. Using the same argument on the CG disclosure, Shariah governance disclosure is expected to influence Takaful companies' performance.

There are limited studies conducted on the Shariah governance and compliance and its impact on the business performance (Khamar Tazilah et al., 2017; Srairi, 2015). Khamar Tazilah et al. (2017) provides an in-depth discussion or meta-analysis to the understand the Shariah governance framework and their impact on the performance of Islamic financial institutions in Malaysia. This study argues that by strengthening the Shariah governance framework in Malaysia, public and investors' confidence will be increased and eventually increase the national economic growth. The relationship between Shariah governance and IFIs' performance shall provide further indicators that would benefit many interested parties to ensure the stability and credibility of the institutions. Hemrit (2020) also found that Shariah board positively affect the financial performance of Takaful operators in the Saudi Arabia. Thus, this study aims to extend the past studies by arguing that Takaful companies with good CG and SSB characteristics will lead to increased Shariah governance disclosure and in turn, will achieve better company performance.

Conclusion

The differences between corporate governance and Shariah governance have been extensively discussed in earlier works. This is clear from the history of corporate governance theories and their development to the Islamic paradigm of corporate governance. The following is the conclusion drawn from these earlier works: Shariah governance is critical for the progress of Islamic Financial Institution, not only to ensure investor and public confidence in the authenticity of the conduct and practise of Islamic finance, but also to minimise fiduciary and reputational risks to these institutions. In keeping with international standards, Shariah governance in Malaysia operates at both micro and macro levels.

In takaful industries, the main difference between CG and SG is the Shariah Supervisory Board. The Shariah committee at the institutional level plays a central role in Shariah governance. Based on the reviewed of prior literatures, the study can conclude that a good CG with additional measure of Shariah governance will lead to a better disclosure and performance of Takaful companies. The presence of Shariah governance will help in increasing the trust level needed, particularly for Shariah compliance companies. Furthermore, the unique contribution of Shariah governance through the Shariah Supervisory Board merits further studies. The index of Shariah governance can be further explored to see how it will affect the disclosure and the performance of Takaful companies. Due to its emphasis on Islamic banking in the SEA and GCC region, these studies specifically take into account the variations in social, economic, and institutional variables.

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