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REVIEWING THE PRINCIPLES OF CORPORATE GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS: THE IMPORTANCE OF ISLAMIC VALUES

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ABSTRACT

The lack of theoretical and empirical research in investigating the principles of Islamic corporate governance in IFIs is the driving force behind this research, as part of the effort to address the issue and thus finding a better solution for corporate governance practices in IFIs within the Islamic financial industry. It is argued the establishment of principles on corporate governance might not be satisfactory whereby there is a compulsion to reevaluate the corporate governance principles of IFIs. Thus, the objective of this paper is to review the principles of corporate governance under the Guidelines on Corporate Governance for Licensed Islamic (GP1-i) in Islamic Financial Institutions. Furthermore, to identify the importance of Islamic values in corporate governance based on Al-Quran and Al-Sunnah. Generally, it is crucial for corporate governance in Islamic banks to have a standardized rules, by the standard setting bodies of Islamic finance to curb the problem of conventional governance weaknesses. IFIs as an Islamic organization that governed by the Islamic principles, must firmly monitor and fulfil their responsibilities as guided by the Islamic law of Sharia'. Thereby, it is required to review the principles of corporate governance which will be supported by the importance of Islamic values. It is hoped this study will contribute to a better understanding of the corporate governance issues of IFIs in Malaysia and to have a deepen analysis of corporate governance with a strong Islamic foundation which refers to Al-Quran and Al-Sunnah.

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1. Introduction

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). Therefore, the main focus of this study is to investigate the current of corporate governance principles in IFIs which will be supported by Islamic values based on Al Quran and Sunnah.

2. Background of the Study

Corporate Governance from an Islamic Perspective

Corporate governance in the banking industry has 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. As an example is the survey by Abomouamer (1989), which focused on Sharia' control in 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 Ihlal Finance House, the Islamic Bank of South Africa and Islamic Investment Companies of Egypt. One of the 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 is not much difference between the definition of Islamic corporate governance to the conventional definition, as ultimately both are the 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.

Reviewing the Principles of Corporate Governance

Many studies have explored corporate governance in different outlook which certainly to give a good effect towards shareholders’ value (Abdallah & Ismail, 2016). For instance, a study conducted by Magalhães and Al-Saad (2013) have done qualitatively to investigate the safeguarding of the interest of unrestricted investment account holders (UIAHs) in 12 IFIs from Malaysia, Kuwait, UAE and Bahrain based on the corporate governance principles. The findings revealed that the current practices implemented by IFIs in protecting the rights of UIAHs are not effective enough.

The principles of corporate governance also have been outlined by Central Bank Malaysia that intentionally to ensure sound corporate governance in licensed institutions. There are fourteen principles laid down by the Central Bank in the BNM/GPI (The Guidelines on Corporate Governance

for Licensed Institutions) which includes effective functions of the board, board composition, division of responsibilities, appointment process of the BOD, highly-skilled and knowledgeable directors, duty of board members to attend meeting regularly, periodical assessment, decision making, functions of shareholders and management, auditors, transparency and the final principle is the responsibility and accountability (Hasan, 2014). These principles also were exactly applied in the IFIs Malaysia that has coded as BNM/GP1-I, but unfortunately the outlined principles does not clearly injected the Islamic values such as tauhid, khalifah, ukhuwah, hisbah or any other Islamic values which has been stated in Al-Quran, Al-Sunnah and Maslahah (Maqasid Al-Sharia’).

Contrariwise, research by Bukhari et al. (2013) has empirically tested corporate governance dimensions that affect Islamic Bank, which BOD and SSB were found the most significant dimensions. The result indicates no significant difference is seen for the rest of corporate governance dimensions such as audit, investment account holder; and disclosure and transparency with Islamic banks and Islamic banking window. In addition, Hashim et al. (2015) have applied resource-based view (RBV) theory to examine the mechanism of corporate governance such as SSB, Board size, independent directors and organization mission and vision with the sustainability practices. It is expected by applying these mechanisms, especially when there is a greater number of SSB scholars and more people in the BOD, the organization tends to do more sustainability practices.

Subsequently, Abdel-Baki and Sciabolazza (2014) have designed corporate governance index (CGI) with the intention to increase financial performance and to ensure compliance with Islamic rulings. The CGI has been used to measure Islamic Banks that have put much an effort in boosting corporate governance for the past ten years (2001-2011). As a result, a positive relationship has shown between corporate governance and financial performance. While misaligned compensation structures for directors has been identified, and poor governance has led to high risk exposure. Equally, Malkawi, Pillai, and Bhatti (2014) have developed a CGI model for non-financial firms in examining the corporate governance practices in emerging markets of the GCC (Gulf cooperation Council’s) oil rich countries. Consequently, the result revealed about 30 internal governance characteristics has been grouped into three sub-indices; such as shareholder rights, board effectiveness and disclosure in order to complement good governance. Hence, the result also discovers that the firms listed in the United Arab Emirates stock markets exhibit the best adherence to the corporate governance attributes examined in the study followed by Oman, Saudi Arabia, Qatar and Kuwait, respectively.

Seeing all the above mentioned literature, it indicates the elements of corporate governance in IFIs has been practiced in respective countries. Although the principles of corporate governance has been established of each country, but it is argued the principles are not being supported with the Islamic core values such as tawhid, hisbah and others. Besides, it is argued limited studies concerns on the establishment of the practices criteria of corporate governance in IFIs based on Al-Quran and Al-Sunnah as well as a little ignorance of Islamic principles among scholars in explaining the corporate governance of IFIs. Moreover, it has shown there is no consensus agreement in forming the criteria of corporate governance in IFIs. It can be seen the term they used to measure the corporate governance is inconsistent such as mechanism, index, dimensions, and principles which has been presented at Table 1.

Table 1
The Elements of Corporate Governance in IFIs

Corporate governance	Magalhães, Es, R., & Al-Saad, S., 2013	Bukhari et al, 2013	Abdel-Baki & Sciabolazza, 2014	Hassan, 2014	Malkawi et al., 2014	Hashim et al., 2015	Mollah et al., 2015
Mechanism							
SSB						x	
Independent directors						x	
Mission and vision						x	
Board Size						x	
Dimensions							
BOD		x	x	x			
SSB		x					
Audit		x		x			
Investment account holder		x					
Disclosure and transparency		x	x				
Index							
Compensation schemes			x				x
Equity structure			x				x
Ownership and control			x				x
Governance teams			x				x
Board size							x
Independent directors							x
Female director							x
Board meeting							x
Board attendance							x
Board committees							x
Chair independence							x
Chair/CEO Split							x
Internal CEO							x
CEO qualification							x
CEO banking experience							x
CEO tenure							x
Disclosure							x
BOD effectiveness							x
Shareholder rights							x
Principles							
Fairness	x						
Accountability	x			x			
Discipline	x						
Independence	x						
Transparency	x			x			
Responsibility	x			x			

From the above Table 1 it has revealed, the most element of corporate governance that frequently being discussed are BOD, disclosure and transparency. The similarities of these two elements are being laid by several reasons; (1) Corporate governance must emphasizes the importance

of human resources that requires a good qualification (Abdel-Baki & Leone Sciabolazza, 2014) in dealing economic and financial activities with full of fairness and trustworthiness (Bukhari, Awan, & Ahmed, 2013). Besides, the stakeholders or shareholders have right to know the disclosure information in transparency manner about the financial position of their corresponding institutions (Hassan, 2014) (2) The duties of BOD to make a good decision making is essential as to ensure that the management and guidance can be done effectively in respective IFIs (Hassan, 2014). It can be successfully achieved by applying the concept of Shura or consensus in order to build up a positive culture and a decent attitude in the organization (Abdel-Baki & Leone Sciabolazza, 2014). In addition, BOD are responsible to draft inclusively the strategic objectives of the bank, guiding principles and codes of conduct (Abdel-Baki & Leone Sciabolazza, 2014).

Therefore, these two crucial elements (BOD; disclosure and transparency) considered amongst the important element of corporate governance in IFIs. While the other elements will be included after identifying the concept of Islamic corporate governance based on Al-Quran and Al-Sunnah and further, the Guidelines of Islamic corporate governance which encompasses three relationships (Allah, human being and environment) will be developed with the connection of Islamic values.

The Importance of Islamic Values

In view of the distinctiveness of the underlying principles and paradigm of the corporate governance in Islam compared with the Western model, there are several studies that attempt to construct an Islamic model of corporate governance. Unlike the Western concept of corporate governance, which is based on the Western business morality that derives from 'secular humanism', the study discovers that Islamic corporate governance is founded on the epistemological aspect of Tawhīd and the embedded Sharī'ah rules and principles where the former refers to the principle of consultation in which all stakeholders share the same goal of Tawhīd or the oneness of Allah (Choudury, 2004 and 2006) and the latter concerns an adoption of the stakeholder-oriented value system (Iqbal and Mirakhor, 2004 and Chapra and Ahmed, 2002). At this point it is worth discussing the foundational dimension and the main arguments of the Islamic corporate governance model, as identified in the literature, which are based on the four fundamentals Islamic values of Tawhīd, shura, property rights and commitment to contractual obligation that govern the economic and social behaviour of individuals, organizations, society and state.

Although there is consensus amongst Islamic economists and Muslim jurists on the concept of Tawhīd as one of the philosophical pillars of Islamic economics, it is observed that little is written on the Tawhīd epistemological aspect of the issue of corporate governance. Fortunately, Choudhury and Hoque (2004 and 2006) lay down the fundamental Islamic epistemology of Tawhīd in Islamic corporate governance.

As the foundation of Islamic faith is Tawhīd (Al-Faruqi, 1982), the basis for corporate governance framework also emanates from this concept.

Allah says in al-Qur'an "*Men who celebrate the praises of Allah, standing, sitting, and lying down on their sides, and contemplate the (wonders of) creation in the heavens and the earth, (with the thought): 'Our Lord! Not for naught Hast thou created (all) this! Glory to Thee! Give us salvation from the Penalty of the the Fire'*" (3: 191).

The praise by Allah upon the believers that remember Him standing, sitting, lying down, and contemplate the wonders of creation indicates the Tawhīd paradigm.

Another verse of al-Qur'an (51: 56) further points out the Tawhīd dimension in Islam as Allah says *"I have only created Jinns and men, that may serve Me"*. Both these verses indirectly provide the fundamental principles of governance, where everything created by Allah has a purpose and a human being is created to be the vicegerent of God on earth towards the Unity of God. By putting His trust in mankind as a vicegerent, Allah plays an active role in monitoring and being involved in every affairs of human beings and He is omnipresent and a knower of everything (Chapra, 1992: 202).

Allah states in al-Qur'an (31: 16) *"O my son! (said Luqman), if there be (but) the weight of a mustard seed and it were (hidden) in a rock, or (anywhere) in the heavens or on the earth, Allah will bring it forth: for Allah understands the finer mysteries, (and) is well acquainted (with them)"*.

As Allah knows everything and all mankind is accountable and answerable to Him, the Tawhīd paradigm therefore enhances the scope of firm's obligation and objectives to include a large group of stakeholders rather than the shareholders alone. Furthermore, it also denotes the concept of accountability, or taklīf, indicating that everyone is accountable to God for his own deeds. As such, the principle of taklīf that is derived from the supreme concept of Tawhīd should be the foundation of corporate governance in Islam.

Inspired by the paradigm of Tawhīd, which acknowledges the stakeholders as vicegerent, firms and corporate organizations have a fiduciary duty to uphold the principle of distributive justice via the shuratic process. There are numerous references in both al-Qur'an and al-Sunnah that oblige every single human being to practice the principle of shura in every aspect of their life.

Allah says in al-Qur'an (3: 159) *"So pass over (their faults), and ask for (Allah's) forgiveness; for them; and consult them in affairs (of moment). Then, when thou hast taken decision, put thy trust in Allah. For Allah, loves those who put their trust (in Him)."* Based on this verse, in explaining as to how important the concept of shura is, Chapra (1992: 234) mentions that the practice of shura is not an option but rather an obligation.

In the context of corporate governance, the constituent of shura provides the widest possible participation of the stakeholders in the affairs of the corporation either directly or via representatives. The constituent of shura's group of participants, namely the shareholders, the management, the BOD, the employees and the communities, plays a crucial role to ensure that all corporation activities not only meet all the firm's objectives but are also in line with the Islamic values. In this aspect, each organization of governance structure has its own unique function. For instance, the management and the BOD act as active participants and conscious stakeholders in the process of decision-making and policy framework. The decisions are made by considering the interests of all direct and indirect stakeholders, rather than maximizing shareholders' profit alone. The other stakeholders, such as the community, on the other hand, play their roles of providing mutual cooperation and stimulating the social wellbeing function of the corporation.

In deconstructing the foundational paradigm of corporate governance in Islam, Choudhury and Hoque (2004) summarize their model of Tawhīd and the shuratic process by referring to four principles and instruments governing Islamic corporate governance, i.e. unity of knowledge, the principle of justice, the principle of productive engagement of resources in social, and the principle of

economic activities and recursive intention. All of these principles are the main premises of the Islamic corporate governance, in which Sharī'ah rules embedded in al-Qur'an and al-Sunnah make the Islamic corporation market-driven and at the same time uphold the principles of social justice (Choudury, 2004: 57–83). Lewis (2005: 16–18) seems to support this approach by mentioning the essence of Tawhīd and the institution of a shuratic decision-making process and explaining how decision-making in business and other activities can meet Islamic moral values. He mentions that all resources are from Allah, ownership of wealth belongs to Allah and the individual is only a trustee who is accountable and answerable to Allah. The ultimate ends of business and economic activities, including the aims of the business organization, shall be in the direction of upholding the principle of Tawhīd.

Therefore, these implementation of corporate governance in IFIs must be focused to the main principles of corporate governance supported by Islamic values which underlined by al-Quran and al-Sunnah.

3. Conclusion

This chapter presented the principles of corporate governance in IFIs Malaysia and it has clearly shown, lack of studies have been done to review the principles of corporate governance. It has been proposed, to further strengthen up the the principles of corporate governance, Islamic values supported by three responsibilities (Allah, human and environment) should be embedded. The implementation of these three responsibilities in IFIs are requiring the Islamic values such as; Tawhid, Syura' and others are interrelated. In this line, the needs between three responsibilities and the Islamic values will strengthen the corporate governance and securely practiced in IFIs. Thus, corporate governance in IFIs can finally touch the basic regulations and rules in IFIs in order to fulfill the needs of stakeholders. Consequently, the implementation of principles of corporate governance with the trusted Islamic values can heal and recover the social problem whether in financial institutions or in community and to strengthen the economics of Muslims globally.

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