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Observing the Corporate and Shari'ah Governance Profiles of Islamic Banks in Malaysia: Do They Matter?

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Abstract

Corporate and Shari'ah governance are vital for enhancing accountability of the key players and corporate performance. This paper aims to observe corporate (CG) and Shari'ah governance (SG) profiles of the Islamic banks in Malaysia since the effective implementation of Shari'ah governance framework from 2011 till present. The relevant information for CG and SG were retrieved from Annual Report of 13 Islamic Banks. CG profile was represented by board size, independent non-executive director, board competency, and board meeting. Shari'ah board and Shari'ah board meeting were the profiles for the SG. The CG and SG profiles were only being chosen from the board and Shari'ah board perspective. They are the key player in making decisions and steering the business operation, process and activities. The observations have been done using trend analysis (graph) and descriptive statistical results. The findings showed that majority of Islamic banks have fulfilled the corporate and Shari'ah governance requirements. This would perhaps give positive indicators to enhance economic growth and stability for Malaysia. The CG and SG profiles can be used further in any empirical testing to examine their influence on performance or any other measurements.

Keywords: *corporate governance, shari'ah governance, islamic bank, board of directors, shari'ah boards*

INTRODUCTION

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On 26 April 2017, a new Malaysian Code on Corporate Governance 2017 (MCCG) was released by the Securities Commission Malaysia. The new MCCG introduces substantial changes and recommendations with a view to raising the standards of corporate governance of companies in Malaysia. Highlights of the new MCCG on the board of directors' role include strengthen the independence of the board, board diversity, and transparency in directors' remuneration. The MCCG now employs the CARE approach (abbreviated from the term 'Comprehend, Apply and Report'). They are shifting from the 'comply or explain' method in the 2012 code to an 'apply or explain an alternative' method. This is believed to allow greater flexibility in the application of the best practices.

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The agency problems in Islamic financial institutions are unique to other financial institutions, and different ways of examining and solving the issues are needed. As highlighted by Bukhari (2013), Darmadi (2013), Safieddine (2009), Grais and Pellegrini (2006), Archer and Karim (1998), and Sarker (1999), the need to comply with Shari'ah rules and regulations makes a huge difference between Islamic finance and other modes of financing. In the financial services sector, the principal-agent relationship carries the same definition as is applied in the corporate sector. However, the additional requirements of governance for Islamic banks need to be understood by the persons responsible when making decisions for Islamic banks.

The people comprising the top management of the institution (board of directors and Shari'ah board) are the key players that bear the ultimate responsibility and accountability to run the business properly. They need to be accountable and responsible in managing; controlling the institutions otherwise, corporate failures and difficulties would be the end-results. This has been proven from failure cases around the world involving senior persons in the business operations who were not acting in the best interests of shareholders and other stakeholders. Among them are the historical cases of the Arcapita Bank (1996), the Gulf Finance House (2009), Bank Islam Malaysia Bhd. (2005), the Ihlas Finance House (2001), the Islamic Bank of South Africa (1997), the Islamic Investment Companies of Egypt (1988), and the International Islamic Bank of Denmark (1986).

At present, the Central Bank, i.e., Bank Negara Malaysia (BNM), has developed the Shari'ah governance framework (SGF) for Islamic financial institutions, effective beginning 1st January 2011 with the ultimate objective being to enhance the role of the board, the Shari'ah Committee and the management in relation to Shari'ah matters. Indeed, the Shari'ah Governance Framework was the first guideline on Shari'ah governance matters to be issued and applied in Islamic financial institutions in Malaysia.

This paper aims to observe the corporate and Shari'ah governance profiles for Islamic banks in Malaysia. Perhaps, this study would be able to highlight the ideal and sufficient practices from corporate and Shari'ah governance profile that are expected to be able to reduce or minimize agency and accountability problems in Islamic financial institutions. This paper only considers Islamic banks (it excludes Takaful) as the sample of study.

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LITERATURE REVIEW

Islamic banks are heavily regulated. The role of the board of directors differs in the banking industry in the sense that they have greater responsibility and accountability in discharging their duties. The duties and responsibilities of the key players in the Islamic banks are more demanding, in that they must ensure both legal and Shari'ah compliance as well as take into account the Islamic moral and ethical values. They are required to be accountable to the broader group of stakeholders. Ultimately, they are accountable to Allah s.w.t. Hence, they are expected to be knowledgeable and skilful in managing, monitoring, and controlling banking institutions to ensure Shari'ah compliance.

In 1999, the Malaysian Finance Committee Report defined corporate governance as "the process and structure used to direct and manage the business and affairs of the institution toward enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholders' value, whilst taking into account the interests of other stakeholders" (MFCR, 1999, p.1). Moreover, the Organisation for Economic Co-operation and Development (OECD) in the Principles of Corporate Governance (2000, revised April 2004) defines corporate governance as the "…set of relationship[s] between a (company's) management, its board, its shareholders and other stakeholders" (OECD, 2004, p.12). Hence, this shows that corporate governance involves a set of relationships between an institution's management, its board, shareholders, and other stakeholders. In fact, the code also further explains that corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Therefore, from the definition itself, corporate governance can be illustrated as a mechanism for managing and monitoring a corporation to achieve its objectives, and, at the same time, to ensure that the interests and welfare of the shareholders and stakeholders are protected.

Meanwhile, the definition of Shari'ah governance in the Shari'ah Governance Framework for Islamic Financial Institutions guideline has been adopted from the definition in the Islamic Financial Services Board (IFSB) (2009). The IFSB (2009) defines the Shari'ah governance system as "a set of institutional and organizational arrangements through which Islamic banks ensure that there is effective independent oversight of Shari'ah compliance over the issuance of relevant Shari'ah pronouncements, dissemination of information and an internal Shari'ah compliance review" (IFSB, 2009, p.2). Besides the corporate governance requirements as prescribed by other codes at the international level and locally, Islamic banks are also required to comply with the Shari'ah governance requirements to ensure Shari'ah compliance.

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Hence, people that manage the Islamic banks need to be able to deliver their duties and responsibilities according to corporate and Shari'ah governance requirements.

METHODOLOGY

This study involves an observation of the corporate and Shari'ah governance profiles amongst all Islamic financial institutions in Malaysia (excluding Takaful and re-takaful). Altogether there are16 Islamic banks in Malaysia (BNM's website assessed on 7th December 2013); however, only 13 have been taken as a sample for this study as three (3) of them (Alliance Islamic Bank Berhad, Alkhair International Islamic Bank, and AmIslamic Bank Berhad) were not able to provide the detailed information needed from their report.

The retrieval relevant data for corporate and Shari'ah governance profile is done from annual reports. The annual report is a crucial instrument, as mentioned by Harahap (2003), Chang, Most and Brain (1983), Anderson and Epstein (1985) that individual investors, institutional investors and financial analysts routinely use the annual report as the primary influence in aiding decision-making. Financial statements or annual reports represent a business language that allows management to communicate the financial condition of their organization, the results of their operations, and other information to interested parties. Table 1 shows the operational definition of the variables used in this study.

Table 1: *Conceptual definition and operationalization of exogenous variables*

Summary of Variables, Definition, and Operationalization			
CORPORATE GOVERNANCE MECHANISM			
Variable	**Code**	**Definition**	**Operationalization**
Board Size	BS	The total number of directors sitting on the board (Mollah & Zaman, 2015; Wasiuzzaman & Gunasegaran, 2013; Pathan & Faff, 2013; Andres & Vallelado, 2008; Adam & Mehran, 2005; Adam & Mehran, 2003; Belkhir, 2009; Mahmood & Abbas, 2011; Al-Shammari & Al-Sultan, 2009)	Actual values
Board Composition-Independent Non-Executive Director	NED	The proportion of independent NED to total number of directors (Mollah & Zaman, 2015; Pathan & Faff, 2013; Andres & Vallelado, 2008; Haniffa & Hudaib, 2006; Adam & Mehran, 2003; Pandya, 2011; Al-Saidi & Al-Sammari, 2013; Jensen & Meckling, 1976; Pearce &	Number of independent non-executive directors/Total number of directors on the board

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		Zehra, 1992)	
Board Competency	BC	The qualification of the boards (Bank Negara Malaysia; Magalhaes & Al-Saad, 2013)	Number of directors with a qualification from finance, accounting, legal, business management, information technology, investment management/ Total number of directors on the board.
Number of board meetings	BM	As a proxy for the functioning of boards (Andress & Vallelado, 2008; Adam & Mehran, 2003)	Actual values - The number of board meetings held during the year.
		SHARI'AH GOVERNANCE MECHANISM	
Shari'ah Board Size	SBS	The total number of Shari'ah board members in the respective Islamic banks. (Mollah & Zaman, 2015; Rammal, 2010; Sheikh Hassan, 2012; Darmadi, 2013; Safieddine, 2009; Haniffa & Hudaib, 2007; Nienhaus, 2007; Magalhaes & Al-Saad, 2013)	Actual values - The number of Shari'ah board members.
Shari'ah Board Meetings	SBM	As a proxy for the functioning of Shari'ah boards (Andress & Vallelado, 2008; Adam & Mehran, 2003)	Actual values - The number of Shari'ah board meetings held during the year.

FINDING AND DISCUSSIONS

Corporate and Shari'ah governance profiles were analysed via the trend analyses that use a graphical representation of the variables. The graphs, as illustrated in Figures 1 to 6, are the corporate and Shari'ah governance mechanisms of the profile of 13 Islamic banks in Malaysia for 2012, 2013, and 2014.

Corporate Governance Profiles

Corporate governance profiles were represented by board size, independent non-executive directors, board competency and board meeting.

Board Size

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The Board is responsible and accountable for the overall control and planning of Islamic banks. Board size is measured by the total number of directors (Wasiuzzaman & Gunasegavan, 2013; Iqbal & Zaheer, 2012; Mahmood & Abbas, 2011; Al-Shammari & Al-Sultan, 2009; Belkhir, 2009; Adam & Mehran, 2005). Adams and Mehran (2005) found that the inclusion of more directors is positively associated with performance. Hence, board size is an essential factor in determining the effectiveness of the board in providing direction and guidance to the management and in performing its oversight role effectively (Andres & Vallelado, 2008) and as also stated in the Bank Negara Malaysia corporate governance guidelines (BNM, 2007).

Figure 1 provides the graph of the size of the board of directors. Although there is no specific number of directors required by Bank Negara Malaysia (Enhancing Corporate Governance for Licensed Institutions), the Cadbury Committee Report (1992) suggests having eight (8) to ten (10) members to ensure board effectiveness. By referring to the descriptive statistics results, the mean value of board size is 7.718; thus, it provides ample evidence that, on average, the board size for Malaysian Islamic banks is almost eight persons. Hence, it can be considered adequate and sufficient. The majority of Islamic banks have at least seven board members with the highest being 10 directors. The smallest number of board members is five (Al-Rajhi Bank & Investment (Corp) Malaysia Bhd. and Maybank Islamic Bhd.). On average, the number of directors in Malaysian Islamic banks is consistently considered ideal and adequate for addressing the complexity, the scope and the operations of Islamic banks. This ideal size is consistent with what has been discussed by Adam and Mehran (2005), Andres and Vallelado (2008), Wasiuzzaman and Gunasegaran (2013), Pathan and Faff (2013), and Mollah and Zaman (2015).

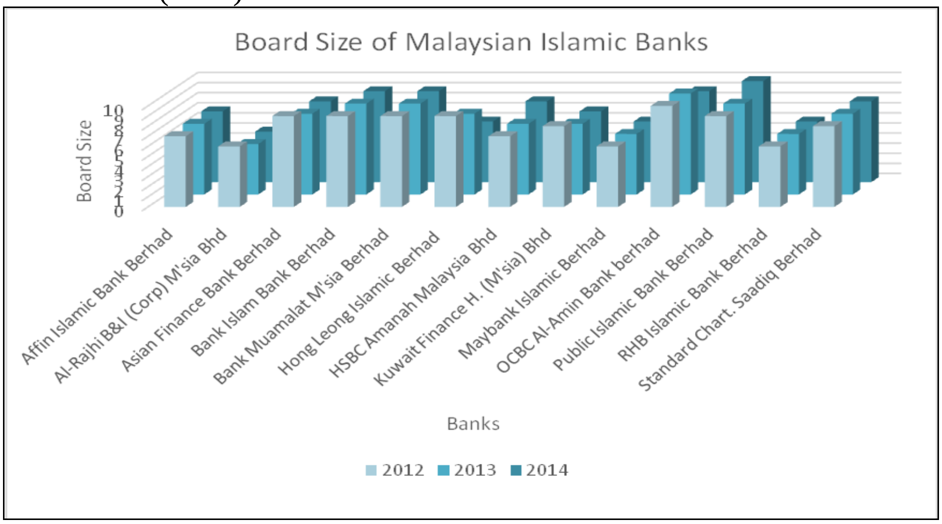

Figure 1: Board size

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Independent Non-Executive Directors

An independent director, as defined by the BNM corporate governance guideline (2007), is 'a director who is independent of management and free from any business or other relationship, which could interfere with the exercise of independent judgement or the ability to act in the best interest of the Licensed Institution.' Hence, the appointment of non-executive directors should provide a balanced and objective consideration of the issues and improve accountability in the decision-making process (BNM, 2007). Independent non-executive directors are crucial in providing external opinion and provide advice on the Islamic bank business operations, process, and activities. They should provide independent thought and actions. Their existence should also enhance accountability in the board's decision-making process.

A higher number of independent non-executive directors could prevent any possible conflict of interest between the policymaking process and the daily operations of Islamic banks. In addition, they can also bring a new perspective from other businesses that may enhance the effectiveness of the board. Thus, they offer the necessary checks and balances for ensuring the safe and sound administration of Islamic banks.

The majority of Islamic banks have more than four (4) independent non-executive directors, except Al-Rajhi Bank & Investment (Corp) Malaysia Bhd. and Asian Finance Bank Berhad, which only have two (2) to three (3) independent non-executive directors on the board; as illustrated in Figure 2. The proportion of independent non-executive directors of Islamic banks has no significant differences in the number and fulfils the requirements of having at least three (3) or 1/3 of the board (Cadbury Committee Report, 1992). BNM (2007) has outlined that the independent non-executive directors are to be sufficient and adequate in number.

The mean value of the number of independent executive directors for Malaysian Islamic banks is 3.873; therefore, it shows strong evidence that, on average, in terms of adequacy, the proportion of independent non-executive directors is almost (4) four persons on the board. Hence, it fulfils the requirement made by the BNM.

Previous studies also confirmed that having an ideal number of non-executive directors may improve the direction and strategic planning of the Islamic banks (Andres & Vallelado, 2008; Haniffa & Hudaib, 2006; Adam & Mehran, 2003; Pandya, 2011; As-Saad & As-Shammari, 2013; Mollah & Zaman, 2015).

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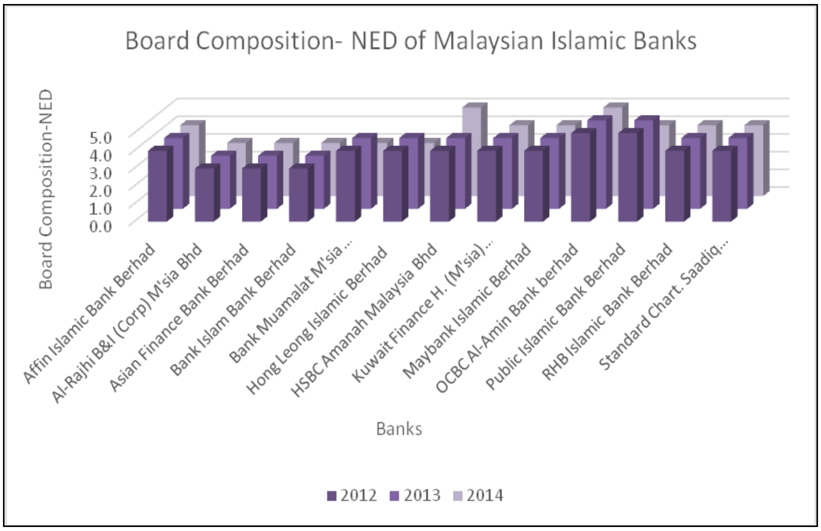

Figure 2: Independent non-executive directors

Board Competency

Board competency refers to the number of board members that have a qualification from finance, accounting, legal, business management, information technology or investment management as per BNM's guidelines. Board members who are competent are considered to have the credibility and integrity, and are equipped with the necessary skills and experience. Thus, they are able to devote time and commitment to the betterment of the strategic direction for Islamic banks (Magalhaes & Al-Saad, 2013).

Furthermore, from the descriptive statistics results, the mean value of board competency is 3.974, which provides evidence that, on average, the adequacy of the board competency is slightly lower, i.e., almost 4 members with the majority of them (7 Islamic banks) having more than 5 directors with academic qualifications of finance, accounting, legal, business management, information technology, and investment management for Malaysian Islamic banks.

The majority of the Islamic banks have more than five directors who can be considered highly competent board members in directing the business operations. The board competency descriptive findings can be referred to in Figure 3.

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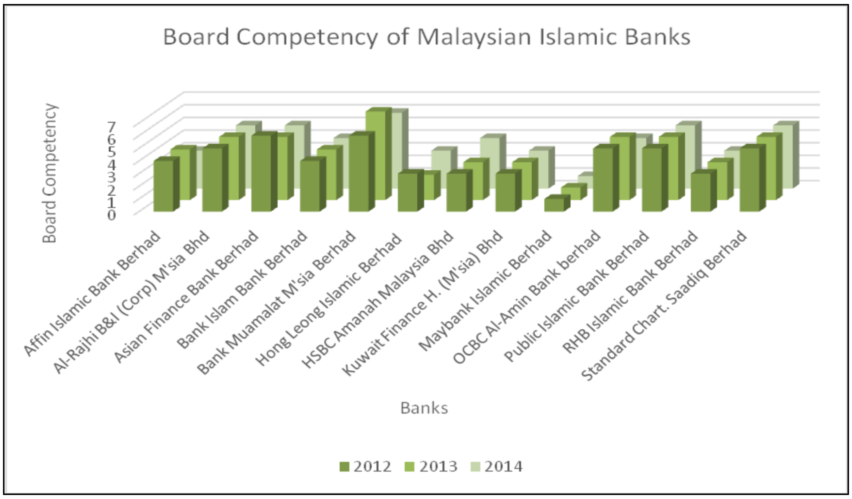

Figure 3: Board competency

Seven (7) Islamic banks representing (53%) half (Al-Rajhi B&I (Corp) Malaysia Bhd., Asian Finance Bank. Bhd., Bank Islam Malaysia Bhd., Bank Muamalat Malaysia Bhd., OCBC Islamic Bank Bhd., Public Islamic Bank Bhd., and Standard Chartered Islamic Bank Bhd.) have five or more board members who are adequate and competent to serve in the industry according to BNM guidelines. The remaining Islamic banks only had 3 or fewer board members who were considered competent in a respective field. They are crucial in the monitoring and control roles, as highlighted by IFSB (2006), as boards having different skills, expertise, and business proficiency provide value added to the business.

Board Meeting

As stated in the BNM guidelines, board meetings are pivotal to ensure that, first, the board is kept sufficiently in touch with the nature of the business; and second, the operations of the Islamic banks are not adversely affected because of the difficulty in securing the board's approval for policies and decisions. Hence, as mandated by BNM, preferably, board meetings should be held once every month. However, once every two months is considered sufficient.

By referring to the descriptive statistics results, the mean value of board meetings is 10.051. This provides ample evidence that, on average, the frequency of the board meetings of 10 times a year is good as suggested by the BNM.

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Figure 4 depicts the number of meetings held by the Islamic banks in Malaysia from 2012 to 2014. The majority of the Islamic banks had less than 10 board meetings a year, but still in accordance with the BNM requirements. The banks holding the most frequent meetings were the Public Islamic Bank Bhd. (18 –19 times a year), RHB Islamic Bank Bhd. (17 times), Bank Muamalat Malaysia Bhd. (13 – 14 times), Kuwait Finance House Malaysia Bhd. (13 – 18 times) and Affin Islamic Bank Bhd. (12 – 13 times). In summary, they were having frequent board meetings and more than required by BNM. Clearly, board meetings are crucial to ensure the board can be duly furnished with complete and timely information (Andress & Vallelado, 2008; Adam & Mehran, 2003). Therefore, through frequent meetings, the board will receive sufficient information from the management to monitor the financial condition and enable the board to deliberate and discuss important strategic issues.

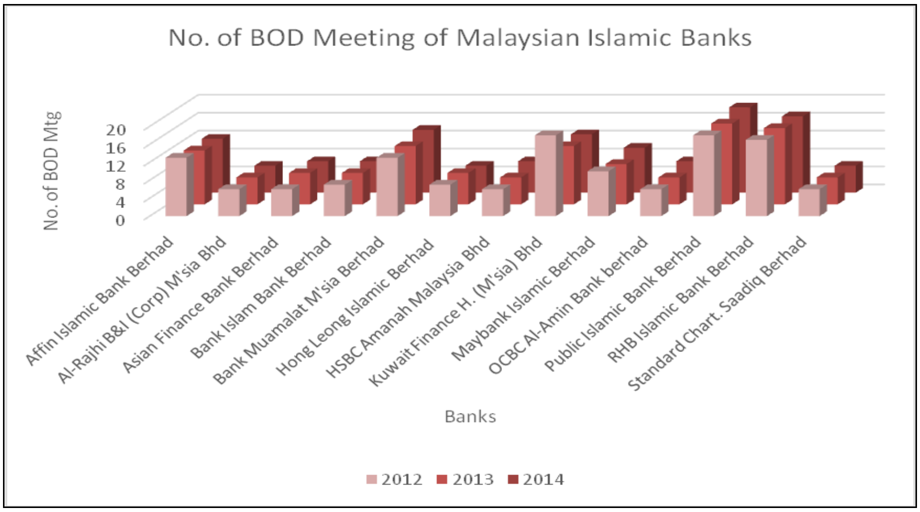

Figure 4: Board meetings

Shariah Governance Profiles

Shari'ah governance profiles were represented by the Shari'ah board/Shari'ah committee size and the frequency of the Shari'ah board meetings in a year. According to the BNM requirements in the Shari'ah governance framework, the Shari'ah Committee is responsible and accountable for all the Islamic banks' decisions, views, and opinions related to Shari'ah issues. Meanwhile, the board bears the ultimate responsibility and accountability for the overall governance of the institution.

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Ultimately, the board is expected to rely on the Shari'ah Committee for all Shari'ah decisions, views and opinions relating to the business, i.e., the Shari'ah decisions as views and opinions bind the operations of the Islamic banks. Hence, the Shari'ah Committee is expected to rigorously deliberate the issues at hand before arriving at any decisions.

Shari'ah Board Size

The AAOIFI governance standard for Islamic banks (GSIB No.1 and No.2) defines a Shari'ah supervisory board as an independent body of specialized jurists in Fiqh al-Mu'amalat (Islamic commercial jurisprudence). However, the Shari'ah supervisory board may include a member other than those specialized in Fiqh al-Mu'amalat but who should be an expert in the field of Islamic financial institutions and with knowledge of Fiqh al-Mu'amalat. Before the implementation of the Shari'ah governance framework in 2011, the AAOIFI (1999 and 2008) standard also specified a minimum number of three Shari'ah advisors on the board for particular Islamic banks. In addition, the IFSB (2005 and 2006) has stated that an appropriate mechanism must be created to ensure Shari'ah compliance in Islamic bank business operations, processes, and activities. Thus, an adequate system may include the Shari'ah board.

The majority of Islamic banks, as shown in Figure 5, have more than five Shari'ah board members. The BNM guidelines state that Islamic banks must not have less than five Shari'ah committee members. On average, the majority of Islamic banks have five (5) Shari'ah board members except for Bank Islamic Malaysia Bhd., Bank Muamalat Malaysia Bhd., and Affin Islamic Bank Bhd., which have six (6).

Moreover, the descriptive statistics results also show that the mean value of Shari'ah board size is 5.154, which provides ample evidence that, on average, the adequacy of the board size for Malaysian Islamic banks is good with 5 persons on the board.

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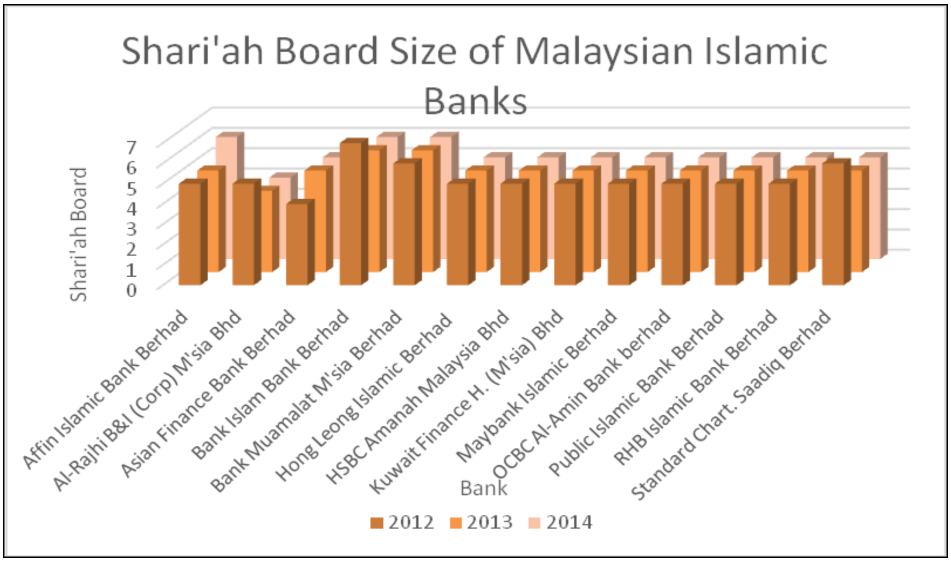

Figure 5: Shari'ah board size

Ghayad (2008) states that the Shari'ah Board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic banking to ensure that they are in compliance with Islamic Shari'ah rules and principles. Thus, they are very important to ensure that Shari'ah compliance and Shari'ah governance are properly in place (Rammal, 2010; Damardi, 2013; Safieddine, 2009; Magalhaes & Al-Saidi, 2013; Mollah & Zaman, 2015).

The mean value of Shari'ah board meeting as in the descriptive statistic results is 11.718; hence, it provides ample evidence that, on average, the frequency of the Shari'ah board meetings is almost 12 times a year, which is considered good. Hence, they provide good monitoring and control mechanisms for the Islamic banks business operations.

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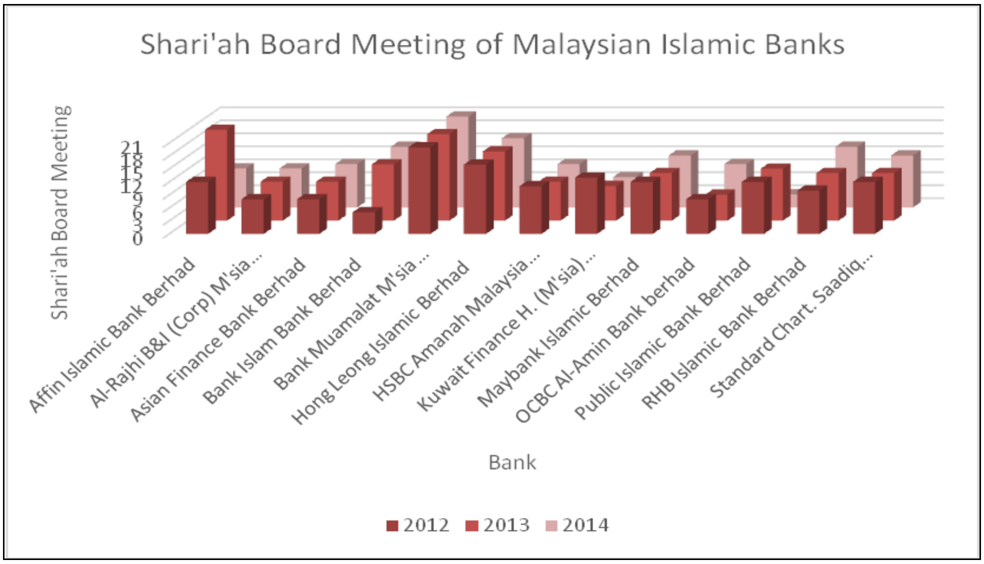

Figure 6: Shari’ah board meetings

The majority of Islamic banks had Shari’ah board meetings more than 10 times a year (Figure 6). This meets the requirements of the Shari’ah governance framework to meet a least once every two months (Appendix 5, SGF, 2011). To sum up, Malaysian Islamic banks are consistently performing well by having appropriate Shari’ah board meetings as per the Shari’ah governance framework requirements stipulated by BNM (2011), and have more meetings than required by the SGF.

CONCLUSION

Overall, the level of corporate and Shari’ah governance mechanisms are good as the majority practices are good and even better than the respective value of the mean together with the recommendations made by the BNM, IFSB, the Cadbury Committee Report, MCCG, and AAOIFI. Ideally, the majority of Islamic banks have more than 7 board members, 4 independent non-executive directors, 5 board members fulfil the competency, 10 board meetings, 5 Shari’ah board members and 10 Shari’ah board meetings. In conclusion, Malaysian Islamic banks consistently practiced good corporate and Shari’ah governance structure for the three-year period. They support the majority of the governance rules and regulations in that by having an ideal corporate and Shari’ah governance profiles, Islamic banks would perform better in the financial performance.

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