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Corporate Governance in Islamic Banks from an Islamic Perspective

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Abstract

Purpose - Corporate governance is crucial for the sustainable development of any corporate entity including Islamic banks. Islamic ethics, values and governance should be inbuilt in Islamic banking operations. The purpose of this paper is to discuss corporate governance from the Islamic perspective in relations to Islamic banking with special focus on Malaysia. This paper focuses on the structure of corporate governance, its implementation and relationship with *Shariah* governance and related parties in Islamic banking by addressing relevant issues and challenges.

Design/Methodology/Approach - The paper follows comparative analysis by taking into account the corporate governance, *Shariah* governance, their relationship and impact on Islamic banking institutions.

Findings - The result shows that corporate governance plays a significant role in Islamic banking for image building, goodwill, and performance and there exist a close relationship between *Shariah* governance and corporate governance for fulfilling the actual objectives of Islamic banking.

Practical Implications -This paper is very useful for understanding corporate governance (its framework, practices and relationship with *Shariah* governance) with a specific focus on Islamic banking institutions.

Originality/Value - The paper provides an in-depth knowledge of corporate governance, its importance and models with emphasis on Islamic banks. It adds value by explaining the complementing nature of *Shariah* governance with corporate governance for better performance and adherence to *Shariah* in Islamic banks. The nature of challenges and issues in implementation of corporate governance as well as the *Shariah* governance in IBIs are also discussed in the paper.

Keywords–*Shariah*, Corporate governance, *Shariah* governance, Islamic banks

Paper Type - Research paper

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1. Introduction

The order of this research paper is that the first part covers introduction of the topic under discussion and related terms, second part is the overview of the corporate governance, third part is about the corporate governance from Islamic perspective, fourth part focus on various corporate governance models around the globe, fifth part of the paper is about the relevant parties in the process of the corporate governance, sixth part explains the *Shariah* governance and its importance, seventh section of the paper discusses the *Shariah* governance framework in different jurisdiction and their comparison, eighth part elaborate the issues and challenges of corporate governance, ninth part is about the recommendation for the industry to improve the corporate and *Shariah* governance framework and the last part is conclusion.

Islamic banking has been defined as banking in consonance with the Islamic ethos and values of governance, in addition to the conventional methods of risk management of banking assets with good governance, by the principles laid down by *Shariah*.

Describing Islamic banking merely as interest free banking is a narrow concept denoting a number of banking instruments or operations, which avoid interest. Islamic banking, the more general term is esteemed not only to avoid interest based transactions, prohibited in the *Shariah*, but also to avoid unethical practices especially suppression of the borrowers or partners. In fact, the Islamic concept of banking actively participates in achieving the goals and objectives of an Islamic economy focusing more on human values.

The cases like Enron, Arthur Andersen, Baring bank, Fannie Mae, WorldCom and many more were the key factor for bringing up the issue of corporate governance into lime light. In organizations, management, companies, banks, business entities, the importance of governance rather corporate governance is the key to good results and cannot be denied. It is equally true in the case of Islamic financial institutions and business organization.

This paper particularly explains how the corporate governance is practiced in Islamic banks from Islamic perspective with special emphasis on the *Shariah* governance. Unlike conventional banking system, the Islamic banks operate under different corporate governance framework as

it's compulsory to appoint *Shariah* Supervisory Board, *Shariah* Advisor or *Shariah* committee as per the jurisdiction requirement in which they operate their business.

Power is of one of the important factors in the corporate governance. Who holds the power of decision making in the organizations, how power is delegated, used, and controlled by the power holders. Although power brings the responsibility of decision making yet if it is absolute power it corrupts as well. Hence it is worth discussing the issue of power because from Islamic point of view all the powers are with Almighty Allah SWT. And human beings are vicegerent of Allah. So, the one who has the power will be not only answerable to the stakeholders but also to Allah SWT as well.

Dr. Zeti Akhtar Aziz (2002) defined corporate governance as "corporate governance involves the manner in which the business and 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 recognized stakeholders including depositors; and how they behave in a safe and sound manner, in compliance with applicable laws and regulations".

Transparency, disclosure and accountability are considered three major ingredients for the good corporate governance.

2. Overview of corporate governance

History of Corporate Governance in the United Kingdom

- The Cadbury Code (1992) focused on board of directors, non-executive directors, executive directors (service contracts and remuneration) and the accounts of the company.
- The Greenbury Report (1995) focused on director's remuneration and service contracts, disclosure about remuneration and the remuneration committee report.
- The Hampel Report (1998) main focus was on the directors, their remuneration, shareholders, accountability and audit.
- The 1998 Combined Code centered on the principles based guidance: 'comply or explain'.
- The Turnbull Report (1999) focused on the directors and their responsibilities.
- Director's Remuneration Report Regulations (2002)
- The Higgs Report (2003) center of attention was the board, the chairman and non-executive directors.
- The Smith Report (2003) focus was on the audit committee and audit of the company.
- The 2003 Combined Code
- The Combined Code and Institutional Investors
- Corporate Governance Guidelines for non-listed companies

Governance' refers to the way in which something is governed and to the function of governing. 'Corporate governance is the system by which companies are directed and controlled' (Cadbury Report, 1992).

A lot of work is done on the corporate governance in the west. Though the concept of corporate governance is not new to Islam but the discussion on corporate governance from Islamic perspective is not very old. In United Kingdom many reports, code of corporate governance were developed and published. The table on the right covers the brief history of corporate governance

in UK. The history reveals that the corporate governance was issue of concern even in 19th century.

The Organisation for Economic Cooperation and Development (OECD) is an international body established in 1998 for helping countries particularly developing economies in order to advice them to adapt to the demands of international economy. The OECD mentions in its preamble to the Principles that a close link among economics and institutional structures and one way of recuperating a country's economic efficiency is through the development of good corporate governance. Following are the OECD six sections:

- Ensuring the basis for an effective corporate governance framework
- The rights of shareholders
- The equitable treatment of shareholders
- The role of stakeholders
- Disclosure and transparency
- The responsibilities of the board

Many parties are involved in the organization/corporate working. For a successful organization, all the relevant parties should be given their due right in the best possible way. Corporate governance is all about ensuring smooth running of the organization, monitoring its activities and justifying all the needs of the stakeholders which includes, organization itself, employees, managers, directors, regulators, financiers, suppliers, shareholders, society and public at large, in a transparent manner.

Another definition of corporate governance is "the process and structure used to direct and manage the business and affairs of the company toward enhancing business prosperity and corporate accountability with the ultimate objectives of realizing long-term shareholder value, while taking into account the interest of other stakeholders". It is not a matter of touch and go rather the corporate governance is a continuous process by which the organizations are controlled, directed and aligned to their objectives. Corporate governance basically helps remove the issues of moral hazards, asymmetric information, inefficiencies of management. The corporations are accountable to the public and their shareholders. Primarily, the accountability is to take care though corporate governance. The reason why the corporate governance is gaining

so much importance as a yardstick is because it ensures honesty, trust, openness, responsibility, accountability, independence, fairness, reputation and any risk to reputation, ethical conduct, etc. there are many parties involved in corporate governance like, shareholders, organization itself, board of directors, management, employees, regulators, and for Islamic banks we need to add *Shariah* board of the Islamic bank to make it a fool proof system. It is important to mention that there is difference in management and governance of the companies including Islamic banks as the earlier drives while the later guides the stake holders.

Corporate governance is a burning issue even for the conventional financial system so when it comes to Islamic banks, it becomes even more important. The corporate governance becomes more important in Islamic financial system because Islam is a religion that imparts cohesive guidance accompanied by inbuilt system of corporate governance in all directions, proceedings, actions and business. There is no doubt that the sound governance of Islamic *banks* has the proven capacity to help Islamic banks for discharge of responsibilities the smooth transferring of the funds from the surplus units to the deficit units and improve the economic conditions of the country. Financial institutions deal with the money which potentially carries a risk. The money matters always require credibility, clarity, and a transparent system especially in the banks to make things, credible, simple and transparent. Generally speaking there is always a room for a bad play in the financial institutions if there are some lose ends, It is the *Shariah* based financial system that plugs the possible loopholes in the financial regime and that is why the focus of corporate governance is pre-requisite in the financial institutions. A failed financial institution not only shatters the confidence of the stakeholders but creates a mess in the whole society.

3. Corporate governance from Islamic perspective

"SLM" is the Arabic root word of Islam and it means peace. This peace is achieved by total submission, surrender, and obedience of one's self to Allah SWT. Islam is a complete code of life. *Shariah* adequately cater all the needs of human beings and have provisions to guarantee good, of mankind in all situations, at present and in future. Generally, *Shariah* means Islamic *law*. It refers to all rules and regulations that Allah (*SWT*) has legislated and is founded upon the primary sources, namely *Al-Quran* and *Al-Sunnah*. In order to apply these rules based

on the primary sources, the Islamic jurists will endeavour to formulate rulings based on their knowledge and understanding of the primary sources, which are supported by other secondary sources like *qiyas*, *maslahah*, *istihsan*, *istishab*, *sadd zari`ah*, *`urf*, *maqasid al Shariah* and many more. Islamic concept of corporate governance is different because it is based on Tawhid. Tawhid is a very complete concept, entailing complete surrender of oneself to the one and unique being, who is the creator, sustainer, owner of everything, all-knowing, all-wise, and the most powerful. Another important factor is Risalah, an institution of Prophet Hood, which is the revealed guidance in all aspects of human life from Allah SWT in the form of the Holy Quran, and reveals its application through practice which is evident in the form of Sunnah. Akhirat means the life hereafter for answerability, and for getting the outcome of all actions including economic activities done by the humans, in an eternal life. Man is the *khalifah* of Allah SWT or vicegerent on earth and the resources at his disposal are a trust (*Amanah*). Man is answerable to Allah SWT for all his deeds and sayings so, he must make judicious use of his powers in accordance with the will of Allah SWT and that is soul of corporate governance which is the soul and spirit of Islamic way of governance.

يَتَأْتِيهَا الَّذِينَ عَامَنُوا إِذَا تَدَايَنْتُمْ بِدَيْنٍ إِلَىٰ أَجَلٍ مُّسَمًّى فَاكْتُبُوهُ
 وَلْيَكْتُب بَيْنَكُمْ كَاتِبٌ بِالْعَدْلِ وَلَا يَأْب كَاتِبٌ أَنْ يَكْتُبَ كَمَا عَلَّمَهُ
 اللَّهُ فَلْيَكْتُبْ وَلْيُمْلِلِ الَّذِي عَلَيْهِ الْحَقُّ وَلْيَتَّقِ اللَّهَ رَبَّهُ وَلَا يَبْخَسْ
 مِنْهُ شَيْئًا فَإِن كَانَ الَّذِي عَلَيْهِ الْحَقُّ سَفِيهًا أَوْ ضَعِيفًا أَوْ لَا يَسْتَطِيعُ
 أَنْ يُمِلَّ هُوَ فَلْيُمْلِلْ وَلِيُّهُ بِالْعَدْلِ وَاسْتَشْهِدُوا شَهِيدَيْنِ مِنْ رِجَالِكُمْ
 فَإِن لَّمْ يَكُونَا رَجُلَيْنِ فَرَجُلٌ وَامْرَأَتَانِ مِمَّن تَرْضَوْنَ مِنَ الشُّهَدَاءِ أَن
 تَضِلَّ إِحْدَاهُمَا فَتُذَكِّرَ إِحْدَاهُمَا الْأُخْرَىٰ وَلَا يَأْب الشُّهَدَاءُ إِذَا مَا دُعُوا
 وَلَا تَسْعَمُوا أَنْ تَكْتُبُوهُ صَغِيرًا أَوْ كَبِيرًا إِلَىٰ أَجَلِهِ ذَلِكُمْ أَقْسَطُ عِنْدَ
 اللَّهِ وَأَقْوَمٌ لِلشُّهَدَةِ وَأَدْنَىٰ أَلَّا تَرْتَابُوا إِلَّا أَنْ تَكُونَ بَجَرَةً حَاضِرَةً
 تُدِيرُونَهَا بَيْنَكُمْ فَلَيْسَ عَلَيْكُمْ جُنَاحٌ أَلَّا تَكْتُبُوهَا وَأَشْهِدُوا إِذَا
 تَبَايَعْتُمْ وَلَا يُضَارَّ كَاتِبٌ وَلَا شَهِيدٌ وَإِنْ تَفَعَّلُوا فَإِنَّهُ فُسُوقٌ بِكُمْ
 وَاتَّقُوا اللَّهَ وَيُعَلِّمُكُمُ اللَّهُ وَاللَّهُ بِكُلِّ شَيْءٍ عَلِيمٌ ﴿٢٨٢﴾

O you who believe! when you deal with each other in contracting a debt for a fixed time, then write it down; and let a scribe write it down between you with fairness; and the scribe should not refuse to write as Allah has taught him, so he should write; and let him who owes the debt dictate, and he should be careful of (his duty to) Allah, his Lord, and not diminish anything from it; but if he who owes the debt is unsound in understanding, or weak, or (if) he is not able to dictate himself, let his guardian dictate with fairness; and call in to witness from among your men two witnesses; but if there are not two men, then one man and two women from among those whom you approve of the witnesses, so that if one of the two errs, the (second) one of the two may remind the other; and the witnesses should not refuse when they are summoned; and disdain not of writing it (whether it is) small or large, with its fixed time; this is more equitable with Allah and assures greater accuracy in testimony, and the nearest (way) that you may not

entertain doubts (afterwards); except when it is ready merchandise which you give and take among yourselves from hand to hand, then there is no blame on you in not writing it down; and have witnesses when you trade with one another; and let no harm be done to the scribe or to the witnesses; and if you do (it) then surely it will be a transgression in you, and fear Allah; and Allah teaches you; and Allah knows all things.

❖ وَإِنْ كُنْتُمْ عَلَىٰ سَفَرٍ وَلَمْ تَجِدُوا كَاتِبًا فَرِهَيْنَ مَقْبُوضَةً فَإِنْ أَمِنَ بَعْضُكُم بَعْضًا فَلْيُؤَدِّ الَّذِي أُؤْتِمِنَ أَمَانَتَهُ ۖ وَلْيَتَّقِ اللَّهَ رَبَّهُ ۗ وَلَا تَكْتُمُوا الشَّهَادَةَ ۗ وَمَنْ يَكْتُمْهَا فَإِنَّهُ عَنِ اللَّهِ ۗ وَاللَّهُ بِمَا تَعْمَلُونَ عَلِيمٌ



And if you are on a journey and you do not find a scribe, then (there may be) a security taken into possession; but if one of you trusts another, then he who is trusted should deliver his trust, and let him fear Allah, his Lord; and do not conceal testimony, and whoever conceals it, his heart is surely sinful; and Allah knows what you do. (Al-Baqarah 283)

The above two Quranic verses emphasize the need of book-keeping and putting all contracts into writing so that there will be no harm and unjust in the society. All the dealing should be transparent, open and written. This will lead to a prosperous and successful society. The business dealing will be just and fair for all. So, everyone will be held accountable for his own actions and responsibilities. Once everything is clear then the duties, responsibilities, functions and accountability of the parties will be transparent. There will be no dispute among the related parties.

The Holy Prophet PBUH said that "Each one of you is a guardian, and each guardian is accountable to everything under his care". If we apply the above Hadees in our business dealings then it explains about the conduct of human behaviour. That one should behave in the proper way, as he will be held accountable for his deeds, decisions, actions and dealings with others. Corporate governance is the process in which it is ensured that the actions taken by the people

are with due diligence and in best favour of all the related parties. This shows that human beings are accountable and they are given the trusteeship.

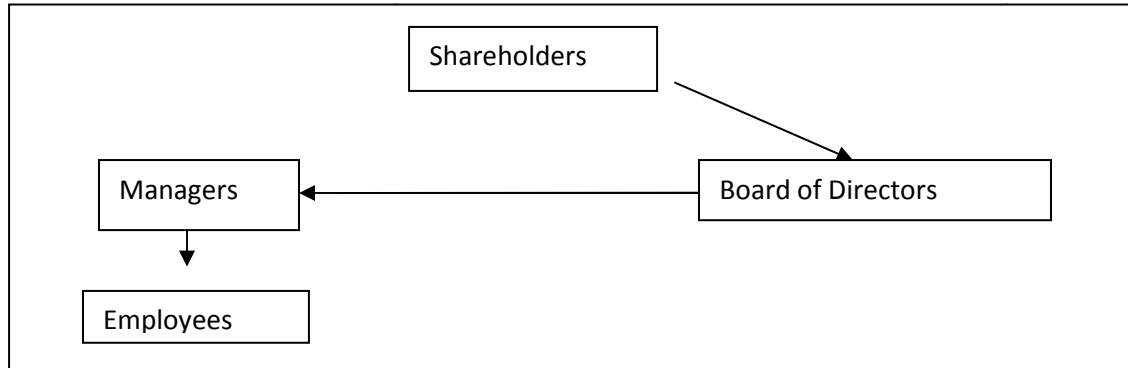
The three main areas of corporate governance stressed in Islam are accountability, transparency and trustworthiness (Mustapha and Salleh, 2002).

4. Corporate Governance Models

The main reasons where issues of corporate governance arise are agency problem or conflict of interest between the management, directors, shareholders and regulators. The cost of these two agency problem and conflict of interest become so high for the affected parties that they cannot ignore it. The underlying principle of the existing corporate governance systems of Anglo-Saxon, the European model and others are the issues of agency problem and conflict of interest. Every model of corporate governance has its own structures, features and objectives. The concept of Islamic model of corporate governance is totally different because in Islam religion is not separated from the financial activities or any activity of life.

4.1 Anglo-Saxon Model of Corporate Governance

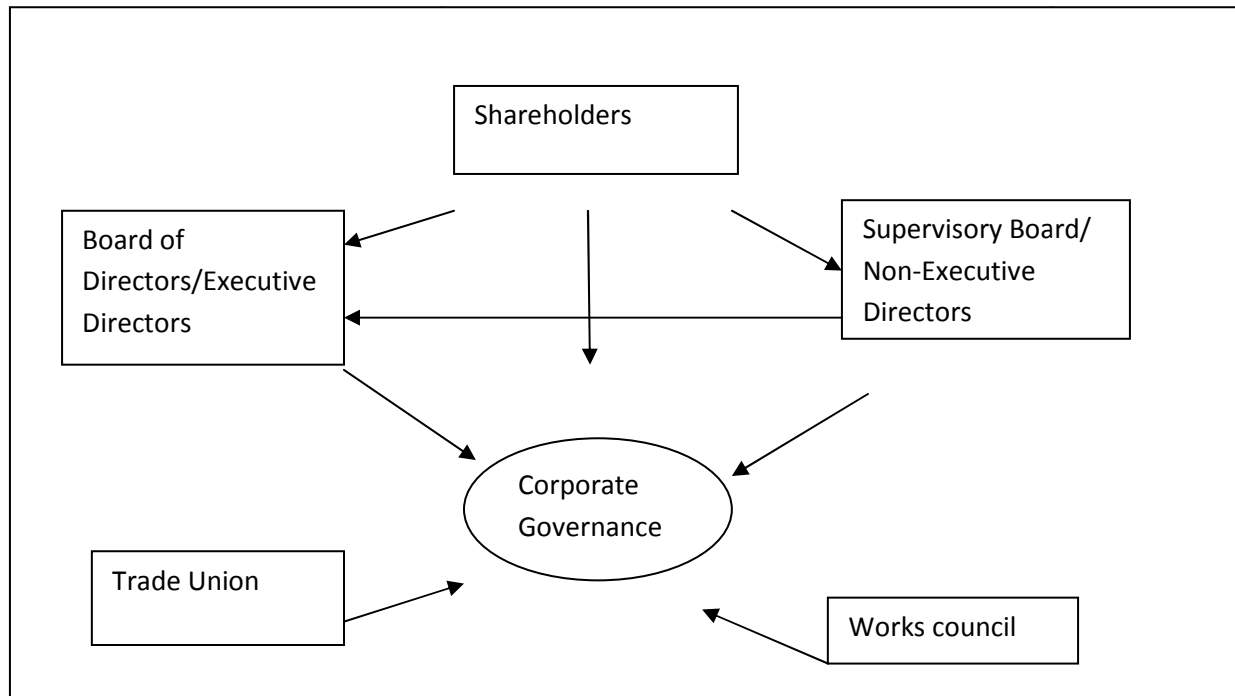
Anglo-Saxon model of corporate governance is also famous as shareholder-value system. This model is mostly used in USA, UK but some organizations who are concerned for the shareholders system practiced this mode in countries like Canada, South Africa and Australia. The shareholder view remained popular in corporations for quite some time. The gist of the shareholder value system is that the owners and investors of the firm are like the customer's of the firm. Hence from the corporate governance perspective, the benefit from firm should not only be given to the customers but also to the shareholders.



Source: Cernat, (2004:153)

4.2 Corporate Governance of the European Model

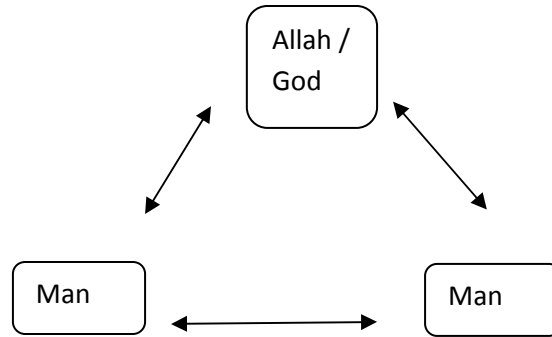
The Anglo-Saxon was criticized by the industry/academics then a new model came known as stakeholders' model or European model. In European model the companies raised funds from the banks and build a strong relationship with the corporate clients. This model is based on the relationship-based model. This model is practiced in countries like Greece, France and etc. The stakeholder model has two boards namely board of directors which comprise of Executive/management directors and the other is Supervisory board which includes outside directors for the benefit of all stakeholders.



Source: Cernat, (2004: 153)

4.3 Islamic Model of Corporate Governance

The foundation of Islamic corporate governance is Tawhid. The corporate governance model of Islam take into account the all stakeholders involved in the process but most importantly the dealings with the God. In Islamic bank an employee is answerable for his actions and deeds to the management of the bank, board of directors, customers but he is also answerable to Allah SWT. Apart from this all the activities, business and conduct of the Islamic bank should be in compliant to *Shariah*. This is why the role of *Shariah* board/*Shariah* Advisor/*Shariah* committee is very crucial for the success of Islamic *bank*. Because the *Shariah* board of the Islamic bank will make sure that all the products, services even the behavior of the employees are in accordance to *Shariah* or not. The goals of Islamic bank are to provide the financial services in accordance to *Shariah* to give the benefit to society at large.



5. Relevant parties in Corporate Governance

The role of the corporate governance in the western, American and other countries is to provide justice and fairness, transparency, accountability for all the shareholders and relevant stakeholders. In America the role of corporate governance was considered important mainly in mergers, acquisitions, hostile takeovers and later on it emerged as the maximization of the shareholder's value. The end result of the corporate governance is to make the firm economically efficient. The corporate governance in Islam as well as the corporate governance term used in the west plays an important role in the achievement of the goals of the firms in the efficient, effective and harmless way. But Islam put a special emphasis on the corporate governance to achieve the *Maqasid al-Shariah*. The following parties are involved in the corporate governance, when we focus on the western idea of corporate governance

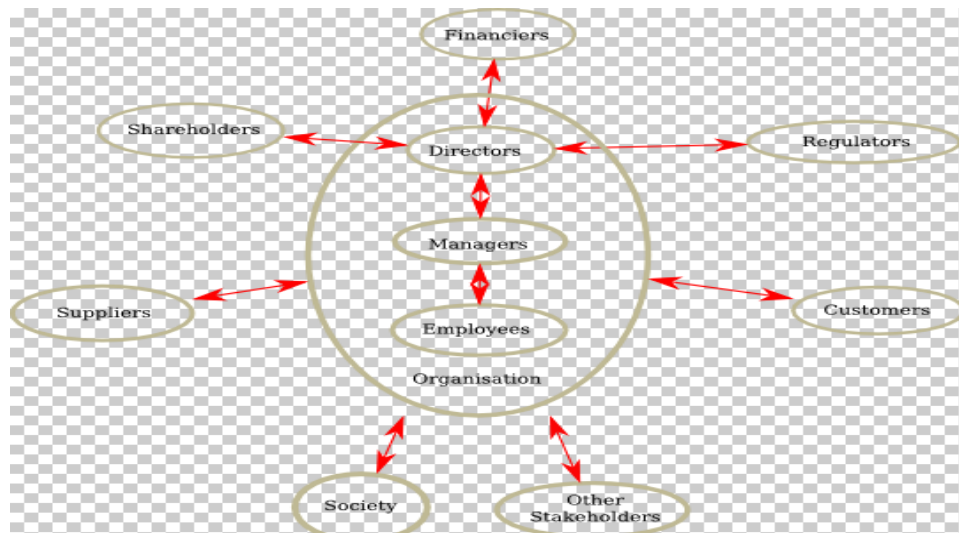
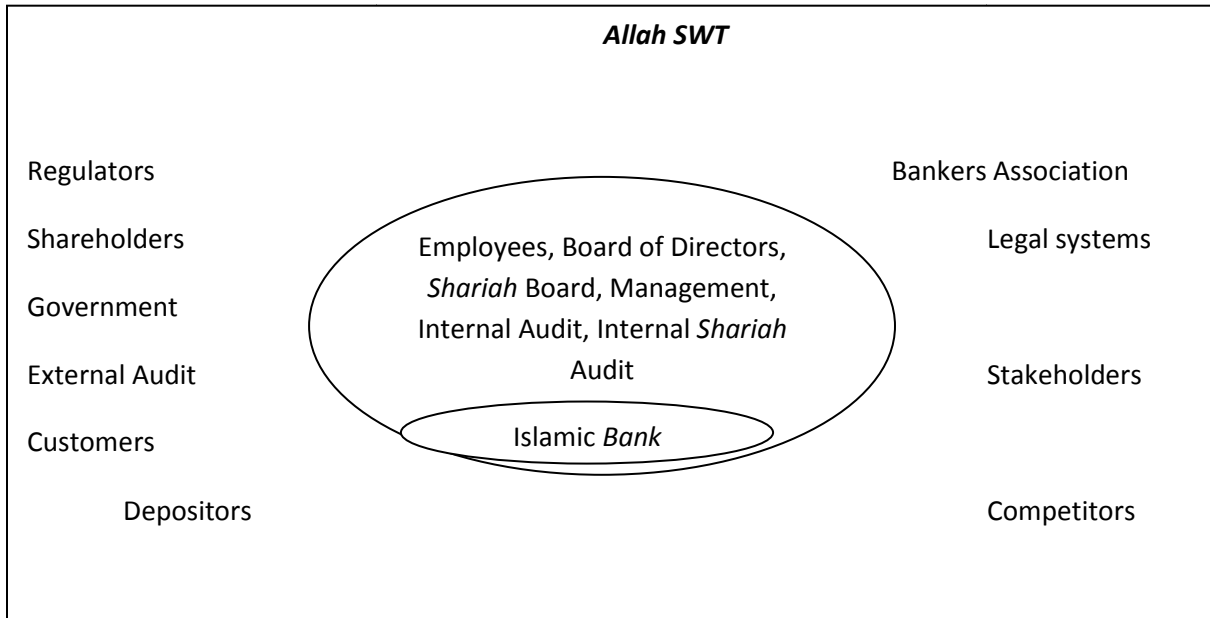


Figure (conventional concept of corporate governance and parties involved in the process of corporate governance)

<http://www.succurro.com.au/articles/49-governance/85-what-is-good-corporate-governance-.html>

But when we talk about the role of corporate governance for the Islamic Financial Institution especially in Islamic banks then the relevant parties are supervisors, associations, shareholders, board of directors, senior management, internal audit, employees, *Shariah* board, *Shariah* audit, depositors, external auditors and other stake holders. Now the main point of difference in the Islamic concept of corporate governance is it revolves around *Shariah*. The Islamic *concept* of corporate governance is vaster and well established.



Islamic Concept of Corporate Governance

6. *Shariah* governance

Shariah governance system put in a supplementary stratum of governance to the existing corporate governance system. *Shariah* governance process is an ongoing and continuous process. It involves the appointment, composition and qualification of the *Shariah* board, the *Shariah* observance process, *Shariah* coordination, the *Shariah* compliance review, *Shariah* audit and the *Shariah* report which is part of the annual report of the Islamic bank. One important thing to mention is that in case of dispute between the Islamic bank and *Shariah* board the decision of *Shariah* board is considered final. Fatwa or ruling given by the *Shariah* board on the bank's

financial dealing or relevant matter is binding on the Islamic bank. The bank can take the decision to the central *Shariah* board of the central bank and in that case the decision of central *Shariah* board or committee is considered final.

As per IFSB's Guiding Principle on *Shariah* Governance System, "“*Shariah* Governance System” refers to the set of institutional and organizational arrangements through which an IIFS ensures that there is effective independent oversight of *Shariah* compliance over each of the following structures and processes:

§ Issuance of relevant *Shariah* pronouncements / resolutions

§ Dissemination of information on such *Shariah* pronouncements/resolutions to the operative personnel of the IIFS who monitor the day-to-day compliance with the *Shariah* pronouncements/resolutions vis-à-vis every level of operations and each transaction

§ An internal *Shariah* compliance review/audit for verifying that *Shariah* compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified

§ An annual *Shariah* compliance review/audit for verifying that the internal *Shariah* compliance review/audit has been appropriately carried out and its findings have been duly noted by the *Shariah* board".

For Islamic Financial Institutions, *Shariah* governance is an important and crucial part of the corporate governance. This is why the umbrella of Islamic corporate governance is bigger and stronger than the simple corporate governance concept of the conventional. Though we accept that the corporate governance in conventional institution or in Islamic institution is to achieve the objectives of the bank and value addition of all the stakeholders and the company itself.

6.1 Corporate governance versus *Shariah* governance

Shariah governance is of supreme importance in the Islamic bank as it is one important point of differentiation between the conventional and Islamic bank. The *Shariah* governance role in Islamic bank is to make sure that all the products and services are in accordance with the

requirement of *Shariah*, the business done by the Islamic bank is halal, to promote justice and transparency in the financial transactions of the bank, to keep up the confidence of the customers and stakeholders, develop risk management tools for the Islamic banks and the most important is to make sure the compliance of *Shariah* from all the operations of Islamic banks including its employees, management and board of directors. IFSB guiding principle 10 on the *Shariah* governance mention that the *Shariah* governance complements the corporate governance process as a whole. Following are the additional requirements for the corporate governance of an Islamic bank.

Functions	Typical Financial Institutions	Additions in Institute offering Islamic financial services (IIFS)
Governance	Board of Directors	<i>Shariah</i> board
Control	Internal Auditors External Auditors	Internal <i>Shariah</i> Review unit/ department (ISRU) External <i>Shariah</i> Review
Compliance	Regulatory and financial compliance officers, unit or department	Internal <i>Shariah</i> compliance unit or department (ISCU)

6.2 Role of *Shariah* Board/*Shariah* committee/*Shariah* Advisor

The word *Shariah* board is synonymously used for the *Shariah* committee, *Shariah* supervisory board, *Shariah* advisory and *Shariah* advisor.

A Mufti/*Shariah* advisory is expected to lead the stakeholder of the Islamic financial institutions toward the lawful transactions and fulfils their needs in religious matters in daily business activities to ensure that their conducts are established according to the divine law. Allah SWT says:

يَا أَيُّهَا الَّذِينَ ءَامَنُوا أَطِيعُوا اللَّهَ وَأَطِيعُوا الرَّسُولَ وَأُولِيَ الْأَمْرِ مِنكُمْ فَإِن تَنَزَعْتُمْ فِي شَيْءٍ فَرُدُّوهُ إِلَى اللَّهِ وَالرَّسُولِ إِن كُنتُمْ تُؤْمِنُونَ بِاللَّهِ وَالْيَوْمِ
الْآخِرِ ذَلِكَ خَيْرٌ وَأَحْسَنُ تَأْوِيلًا ﴿٥٩﴾

"O you who have believed, obey Allah and obey the Messenger and those in authority among you. And if you disagree over anything, refer it to Allah and the Messenger, if you should believe in Allah and the Last Day. That is the best [way] and best in result." (An-Nisaa 59)

The Islamic bank's credibility is highly dependent on the credibility of their *Shariah* governance system and when it comes to *Shariah* governance the role of *Shariah* committee/ board/advisor need to be focused by the bank. An Islamic bank can have *Shariah* board, *Shariah* Advisor, *Shariah* committee or *Shariah* Supervisory board depending on the requirement of the Central bank of the country and its jurisdiction. But either its *Shariah* advisor or *Shariah* committee or *Shariah* board the roles and responsibilities of them are almost same.

Shariah board can be defined as " Specific body set up or engaged by the IIFS to carry out and implement its *Shari`ah* Governance System". *Shariah* board members means " The category of *Shariah* scholars, orulama, who are equipped with not just general knowledge of *Shari`ah* or other disciplines, but more importantly have reached a specialized level of being learned and expert in *Fiqh al-Muamalat*. That specialization is then dedicated to providing professional expert opinions in the form of *Shariah* pronouncements/resolutions, specifically to IIFS, beyond mere academic discourse and often not directly to the general public or to corporations in other industries.

Shariah Advisory firm is " an entity that, depending on its size and capacity, provides *Shariah* advisory services, including *Shariah* audit reviews, as well as advice on *Shariah*-compliant product development, as part of its professional services. Islamic financial institutions including Islamic banks can have their own *Shariah* board or may hire a *Shariah* advisory firm for the matters related to *Shariah*.

The important elements of a good *Shariah* board are clear responsibility, independence in its decisions regarding bank, competent in terms of knowledge, behaviour and conduct, have well defined operating procedures and manuals, sound code of ethics and transparent.

The *Shariah* board of the Islamic bank carries Islamic knowledge that develops the operations and actions of the Islamic bank. The *Shariah* board is trusted with the responsibility of directing, examining and supervising the activities/conduct of the Islamic financial institution in order to make sure that they are in conformity with Islamic *Shariah* rules and principles. *Shariah* board should be more concerned on the aspects of *Shariah* non-compliance and reputational risks of the Islamic banks. Following are some of the important tasks performed by the *Shariah* board/*Shariah* committee of Islamic bank:

- To advise the board of the bank on the matters related to *Shariah*
- To ensure the *Shariah* compliance of the financial transactions done by the bank
- To design and endorse the *Shariah* compliance manual for the bank
- To assess and endorse all the products offered by the Islamic bank to its customers To give the *Shariah* report of the bank's business at the end of the sure
- To participate in the bank's activities, to understand the business and to give *Shariah* rulings wherever needed
- To give trainings to the bank's staff for the understanding of *Shariah*
- To conduct the *Shariah* review/*Shariah* audit
- To act as adviser for the stakeholders of Islamic bank
- To attend meetings with central bank and other related parties
- To give feedback to the board of directors on regular basis, as the *Shariah* board should report to the board of directors
- To review and ensure that all financing proposals/products offered by the bank are *Shariah* compliant at all times

Following table summarize the roles and responsibilities of the *Shariah* board and board of directors of an Islamic bank or Islamic financial institution. This table will also help to understand the difference between the corporate governance and *Shariah* governance.

Role of board of directors	The Role of the <i>Shariah</i> Supervision Board
<p>The Board of Directors is accountable for providing stewardship and supervision of organization, oversight of management and its operations.</p> <p>The key responsibilities consist of:</p> <ul style="list-style-type: none"> • Appointment of the <i>Shariah</i> board/<i>Shariah</i> committee of the Islamic financial institution. • Reviewing and approving organizational structure and controls; • Ensuring that management is qualified and competent; • Reviewing and approving business objectives, strategies and plans; • Reviewing and approving policies for major activities; • Providing for an independent assessment of, and reporting on the effectiveness of, organizational and procedural controls; • Monitoring performance against business objectives, strategies and plans; • Reviewing and approving sound corporate governance policies, and • Obtaining reasonable assurance on a regular basis that the institution is in control. <p>Apart from the first key responsibility of the board of the directors of an Islamic institution all the other responsibilities of BODs should be in compliance with <i>Shariah</i> and this need to be taken care by the <i>Shariah</i> board of the institution.</p>	<p>Generally a <i>Shariah</i> supervisory board or <i>Shariah</i> committee performs the following functions.</p> <ul style="list-style-type: none"> • Supervise the <i>Shariah</i> compliance of all the transactions in the Bank. The Shari'ah auditors ensure that all the transactions are carried out in strict compliance to Islamic principles of banking. • Supervise and approve the development of Shari'ah compliant investment and financing products. • Supervise and approve the development of Shari'ah compliant procedures. • Analyze, advise and direct the bank on new situations reported by different departments, branches or customers to ensure Shari'ah compliance before the Bank implements new products or procedure. • Certify Shari'ah compliance of Bank's product documents, contracts and agreements. • Recommend on administrative decisions, issues and matters that require the Board's approval. • Supervise <i>Shariah</i> training programmes for the Bank's staff. • Prepare an annual report on the Bank's Shari'ah compliance.

7. *Shariah* Governance System in different regions

Four countries are selected for the discussion on the *Shariah* governance framework for the Islamic financial institutions. The countries included in this paper are Malaysia, Bahrain, Pakistan and UK

7.1 Malaysia

Malaysia have developed the support system for Islamic banks by devising the Islamic Banking Act 1983 (IBA), the Takaful Act 1984, The Central Bank of Malaysia Act 2009, Securities Commission Act 1993 and the Banking and Financial Institutions Act 1989 (BAFIA). The IBA defines the *Shariah* board as *Shariah* supervisory council and the BAFIA as *Shariah* advisory council, so both terms *Shariah* supervisory council and *Shariah* advisory council are used interchangeably. The *Shariah* board of Bank Negara Malaysia is known as *Shariah* Advisory Council. All the banks offering Islamic financial services are bound to establish *Shariah* committee or *Shariah* board under BAFIA and IBA. The main objective of the *Shariah* committee (SC) is to advise, monitor and give *Shariah* ruling on case to case basis. The appointment of the SC members will be done by the board of directors of the Islamic bank subject to the approval of the BNM. The requirements for the SC members are prescribed by the BNM. The SC will give the *Shariah* ruling on the Islamic banks affairs but in case of dispute between the SC and bank's management, the matter will be referred to the SAC of BNM and the decision of SAC BNM will be considered final.

7.2 Bahrain

Bahrain is famous as one of the leading player of Islamic finance. International Islamic Financial Market (IIFM) and AAOIFI are based in Bahrain. Bahrain established liquidity management centre for the growth and success of Islamic banking industry. The Central Bank of Bahrain (CBB) is responsible for the regulation of the Islamic finance industry in the country. The legislation documents of Bahrain are, the Bahrain Stock Exchange Law 1987, the Commercial Companies Law 2001, The Anti Money Laundering Law 2001 the Central Bank of Bahrain and Financial Institutions Law 2006, and the Financial Trust Law 2006. The authorized provisions for the implantation of Islamic finance in Bahrain are given in the CBB Rule Book Volume 2, Islamic Banks. As per CBB all the Islamic banks are bound to establish *Shariah* board in compliance with AAOIFI's governance standards. CBB has its own National *Shariah* Advisory Board for the *Shariah* compliance.

7.3 Islamic Republic of Pakistan

Being a Muslim populated country, it's in the constitution of Pakistan to establish interest free banking system. Pakistan tried to establish Islamic banking system in 1980s but that was not a success. The Islamic banking was re-launched in 2002 by the State Bank of Pakistan (SBP). The Islamic Banking department of SBP issued circulars time to time for Islamic banking. The *Shariah* governance framework as adopted by the SBP is that all Islamic banks have to appoint one *Shariah* advisor for their bank with the approval of the SBP. SBP have its own *Shariah* board as well. Islamic banks are free to establish their own *Shariah* board but with the permission of SBP.

7.4 United Kingdom (UK)

Though UK is promoting Islamic finance but there are many issues unresolved for the Islamic banking and finance. Currently, there is no compulsion from the Financial Services Authority (FSA) for Islamic banks to establish their own *Shariah* board or committees. The Islamic banks in UK are free to adopt any *Shariah* governance framework. FSA believes that the *Shariah* compliance is the issue of the banks themselves not of the regulatory body.

Summary of *Shariah* Governance System in Malaysia, Bahrain, Pakistan and UK

	Malaysia	Bahrain	Pakistan	UK
Central Bank	Bank Negara Malaysia (BNM)	Central Bank of Bahrain(CBB)	State Bank of Pakistan (SBP)	Bank of England
<i>Shariah</i> Regulatory body in Central Bank	<i>Shariah</i> Advisory committee (SAC) in BNM	National <i>Shariah</i> Board at CBB	Central <i>Shariah</i> Board at SBP	No <i>Shariah</i> board but Financial Services Authority (FSA) looks after all the financial matters.
<i>Shariah</i> governance requirement	<i>Shariah</i> Committee	<i>Shariah</i> Supervisory Board	<i>Shariah</i> Advisor is required but bank can have their	There is nothing specific as such in the regulations. A

t for Islamic Banks			<i>Shariah</i> board.	regulated entity, if claims to be Islamic, shall need to have its own arrangements / mechanism to sell itself as Islamic. If it means forming a <i>Shariah</i> board or appointing a <i>Shariah</i> advisor, FSA has not objection to that.
Appointment of Members of <i>Shariah</i> Board/<i>Shariah</i> Advisor in Islamic Bank	The Board of Directors of Islamic Financial Institution upon nomination from its nomination Committee shall appoint the <i>Shariah</i> committee members. The appointment and reappointment shall obtain written approval from BNM.	<i>Shariah</i> Supervisory Board member is to be appointed by the shareholders in the AGM upon the recommendation of the Board of Directors and taking into account the local legislation and regulations.	Appointment of <i>Shariah</i> advisor shall be approved by the Board of Directors of the IBI in case of domestic bank and in case of foreign bank it shall be appointed by the management. Appointment of SA requires prior written approval from SBP.	If a <i>Shariah</i> board is appointed, the approval needs to be obtained from Board of Directors of the Islamic bank.
<i>Duties and Responsibilities of <i>Shariah</i> board of Islamic bank (Islamic Financial Institution)</i>	<i>Shariah</i> Advisor (SA) shall ensure that all Products and services and policies of IBIs are in compliance with <i>Shariah</i> rules and principles. SA shall have access to all documents and information from all sources. The SA may provide advice to the legal Council, auditor or consultant of an	To advise the Board on <i>Shariah</i> matters in its business operations. To endorse <i>Shariah</i> Compliance manuals. To endorse and validate relevant documentations. To assist related parties on <i>Shariah</i> matters. To advise on	SSB must cover ex-ante <i>Shariah</i> rulings as well as ex-post <i>Shariah</i> rulings. To review and certify the permissibility of all contracts, documentation and products. Issuing a <i>Shariah</i> supervisory report certifying that all transactions conducted by the IFIs comply with <i>Shariah</i> . Advising and monitoring the	If there is a <i>Shariah</i> board / advisor, FSA would expect all the usual duties as agreed in the contracts between them and the IFI. However, FSA does not provide any guidance on as to which particular duties they should be performing. IFI shall decide it all by itself.

	<p>IBI. The decisions and rulings of SA shall be subject to instructions, guidelines and directives issued by SBP <i>Shariah</i> Board.</p>	<p>matters to be referred to SAC. To provide written <i>Shariah</i> opinion. To assist SAC on reference for advice.</p>	<p>manner of disposing the non-<i>Shariah</i> compliant earnings.</p>	
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8. Issues and challenges of Corporate Governance for IBIs

The corporate governance model of conventional perspective is evolved in years. The issue is to design a well established model of corporate governance for the Islamic financial institution in compliance with Islamic concept, though we have strong theoretical foundations of corporate governance in Islam but the need of the time is to clearly identify the features, norms, behavior and characteristics of corporate governance from an Islamic perspective. There are always questions raised that are the corporate governance under Islamic perspective is same like the conventional or there is a difference. If there is a difference then how the model of Islamic corporate governance looks like. The questions also rose about the *Shariah* governance that is it different from the corporate governance or its part of corporate governance. In this paper we have tried to explain the connection of *Shariah* governance and corporate governance, also the linkage of corporate governance from conventional perspective and corporate governance from Islamic perspective in best possible way.

To talk about the issues of the corporate governance in Islamic banks we need to discuss the issues from two sides namely issues from the *Shariah* governance perspective relevant to Islamic banks only (which is part of Islamic corporate governance) and general corporate governance issues and challenges which are applicable to both conventional and Islamic banks. There are many issues and challenges in the proper implementation of corporate governance for Islamic banks.

The important issues faced by the Islamic banking industry in the implementation of the corporate governance are given below:

- Independence and Freedom of the *Shariah* board of the Islamic bank and board of directors is a very important issue. *Shariah* board members might fear for their job renewals and become a silent or dummy *Shariah* board or committee members of Islamic bank. The issue of independence is also important in the case of Non-Executive directors (NEDs)
- Issues related to competency, knowledge and behaviour of the *Shariah* board of the Islamic bank and NEDs.
- Conflict of interest and issue of confidentiality of the bank's business and *Shariah* resolutions/decisions
- Issue of *Shariah* compliant versus *Shariah* based products and approvals
- The uncertain status of *Shariah* resolution given by the *Shariah* board and to stop fatwa shopping
- Lack of effective communication between the directors, *Shariah* board members, management and shareholders
- Lack of trainings for the *Shariah* board members, board of directors , management and employees of the banks
- Lack of well defined operational procedures and manuals for the *Shariah* board
- Corporate social responsibility

9. Recommendations

- For the development of the Islamic financial industry and Islamic banks it is highly recommended to establish a strong *Shariah* governance framework.
- Islamic banks should adhere to the strict compliance of *Shariah* for their success.
- The board of directors, management, *Shariah* board and employees of the Islamic bank all has to play their due role for the good Islamic corporate governance.
- There should be proper communication between the *Shariah* board, Board of directors and management of the bank. Relevant and important trainings should be provided to the

Shariah board members, Board of directors and employees in line with the achievement of the objectives of the institution and to better serve their stakeholders.

- *Shariah* board members must meet the fit and proper criteria as set by the regulatory authority of the country in terms of their competency, knowledge and experience. *Shariah* board must have their code of conduct.
- The process of obtaining fatwa must be written down. The process of *Shariah* governance must be transparent.
- The *Shariah* board members must be independent in their decision making.
- All the business plans, strategies, marketing material, product manuals, and operational manuals should be approved by the *Shariah* board member.
- Boards comprising of members who have relevant experience and expertise are likely to be good and effective boards. A board of an Islamic bank probably should include someone who has worked in the same or similar industry for many years and has achieved some success in it. There is a general consensus that when a board has a higher fraction of non insiders (otherwise known as outside or independent directors), then it is presumed to be more effective at monitoring management. To facilitate the growth of Islamic banking, it will be good if Islamic banks have one *Shariah* scholar as an independent director. Independent directors have duty of care and due diligence like other board directors and a *Shariah* scholar can perform this duty not only in general matters discussed in board but also specific matters related to *Shariah*.

10. Conclusion

Corporate governance facilitates in preventing the fraudulent activities and corporate scandals in any organization. Islam prohibits all those activities that are haram like dishonesty, frauds, corruption, interest, gharar, zulm that bring harm to people. The Islamic concept of corporate governance uses the stakeholder approach by which all the stakeholders are taken care. The Islamic rules of corporate governance are based on the mutual help, mutual accountability, transparency and honesty, protection of minorities, disclosure and equitable distribution of wealth, brotherhood and responsibility. The Islamic banks have a very strong theoretical governance system as it include *Shariah* governance framework as well. There are many

challenges for the development of strong Islamic corporate governance implementation like the communication barriers between the *Shariah* board, board of directors and management in the Islamic banks but things are moving in the positive direction. It is worth to note that the Islamic corporate governance is one of the most comprehensive and focused governing system when compared with the western corporate governance models. The *Shariah* governance system varies from country to country and from organization to organization on the basis of jurisdiction and regulation. There is dire need of more regulations and guidelines from the central banks. AAOIFI and IFSB are playing very good role in the promotion and establishment of corporate and *Shariah* governance.

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