

Shariah, Social Responsibilities and Corporate Governance of the Islamic Banks in Malaysia



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1. Letter of Report Submission

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30 June 2012

- i. Prof Dr Normah Omar
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Faculty of Accountancy
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Dear Professor

SUBMISSION OF REPORT FOR RESEARCH PROJECT FINANCED BY ACCOUNTING RESEARCH INSTITUTE (ARI) – RESEARCH CATEGORY: A (Institutional Research)

Your letters 100-RMI/ARI 16/6/2 (60/2010) dated 30 Mac 2012 and 20 August 2010 are referred.

I'm hereby submitting the final report for the research project financed by Accounting Research Institute titled Shariah and Corporate Governance Compliance by Malaysian Islamic Financial Institutions.

This report contains the information about the Shariah reporting and compliance reporting related to Corporate Governance by Malaysian Islamic Financial Institutions specifically Islamic banks. This report is based on explanatory study focusing only in the level and context of reporting.

It has been pleasure and challenging working on this report. Please feel free to contact me in case of clarification or queries on this report.

Yours sincerely,

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Dr Halil Paino
Project Leader

5. Report

5.1 Proposed Executive Summary

The demand for Islamic Financial Institutions (IFIs) is increasing. Not only Islamic Financial Institution, even, the conventional financial institutions have adopted Islamic principle in their system. This is because it can create trust and integrity to the stakeholders. Islamic Financial Institutions were introduced in Middle East countries as a new player in financial institutions industry (Samy and Vincent, (2007). Islamic Financial Institution is a financial institution that provides Islamic services or products according to the Islamic principle (Shariah). Shariah prohibited the activity which is contrary to Shariah principle such as charging interest (Riba'), pork, pornography, conventional finance service, arms and munitions, cinema, tobacco, gambling and alcoholic liquor (Samy and Vincent, 2007).

Through Shariah compliance, IFIs can convince their stakeholders on their services and products that they are free from prohibited elements. In respect to that, in 2003, Bank Negara has amended Central Bank of Malaysia Act 1958 and enhances the role and function of companies' Shariah Advisory Council (SAC) for Islamic Banking and Takaful (BNM/RH/GL/005-6, 2003, [online] accessed on 9 July 2010).

SAC is another independent board formed in the IFIs, besides Board of Director (BOD). This board is responsible to ensure the financial operations, policies and transactions are conformed the Shariah law. Not only that, the board may provide advices and source of references on Shariah matters to Board of Directors (BOD) and top management (Zulkifli,2006 ,Ousama and Fatima, 2010).

By having SAC in the Islamic Financial Institutions, good corporate governance framework can be established and may add value to the IFIs structure. Thus, this study will investigate to what extent SAC roles in the level of corporate governance compliance in the Islamic financial institutions. The measurement will involve the content analysis on the comparative disclosure and presentation relating to the 6 main elements of:

- a) *Performance Overview and Statement of Corporate Governance*
- b) *Disclosure of Shariah Advisory Board/ Committee and Zakat Obligations*
- c) *Report of the Shariah Advisory Board/ Committee*
- d) *Profit Equalization Reserves (PER)*
- e) *Classification of Deposits from Customers and Placements from Banks and Other Financial Institutions*
- f) *Presentation of the Income Statement*

5.2 Enhanced Executive Summary

The banking and other financial institutions play a key role in the economy of Malaysia. They provide a platform to facilitate the intermediation process in the financial system. The Islamic financial services such as Islamic banks operate under a different structure of corporate governance that one used in the conventional banking. An Islamic bank is obliged to appoint a board of Islamic scholars called *Shariah Supervisory Board or Shariah Advisory Council/Board (SAC)*.

Corporate Governance in financial institutions has been analysed almost exclusively in the content of conventional commerce industry. By contrast, very little is written on governance structures in Islamic banking and other Islamic financial institutions, despite the rapid growth of Islamic banks since 1970s and their increasing presence on world financial markets (Nasser M Sulaiman, 2000). Quoting the definition by Dr Zeti Akhtar Aziz (2002), *“corporate governance involves the manner in which the business and the affairs of the individual banking institutions are being governed by their board of directors and senior management, how the economic returns are generated to the owners, the day-to-day running of the operations of the business and the consideration of the interests of recognised stakeholders including depositors; and how they behave in a safe and sound manner, in compliance with applicable laws and regulations”*.

Islamic banking in modern world aims to promote and develop the application of Islamic principles, law and traditions to transactions of financial, banking and related business affairs. It is also promote investment companies to engage in such business activities that are acceptable and consistent with the Shariah concept. The main principles of Islamic banking are the prohibitions of interest (*usury*) in all transactions, the undertaking business and trade activities must be on the basis of fair and legitimate profit and the prohibitions of monopoly and hoarding. By doing so, Islamic banks will safeguard the Islamic communities and societies from activities that are forbidden in Islam. In Malaysia, with Bank Negara Malaysia (BNM) regulated as a central bank, currently there are 17 local banks registered as Islamic bank, 4 international Islamic banks and another 6 banks participated in Islamic banking scheme. There are various of products range such as general account, deposits, investment account, fund based, fee based, trade finance and card services.