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# A Comparison between Corporate Governance and Corporate Governance in Islamic Perspective

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**Abstract**
The corporate governance issues have been endlessly discussed in the wake of perpetual corporate scandals and crisis. Thus, the Malaysian government has indeed made several initiatives to strengthen the practice of Malaysia's corporate governance, where the Malaysian Code on practicing good Corporate Governance has been introduced in 2000, which was later revised in 2007 and 2012 with the objectives to strengthen the monitoring in the interest of shareholders of several systems. The concept of corporate governance can be explored from different sources, which most of the previous scholars exploring the corporate governance from conventional perspective compared to corporate governance from Islamic perspective. Moreover, the conventional of corporate governance has been influenced by cultures, faith and religion of Christian which grown in Western. Therefore, the main focus of this study is to discuss the comparison between corporate governance and corporate governance in Islamic perspective in the context of definition and role of corporate governance in Islamic Financial Institutions.
**Keywords:** Corporate Governance, Corporate Governance in Islamic Perspective, Islamic Financial Institution.

## Introduction

The corporate governance issues have been endlessly discussed in the wake of perpetual corporate scandals and crisis. Thus, the Malaysian government has indeed made several initiatives to strengthen the practice of Malaysia's corporate governance, where the Malaysian Code on practicing good Corporate Governance has been introduced in 2000, which was later revised in 2007 and 2012 with the objectives to strengthen the monitoring in the interest of shareholders of several systems (Zulkarnain, Shamser, & Mohamed Eskandar Shah, 2015).

On the other hand, since the establishment of the Islamic finance industry about 40 years ago, the issue of corporate governance has been constantly deliberated to ensure Islamic Financial Institutions (IFIs) serve the interests of various parties like the depositors, investment account holders, stockholders and the other general stakeholders. The difference between IFIs and the other organization like conventional banks and others lies in the objective of establishing IFIs which is to carry out business activities that are consistent with *Sharia'*. Whereas, for the conventional counterpart objective is to create and increase shareholders value throughout the time (Zulkarnain et al., 2015).

The concept of corporate governance can be explored from different sources, which most of the previous scholars exploring the corporate governance from conventional perspective compared to corporate governance from Islamic perspective. Moreover, the conventional of corporate governance has been influenced by cultures, faith and religion of Christian which grown in western (Franks & Mayer, 2004; Hansmann & Kraakman, 2001; O'Hara 2001). Therefore, the main focus of this study is to discuss the comparison between corporate governance and corporate governance in Islamic perspective in the context of definition and role of corporate governance.

**The Difference between Islamic Financial Institutions and Conventional Institutions**

Islamic financial institutions (IFIs) and conventional financial institutions have several differences that make them distinct from one another. To begin with, IFIs adhere to *Sharia'*, and as such strictly does not allow for any *riba'* (interest), *maysir* (gambling), and g*harar* (uncertainty) (Muneeza, Hassan & Wisham, 2011). Banks and customers are seen to have a relationship similar to business partners.

On the other hand, conventional institutions base their functions and operations on man-made principles that places importance on profit maximization and involve interests, rather than focusing on providing services (Muneeza, Hassan & Wisham, 2011). The relationship between a bank and a customer remains on a borrower-lender nature. The differences in fundamental principles between these two types of financial institutions are clear.

There is significance difference, too, in the way IFIs and conventional institutions deal with risk sharing (Muneeza, Hassan & Wisham, 2011). As mentioned earlier, Islamic banks hold a partnership-like relationship with their customers; thus, both share risks together instead of the customer bearing all the risks alone. But the relationship between institution and customer in conventional banks, on the other hand, is a relationship between a debtor and creditor where the environment does not encourage risk-sharing between the two parties.

One other difference is the requirement by IFIs to pay zakat, an obligation that conventional financial institutions do not share (Muneeza, Hassan & Wisham, 2011). Islamic banks and financial organizations are operating businesses; hence, they need to pay zakat, with the objective of purifying their businesses and conscience.

In IFIs, profit is just as important as in any other types of businesses and operations, but efforts to gain them needs to be guided by certain restrictions based on *Sharia'* (Muneeza, Hassan & Wisham, 2011). However, conventional institutions do not have such restrictions and operators will do all they can to maximize their earnings.

In conclusion, it is evident that despite the similarities, there are major differences between IFIs and conventional financial institutions. Given this fact, considerations must be made when dealing with either of these two financial products and services providers.

## Literature Review

### Corporate Governance from the Conventional Perspective

### Conceptual Definition

The discussion on corporate governance is not new and has been talked about for many years (Cadbury, 1999). There are many definitions to corporate administration, and the lack of agreement on its meaning has led to many different versions existing. Oxford English Dictionary (1989) has noted that the word 'corporation' came from the Latin word corpus, and means "a group of people authorized to act as an individual and recognized in law as a single entity". Meanwhile, in the Harcourt (2006) defined it as "a body that is granted a charter recognizing it as a separate entity having its own rights, privileges, and liabilities distinct from those of its members". At the same time, Blacks' Law Dictionary (2009) stated that 'corporation' in the legal term means "an artificial person or legal entity created by, or under the authority of, the laws of a country". From these three definitions, we can conclude that 'corporation' is a type of organization representing a group of individuals as an entity for specific reasons and purposes.

As for governance, the word also has a Latin origin, gubernare, meaning to direct or to govern (Cadbury, 2002). On the other hand, Lewis (2005) noted that it comes from a Greek word kyberman, which also has a similar meaning. The Oxford English Dictionary (1989) has a wider definition to the word to also include "act or manner of governing". Due to the broad meaning, these definitions can be applied to various areas such as politics, economics, social justice, and public administration. As such, the word can be generalized as the way an entity such as an organization, institution, or corporation is guided, steered, and controlled.

Thus, from the definitions derived, corporate governance can be categorized into a narrow sense and also into a much more expansive term. In the former, corporate governance can be considered as a formal system of accountability between shareholders and their agents in an institution, which includes BOD and senior management. As for the latter, it can be perceived as a network of relations – both formal and informal – that involves stakeholders in the firm, including but not limited to shareholders, management, employees, as well as the external community.

### 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.

Due to its role in promotion ideas of fairness, transparency, and accountability, it cannot be denied that corporate governance is one of the most important aspects in IFIs. As a matter of fact, the challenge is greater compared to conventional finance system due to the additional risks it poses. As such, it is highly recommended for Islamic banks and financial institutions to apply a governance system and strategies that are effective as to encourage the adoption of Islamic corporate governance. In light of this, this section will provide an overview of its foundational dimension, paying focus on the governance frameworks of IFIs. At the same time, it will attempt to shed light on the basics of Islamic corporate governance and to discuss any possible issues that can assist in clearing up the distinction between it and its conventional counterpart. The initial study is of the opinion that there are specific values and characteristics that Islam gives in corporate governance, with the purpose of upholding and maintaining social justice to both shareholders as well as stakeholders.

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.

**Role of Corporate Governance**

In an academic discussion on the issues of corporate governance in the United States of America (USA) by Macey (2004), it was noted that the main function of corporate governance is to reduce agency costs from mergers and hostile takeovers, which has since then included other areas as well, such as including the role of investors as corporate monitors to manage managerial incompetence and to maximize shareholder value. This is supported by Scott (2003), who said that corporate governance's purpose is to act as a set of legal guideline, incentives, and behaviors that upholds investors and shareholders' confidence to increase a firm's economic efficiency. Additionally, Selvaggi and Upton (2008), Black (2001) and Black et al. (2006) have all found evidence supporting the link between corporate governance and the performance of an organization.

Claessens (2003) considers corporate governance as crucial in the financial service industry, especially in figuring out the performance of a firm in terms of its ability to oversee access to external finance, to lower capital cost, to increase operational performance, to alleviate operational risks, and to improve stakeholders' relationships. A clear and definitive framework of corporate governance will be a beneficial contributor to a finance institution's performance, as well as to avoid any redundant agency cost, and to resolve any agency issues (Hart, 1995).

Other than the ones mentioned above, another important role of corporate governance is to encourage fairness, transparency, and accountability (Wolfensohn, 1999), not just among shareholders but stakeholders as well. This will allow an organization a better avenue to achieve their goals or objectives.

It must be reiterated that in the financial service industry, corporate governance is essential in the formation of policies as well as legal and managerial guidelines for the shareholders, managers, BOD, depositors, and also stakeholders. The larger the number of stakeholders in a financial institution, the more complicated it is, and the more it can affect the scope and framework. As a result, this brings attention for the need of codes and guidelines that can specifically cater to the special needs of the industry players.

**Role of Corporate Governance in IFIs**

A need for an efficient and effective governance system is very important in corporate governance, especially after the high-profile falls of many IFIs (such as Ihlas Finance House in Turkey, the Islamic Bank of South Africa and the Islamic Investment Companies of Egypt) and the difficulties some of the others face (Dubai Islamic Bank and Bank Islam Malaysia Berhad, to name a few). Islamic institutions are no less vulnerable to crises and issues that arises from governance-related problems like other organizations.

There isn't much difference between the roles of corporate governance in IFIs to other types of organizations, with promoting corporate fairness, transparency, and accountability as the main objectives. It is vital to have a good corporate governance to ensure that the rights and interests of stakeholders are protected fully. As such, this has been known to be the reason for the increasing attention the subject is getting, especially in firms in the finance industry (Macey and O'Hara, 2003). And, in the case of IFIs, the relationships that need to be maintained are not only the ones between stakeholders, shareholders, and BOD, but with God, as well. This is why Sharia' elements must be included in its frameworks, to accommodate to all of these needs and relationships equally.

It has been noted by Grais and Pellegrini (2006) that there are two corporate governance roles that are only for IFIs: to assure stakeholders of their organization's activities are in compliance to Sharia', and that they are committed to ensuring that they will improve their growth as well as their efficiency, stability, and dependability or trustworthiness. Hence, corporate governance reconciles these two roles as to make sure that they do not steer away from the original purpose of an organization, which is to maximize profits and at the same time safeguarding the stakeholders' interests.

Governance risk is one among many issues that implementation of corporate governance in IFIs can address. According to Iqbal and Mirakhor (2007), corporate risk is "the risk arising from failure to govern the institution, negligence in conducting business and meeting contractual obligations and from a weak internal and external environment", which is then further classified into different subcategories, namely operational, fiduciary, transparency, Sharia', and reputation risks. Risks in IFIs are unique and have complexities that are unlike conventional financial institutions, and thus a specialized and efficient system is needed to alleviate them.

As part of achieving this, IFIs must refrain from getting involved in any businesses or transactions that deal with riba (interest), gharar (uncertainty), speculation and maysir (gambling), and also staying away from investing in any illegal activities, as well as observing and respecting the Islamic morality or ethical codes. IFIs have the responsibility to assure their stakeholders and the public that their products and services as well as their operations are free from anything that is not permissible, and adhere to Sharia'.

**Conclusion**

Previous literatures have covered quite comprehensively the difference between conventional corporate governance and Islamic corporate governance. This is apparent from the background and the rise of Western corporate governance theories, to the corporate governance concept in Islam. The conclusion of these previous literatures is as the following:

Firstly, 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.

Secondly, 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.
Thirdly, to determine whether the corporate governance is practiced in IFIs based on the criteria of corporate governance.
In conclusion, it is evident that despite the similarities, there are major differences between IFIs and conventional financial institutions. Given this fact, considerations must be made when dealing with either of these two financial products and services providers.

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