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## Islamic Corporate Governance in Islamic Financial Institutions

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### Abstract

From the previous literature, Islamic corporate governance is not something new and was brought into attention by Prophet Muhammad S.A.W., and mentioned in Al-Qur'an and Al-Sunnah. It is rife with principles concerning Tawhīd, freedom, and responsibility, as well as Taqwa to Allah S.W.T. Islamic banks is one of the category in IFIs that has been identified to face a greater challenge in corporate governance such as fraud, corruption, financial distress, poor supervision, poor leadership and other conflicts. As stated by Hassan (2012), all these cases show that the IFIs are not immune from the crisis and failures due to governance issues and conundrums. Therefore, the main focus of this study is to meliorate the present of corporate governance principles in Islamic Financial Institutions (IFIs) Malaysia stemming from the concept of corporate governance of IFIs based on *Al-Quran*, *Al-Sunnah* and *Maslahah (Maqasid Al-Sharia')* which align with the Islamic values. Thus, this research has applied qualitative as research design using case study approach to review the current principles of corporate governance in IFIs.

**Keywords:** Islamic corporate governance, Islamic banks, Islamic Financial Institutions.

### Introduction

Islamic banking assets in Malaysia had reached 27 percent or more than a quarter, of the total banking system, exceeding the targeted 20 percent under Central Bank Malaysia's financial sector master plan. In accordance with the plan, the country's Islamic finance industry has developed to become a key sector in the financial system. Moreover it was reported in the New Straits Time on Islamic finance assets; Malaysia, Saudi Arabia and Iran embrace nearly 65 percent of global Islamic assets in 2015.

Nevertheless, the firm said the sukuk market had been resisted in the past couple of years due to the global economic turmoil, which had caused absence of new players. It was reported, the sukuk market fallen to US\$66 billion (RM264 billion) in 2015 compared with US\$101.8 billion in 2014, a performance that was not foreseen by market players after completion 2014 on a strong note.

Moreover, the crucial of IFIs to drive the Malaysia economy to the highest level has been highlighted in the Eleventh Malaysia Plan, 2016-2020 (Economic Planning Unit, 2015). It is emphasized, the services sector, which includes the financial and banking has played the biggest role in economic development in Malaysia. The services sector, such as Islamic banking, Takaful, government service, electricity, water, transport storage communications will be remained as a main driver for the economic development in Malaysia. The plans have been created to trigger the effectiveness and competitiveness in the services sector.

Referring to the Tenth Malaysia Plan, the estimation of growth in services sector is expected in 6.3 percent per year, which considerably greater compared to the total average of Gross Domestic Product (GDP) at 5.3 percent. Following, the finance and insurance have contributed 22.3 percent of the year 2010 followed by the year 2015 with only 22.1 percent of total income in the services sector. The average of annual growth return, specifically in financial and insurance has been succeeded with 5.3 percent within five years' operation (2010-2015). Consequently, the new target for the next Eleventh Malaysia Plan (2016-2020) has been planned strategically with 6.9 percent for the next five-year improvement.

Thus, the importance of financial services in economic development has been given due recognition and are emphasized in the Eleventh Malaysia Plan (Economic Planning Unit, 2015) and among others. In tandem with that, the plan emphasizes on the efficiency and effectiveness of corporate governance with the broad-based approaches in order to sustenance the Malaysian economic development. The participation and commitment among shareholders is an essential in determining the corporate behavior along with the culture and integrity in social responsibility objectives. Therefore, the presence of the effectiveness and the efficiency of corporate governance are vital to be practiced in the business operation to curb the current problem in IFIs. Further, Dahlawi (2005) has been emphasized and proposed that all the business operations of IFIs must always be in compliance with Sharia'.

In sum, the study of the corporate governance system in IFIs is viable, indispensable and, in fact, beneficial, especially if it is explored qualitatively. Indeed, this brings into focus the analysis of study that needs to be carried out, to strengthening the corporate governance in IFIs, Malaysia, and stemming from the concept of corporate governance of IFIs based on Al-Quran, Al-Sunnah, Maslahah (Maqasid Al-Sharia').

### **Problem Statement**

The 2009 global economic downturn has called for an increased to promote good corporate governance around the world (Adegbite, 2012). However, there are some issues still actively debated among academicians, especially controversial about the efficiency of corporate governance and corporate accountability (Talamo, 2010). Haspeslagh (2010) states that the failure of corporate governance is due to greed, ambitious thinking and direct estimation, effective principal agent model, capital markets and confidence in mathematical models replacing judgment and in common, supervisory capacity and covering the developments of international financial markets. Mostovicz, Kakabadse and Kakabadse (2011) also underlined poor leadership of professional management, such as emotions, sensuality and corporality were the highlighted issues of the corporate governance.

For instance, the failure of Ihlis Finance (the first local bank in Turkey) in 2001 has led to the closure of the company due to the failure in management, control and regulatory (Ali, 2007).

Moreover, it was found that the majority of the Board of Directors (BOD) does not have a sufficient experience, unaware with the job tasks and bank faced the conflict of interest due to their role as clients and members. The weakness of BOD managing the challenges due to changes in regulations also accounts for the fraudulent practices of Ihlas Finance.

In contrary, for the case of Islamic Bank South Africa (IBSA), Islamic Investment Companies of Egypt (IICE), Dubai Islamic Bank (DIB) and Bank Islam Malaysia Berhad (BIMB) the governance issues were mainly due to poor corporate governance, poor internal control, poor management and trading. The weaknesses have led the closures of IBSA and IICE. In the case of BIMB, it was highlighted that the BOD was not competent and none of the board member was familiar with the banking industry, or in other words their roles not consistent with their academic and training backgrounds. For instance, as has been reported under the statement of corporate governance in Bank's Annual Report, board meetings are essential to discuss and deliberate important issues that relate to their business and affairs. Besides, to ensure the interests of stakeholders shall be protected and to maximize shareholders value.

Besides, there are several issues related to corporate governance that were also actively debated and predominantly discussed among scholars such as firm performance (Abdallah & Ismail, 2016; Abdel-Baki & Leone Sciabolazza, 2014; Mollah & Zaman, 2015; & Ghayad, 2008), role of governance in IFIs (Bukhari, Awan, & Ahmed, 2013; & Rashidah & Faisal, 2012), sustainability practices (Hashim, Mahadi, & Amran, 2015), disclosure information (Abdullah, Percy, & Stewart, 2015), and safeguarding of the interests of unrestricted investment account holders (UIAHs) (Muneeza, Hassan, Magalhães, & Al-Saad, 2012).

From the above cases in the view of practical and academics, it has shown the flaws and variations results of the corporate governance which not only occurs in Malaysia, but also around the globe. Given the fact that, although Central Bank has provided 14 principles under the Guideline of Corporate Governance BNM/GP1 for Financial Institutions whereas BNM/GP1-i specifically for Islamic Banks but unfortunately it remains continue to shake the business world (Ginena, 2015). It is argued the establishment of Guidelines on corporate governance might not be sufficient whereby there is a necessity to intensely reassess of corporate governance principles of IFIs (Sulaiman, Majid, & Ariffin, 2015). As suggested by Arshad and Rizvi (2013), it is crucial for corporate governance in Islamic banks to have a standardized rules, by the standard setting bodies of Islamic finance to tackle the problem of conventional governance weaknesses. Thereby, it is required to examine what are the lacking of the existing Guidelines that formed by Central Bank of Malaysia or what are the new principles should be added in order to strengthening the role of BOD and top management under the Guidelines of Corporate Governance for Islamic Banks.

Looking back at the 14 principles which has been formulated based on the three fundamental concepts such as transparency, accountability and responsibility (Central Bank, 2017), undeniably it much focuses on the role of BOD and top management, but not emphasizes on what are the elements of Islamic values that should be inserted in the Guidelines of corporate governance. In this regard, the motivation of this study is to meliorate the present of corporate governance principles in IFIs by interviewing a present top management such as Director, Chairman, President, Regulator and BOD in IFIs as well as Central Bank to give their thoughts and suggestions about the current practice of corporate governance to differ from the conventional principles.

Besides, it is hoped the findings are aligned with the Islamic values and also governed by the three main pillars which covers three relationships (Allah, human being and environment). With these added value principles, it is expected that the researcher can shed some light to further enhance and strengthen the credibility of corporate governance and finally to be adopted by IFIs Malaysia as well as internationally.

## **Literature Review**

### **Corporate Governance from an Islamic Perspective**

Corporate governance in the banking industry have been discussed primarily in the conventional perspective, where we find that the two main models – Anglo-Saxon model which emphasizes on shareholder value, and the stakeholder-centric European model – and their differences have been the subject of constant debate for years. However, not much have been written about the Islamic banking perspective despite the rapid growth of the industry since the mid-70s, and the mark it is continuing to make in financial markets globally (Yunis, 2007).

This study groups the available literature on IFIs' corporate governance into three categories: the first phase (before the 1980s), the second phase (1980s to 1990s), and the third phase (after the 2000s). In the first phase, there is a definite lack of studies on corporate governance, and no concern at all in any mainstream research, which is affirmed by Siddiqi (1981), Mannan (1984) and Haneef (1995) in their survey findings. However, the second phase is when discussions on the corporate governance of IFIs began to surface, which was started by individuals. An example is the survey by Abomouamer (1989), which focused on Sharia' control is Islamic law, and its role and responsibilities. Another example is Banaga et al. (1994) who did a research on external audit and corporate governance in Islamic banks.

The third phase is when conversations about corporate governance in IFIs started to flow. More individuals, organizations, and institutions started carrying out studies to address corporate governance issues, propelled by the failures of a number of IFIs in the 1990s and 2000s; such as the falls of Turkey's Ihlas Finance House, the Islamic Bank of South Africa and Islamic Investment Companies of Egypt. One such studies that stood out was by Chapra and Ahmed (2002), who focused their research on the roles of Sharia' boards, as well as the auditing, accounting, and frameworks of corporate governance in IFIs. Others include Al-Baluchi (2006) on IFIs' corporate disclosure methods, and Al-Sadah (2007), who studied corporate governance of Islamic banks, its components, the effect it has on stakeholders, and the role that supervisors of Islamic banks play. Meanwhile, IFSB released a survey on Sharia' Boards of Institutions Offering Islamic Financial Services across Jurisdictions in 2008 (IFSB, 2008), as well as Faizullah (2009) who talked about Islamic banks and its governance, as well as the transparency and standardization of the framework.

As numerous as the researches have been, there is still not much literature available that thoroughly studies corporate governance and its theoretical foundation from the views of Islam. Choudhury and Hoque (2004) did change it by deconstructing the framework of corporate governance from an Islamic perspective, which has shown that the theory is based on Tawhīd, or the 'Oneness of God. Similarly, Iqbal and Mirakhor (2004) also did the same, and recommended via their research the stakeholder value system, with a basis on the foundation of property rights and contractual obligation. Additionally, Safieddine (2009) also added to the existing studies by calling attention to the varieties in agency theory in Islamic banks amidst of all its uniqueness and

complexity. Even today, corporate governance is seen to be a great concern to IFIs, supervisors, regulators, and standards body internationally.

It must be noted that there isn't much difference between the definition of Islamic corporate governance to the conventional definition, as ultimately both are systems where organizations are managed, directed, and controlled as to achieve the objectives and goals set by said corporation, while protecting the interests of the stakeholders. What makes the Islamic perspective distinctive to conventional ones is some of its characteristics and features which are unique in comparison.

Choudhury and Hoque (2006) said that theoretical structure of corporate governance in Islam is basically a decision-making process based on the Tawhīd epistemology. They also made a point to note its practical implications, particularly when it comes to transaction cost minimization in environments where the decision-making process takes place, and when striving to achieve an organization's objectives within the confines of Sharia' permissibility (Choudhury & Hoque, 2006). As such, it is imperative to understand the Islamic point-of-view of governance as to ensure that any discussion of it is done with clarity.

### **Types of Institutions Operating Islamic Banking in Malaysia**

There are three types of Islamic financial institutions operating in Malaysia under its law. The first is Islamic banks that are licensed under IFSA 2013 (Muneeza & Hassan, n.d). These banks are full-fledged banks operating under an Islamic structure, such as BIMB and BMMB. As these banks are regulated under IFSA 2013, they are required to apply for licensing under the jurisdiction of the aforementioned Act.

Secondly are conventional banks offering Islamic banking services, or Islamic windows. They provide conventional banking and finance services, as well as Islamic ones. For this reason, they need to have a separate administration for both, as the Islamic-based services must comply with Sharia'. These types of institutions are established under Financial Services Act 2013.

The third category is banks that fall under the jurisdiction of Development Financial Institutions Act 2002 (DAFIA 2002), such as Bank Kerjasama Rakyat Malaysia Berhad, or also known as Bank Rakyat (Muneeza, Hassan, & Wisham, 2011). These banks were founded by the Malaysian government to provide financial assistance to develop economic sector in agriculture, SMEs, as well as in infrastructure (Hassan, 2011). According to Section 129(1) of the Act, these institutions are allowed to operate Islamic windows along with their existing operations, but must first gain approval from the Central Bank of Malaysia (Bank Negara Malaysia, or BNM) in order to do so.

Another type of financial institution that offers Islamic products and services are investment banks. These types of banks require two licenses in order to operate, namely a merchant banking license and a dealer's license. They are also required to be overseen by BNM who regulates their banking operations, as well as by Securities Commission Malaysia who observes their activities in the capital market. A full list of IFIs can be found online at Malaysia International Islamic Financial Centre's website (<http://www.mifc.com/>).

Irrefutably, it is claimed Islamic banks as one of the categories in IFIs has been identified to face a greater challenge in corporate governance such as fraud, corruption, financial distress, poor supervision, poor leadership and other conflicts which has been mentioned earlier in the Chapter One. As stated by Hassan (2012), all these cases show that the IFIs are not immune from the crisis and failures due to governance issues and conundrums. Thus, several questions have emerged

that need to be answered. Does Islamic banks fail to comply with the Principles that given by OECD? Does the guidelines provide by BNM was not sufficient? Do the stakeholders in Islamic Banks fail to understand comprehensively the Standard of corporate governance? Or another type of financial institution that offers Islamic products and services are investment banks. These types of banks require two licenses in order to operate, namely a merchant banking license and a dealer's license. They are also required to be overseen by BNM who regulates their banking operations, as well as by Securities Commission Malaysia who observes their activities in the capital market. A full list of IFIs can be found online at Malaysia International Islamic Financial Centre's website (<http://www.mifc.com/>). perhaps the implementation of standard or principles or guidelines on corporate governance was not successful? Therefore, it indicates that Islamic banks need to have a sound governance system an applicable strategy that will promote the adoption of strong, effectiveness and efficiency of corporate governance within the Islamic paradigm. Furthermore, it is vital to relook all the Standard/Guideline/Principles of corporate governance that has been established by a certain body to ensure it is sufficient for stakeholders in Islamic Banks to comply.

### **Methodology**

This research has applied qualitative as research design using case study approach and as defined by Yin (2009), case study research comprises the study of a case within a real-life context and examines a contemporary event or case in depth. The researcher starts by qualitatively to identify the concept and the criteria of Islamic corporate governance in IFI's Malaysia using document analysis. Next process, one of the most important sources of case study evidence is the interview which interviews are commonly found in case study (Yin, 2014). The purpose of interviewing is to allow the researcher to enter into the other person's perspective (Patton, 2002). Interview session will be conducted to ask an expert among top management, BOD or regulators from Islamic Banks which also represent the sample size of this study. Then, the data will be analysed using content analysis which will focus on books, documentation and text. Another aspect, the researcher will count how many verbs that frequently used during interview session with the purpose to do the coding process. Prior to that, triangulation method and peer review will be used to do the validation of the data. This process is crucial to ensure the data obtained is accurate and valid, and most importantly, it helps to answer research questions of this study.

### **Conclusion**

In conclusion, both the Western and Islamic views agree that corporate governance is a responsibility that must be met by any and all organizations. However, these corporate governance structures have different philosophies, Tasawwur, and concepts. Additionally, the conventional concepts have grown from Western cultures and faiths, which makes it conflicting with Sharia' and may be difficult to be implemented in Islamic corporations.

Consequently, as noted in previous literatures, Islamic corporate governance is not something new and was brought into attention by Prophet Muhammad S.A.W., and mentioned in Al-Qur'an and Al-Sunnah. It is rife with principles concerning Tawhīd, freedom, and responsibility, as well as Taqwa to Allah S.W.T. But more research and study on corporate governance are needed, as well as on its criteria, especially when it concerns Islamic finance.

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