Proposing Islamic Core Values: Firming Up the Principles of Corporate Governance in Islamic Financial Institutions

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ABSTRACT

The concept of corporate governance in Islam refers to establish an organizational planning on how a corporation is directed, managed, governed and controlled. This provides the governance structure through which all stakeholders interests are protected, the company's objective is achieved and the principles of *Sharia'* have complied with. 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'*. However, there are some issues still actively debated among academician, especially controversial about the efficiency of corporate governance and corporate accountability. Furthermore, it is argued the establishment of Guidelines on corporate governance might not be sufficient whereby there is a necessity to intensely reassess of corporate governance principles of IFIs in order to tackle the problem of governance weaknesses. Therefore, it is required for this study to bridge the gap between conventional and Islamic by proposing Islamic core values based on *Al-Quran* and *Sunnah* in order to firm up the principles of corporate governance in Islamic Financial Institutions.

Key Words: Corporate governance, principles of corporate governance, Islamic core values, Islamic Financial Institutions

INTRODUCTION

Islamic finance has undergone a phenomenal development since it was first established in the late 1970's. The industry's assets are valued to be worth USD1.87 trillion as at 2014, having developed from USD1.79 trillion as at the end of 2013 (IFSB, 2015). There are 300 IFIs across 75 countries with the World's 100 largest Islamic banks having a yearly asset growth rate of 26.7 percent and equivalent with the Islamic Finance industry of 15-20 percent per year (Central Bank of Malaysia, 2016). The assets of Islamic finance are seriously focused in the Middle East and Asia, although there is a new figure of markets is growing.

Subsequently, Islamic banking assets in Malaysia had reached 27 percent or more than a quarter, of the total banking system, exceeding the targeted 20 percent under Central Bank Malaysia's financial sector master plan. In accordance with the plan, the country's Islamic finance industry has developed to become a key sector in the financial system. Moreover, it was reported in the New Straits Time on Islamic finance assets; Malaysia, Saudi Arabia and Iran embrace nearly 65 percent of global Islamic assets in 2015 (refer Figure 1).

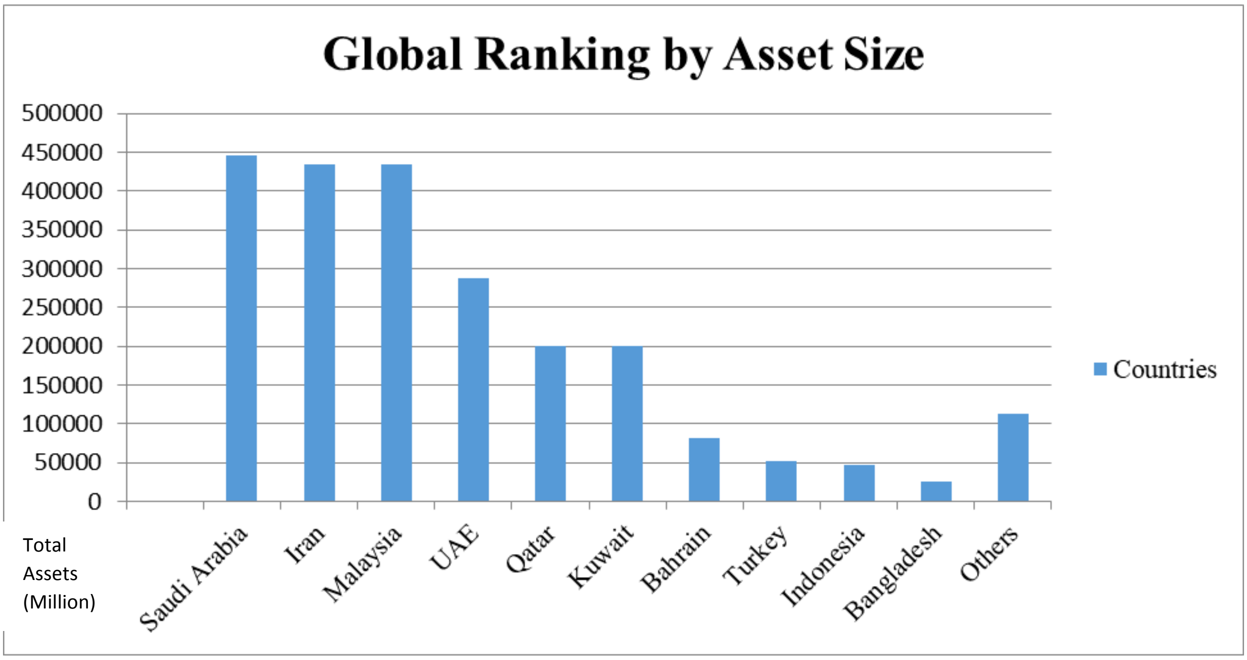

Figure 1 ***Global Ranking by Asset Size***

Source: News Strait Times, 2016

Nevertheless, the firm said the sukuk market had been resisted in the past couple of years due to the global economic turmoil, which had caused absence of new players. It was reported, the sukuk market fallen to US$66 billion (RM264 billion) in 2015 compared with US$101.8 billion in 2014, a performance that was not foreseen by market players after completion 2014 on a strong note.

Moreover, the crucial of IFIs to drive the Malaysia economy to the highest level has been highlighted in the Eleventh Malaysia Plan, 2016-2020 (Economic Planning Unit, 2015). It is emphasized, the services sector, which includes the financial and banking has played the biggest role in economic development in Malaysia. The services sector, such as Islamic banking, *Takaful*, government service, electricity, water, transport storage communications will be remained as a main driver for the economic development in Malaysia. The plans have been created to trigger the effectiveness and competitiveness in the services sector.

PROBLEM STATEMENT

The 2009 global economic downturn has called for an increased to promote good corporate governance around the world (Adegbite, 2012). However, there are some issues still actively debated among academician, especially controversial about the efficiency of corporate governance and corporate accountability (Talamo, 2010). For instance, Haspeslagh (2010) states that the failure of corporate governance is due to greed, ambitious thinking and direct estimation, effective principal agent model, capital markets and confidence in mathematical models replacing judgment and in common, supervisory capacity and covering the developments of international financial markets. Mostovicz, Kakabadse and Kakabadse (2011) also underlined poor leadership of professional management, such as emotions, sensuality and corporality were the highlighted issues of the corporate governance.

Due to the above scenario, numerous cases of ineffectiveness and inefficiency in the corporate governance system, IFIs have been identified. For instance, the failure of Ihlas Finance (the first local bank in Turkey) in 2001 has led to the closure of the company due to the failure in management, control and regulatory (Ali, 2007). Furthermore, it was found that the majority of the Board of Directors (BOD) does not have a sufficient experience, unaware with the job tasks and bank faced the conflict of interest due to their role as clients and members. The weakness of BOD managing the challenges due to changes in regulations also accounts for the fraudulent practices of *Ihlas* Finance.

In contrary, for the case of Islamic Bank South Africa (IBSA), Islamic Investment Companies of Egypt (IICE), Dubai Islamic Bank (DIB) and Bank Islam Malaysia Berhad (BIMB) the governance issues were mainly due to poor corporate governance, poor internal control, poor management and trading as presented in Table 2 (ISRA, 2012). The weaknesses have led the closures of IBSA and IICE. In the case of BIMB, it was highlighted that the BOD was not competent and none of the board member was familiar with the banking industry, or in other words their roles not consistent with their academic and training backgrounds. For instance, as has been reported under the statement of corporate governance in Bank's Annual Report, board meetings are essential to discuss and deliberate important issues that relate to their business and affairs. Besides, to ensure the interests of stakeholders shall be protected and to maximize shareholders value. The board meeting generally will be attended among committee members based on the frequency as stipulated in the Terms of Reference. Table 1 shows an attendance among committee members in Kuwait Finance House as to meet the requirement and recommendations set out in Central Bank.

Table 1 Meeting Attendance by Board Committee

	Board Meeting		BNRC Meeting		BRC Meeting		BCC Meeting	
	Held	**Attended**	**Held**	**Attended**	**Held**	**Attended**	**Held**	**Attended**
A	13	12	8	8	-	-	-	-
B	8	8	8	8	12	12	-	-
C	13	12	5	5	-	-	-	-
D	13	11	-	-	-	-	-	-
E	13	13	5	5	-	-	-	-
F	13	13	-	-	-	-	38	37
G	6	6	5	4	6	5	38	27
H	4	3	-	-	-	-	-	-
I	7	7	-	-	-	-	-	-

Source: Kuwait Finance House (2016)

As has been presented in the Table 1.3, it shows board committees in several of IFIs unable to fulfill the meeting schedule accordingly which will be affected the process of decision making in the context of the interest of stakeholders especially among shareholders. Appendix 1 will represent the details of BOD's meeting from the various of IFIs in Malaysia. As a consequence, with this failure in attending meeting that organized by board committee, an issues of fraud and corruption will arise in the IFIs. In particular, the current issues of fraud and corruption are actually transpired in IFIs Malaysia which has been debated by myriad scholars such as Bougatef (2015) and Rahman and Anwar (2014). Addition to this, Table 2 provides an evidences of corporate governance cases and issues that shed some light on the main determinants of corporate governance issues around the world.

In addition, Boards and Board Committees (including Shariah Boards) are not meeting as frequently as might be expected given the responsibilities they should be carrying. There thus seems to be a weakness in the level of challenge offered to banks' executive teams.

Table 2 Corporate Governance Cases and Issues in IFIs

Cases in IFIs	Corporate Governance Issues
Islamic Investment Companies of Egypt (IICE) (Zuhaida, 1990).	The closure of the IICE in 1998 was due to poor corporate governance, negligent management and inappropriate regulatory frameworks as well as involvement in non-*Sharia'* compliant activities (Zuhaida, 1990). Over one million small investors lost their investments when the IICE was an investment company that offered services free from interest.
Dubai Islamic Bank (DIB) (Za'za, 2009).	This refers to the fraud case in DIB involving US501 million. Seven individuals were charged, including DIB former executives. This was the biggest court case in the Dubai court involving financial irregularities (Za'za, 2009).
Bank Islam Malaysia Berhad (BIMB) (Parker, 2005).	The BIMB declared losses, amounting RM457 million in 2005 mainly due to the provisioning of RM774 million as a result of suffers in financing and investment incurred by its Labuan Branch (Parker, 2005). The composition of the board was not suitable as there were no board members who were familiar with the banking sector as well as having sound and appropriate credit and debt management (Parker, 2005).
Islamic Bank South Africa (IBSA). (Okeahalam, 1998)	The IBSA was closed in November 1997 with outstanding amount of between R50-R70 million. This was mainly due to poor supervision and governance from regulatory authority, weakness of risk management and numerous loan given out to insiders (Okeahalam, 1998). IBSA was unable to compensate all depositors who were mostly Muslims and had saved their money to perform their pilgrimage to Mecca.
Ihlas Finance, Turkey. (Ali, 2007)	*Ihlas* Finance, Turkey was shut down on 10 February 2001 due to the financial problems and poor corporate governance. Ali (2007) reported that the closure of *Ihlas* finance was mainly attributed to the failure of corporate governance and internal checks and balances. It was found that the banks were running without a proper system of internal control. The management was not prepared for changes in regulations and the scope of regulations was not clearly specified.

Source: ISRA (2012)

From the above cases in the view of practical and academics, it has shown the flaws and variations results of the corporate governance which not only occurs in Malaysia, but also around the globe. Given the fact that, although Central Bank of Malaysia has provided 14 principles under the Guideline of Corporate Governance BNM/GP1 for Financial Institutions whereas BNM/GP1-i specifically for Islamic Banks but unfortunately it remains continue to shake the business world (Ginena, 2014). Looking back at the 14 principles which has been formulated based on the three fundamental concepts such as transparency, accountability and responsibility (Central Bank, 2017), undeniably it much focuses on the role BOD. Rahman and Saimi (2015) asserted BOD considerably as one of the important functions in corporate governance and is accountable to direct and control the organization where it should be. Therefore it is required for this study to bridge the gap between conventional and Islamic by proposing Islamic core values based on *Al-Quran* and *Sunnah* in order to firm up the principles of corporate governance in IFIs.

LITERATURE REVIEW

In recent years, there has been an increasing interest in qualitative and quantitative studies on corporate governance in IFIs (Abdallah & Ismail, 2016; Mersni & Othman, 2016; Hashim, Mahadi, & Amran, 2015; Ginena, 2014; Abdel-Baki & Sciabolazza, 2014; Magalhã Es, R., & Al-Saad, S. 2013.; Bukhari, Awan & Ahmed, 2013).

However, 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. Moreover, it was found lack of responsibility, accountability and independence in decision making, as corporate governance principles, is contributing to the ineffectiveness of current practices in the investigated IFIs.

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'*).

Conversely, 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. Nevertheless, the effectiveness of BOD and the functions of SSB seems to be more imperative as to ensure the quality of corporate governance can be improved by applying all the dimensions which has been stated in Table 2.4.

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.

Likewise, 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.

Following research by Haniffa and Hudaib (2007) have developed Ethical Identity Index (EII) for Islamic Banking based on the understanding of the *Sharia'* as well as the extant Islamic and corporate social responsibility literature to reflect the ideal ethical identity. The purpose of this index is to explore whether any discrepancy exists between the communicated (based on information disclosed in the annual reports) and ideal (disclosure of information deemed vital based on the Islamic ethical business framework) ethical identities. Thus, the result has disclosed from the longitudinal survey, overall mean EII of only one Islamic Banks from seven measured to be above average. The remaining six Islamic Banks agonize from disparity between the communicated and ideal ethical identities. Further, they have found the major incongruence to be associated to four dimensions: commitments to society; disclosure of corporate vision and mission; contribution to and management of *zakah*, charity and benevolent loans; and information concerning top management.

In subsequent work, the EII has been extended to be a benchmark of an ideal Corporate Ethical Identity (CEI) index based on Islamic Business ethics for Sharia Compliant companies (Said, Daud, Radjeman, & Ismail, 2013). The index has been divided into four themes which consist of the underlying philosophy and values theme, interest-free and Islamically acceptable activities community theme, development and social goals theme, and environment theme. Hence, the study reveals that Theme 1 (Underlying Philosophy and Values) has the highest disclosure level of CEI as compared to other themes in the Annual report for the year ended 2008, 2009 and 2010. While, further analysis reveals that the developmental and social goals theme has the greatest influence on CEI.

Another survey performed by Yusof (2011) also constructed criteria of corporate social responsibility of Islamic Banks in Indonesia. The criteria comprise *sharia'* compliance, equality, responsible in work, guarantee of welfare, guarantee of environmental sustainability, and charity for preservation of virtue. The result indicates a strong relationship has been found between the selections of IFIs and the perception of stakeholders which includes employees and customers.

Considering 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, syura, khalifah,* justice and others. As supported by Dusuki (2012), 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'. He also further mentioned that the current literatures have recommended a good corporate governance practices depends on how the companies well managed and diverse the expectations and interests of stakeholder groups in IFIs.

Thereby, it is required to propose Islamic core values in order to strengthening the principles of corporate governance under the Guidelines of Corporate Governance for Islamic Banks of IFIs in Malaysia.

METHODOLOGY

The main purpose of this research is to propose Islamic core values in firming the principles of corporate governance in IFIs. Thus, qualitative research has been chosen because it requires a high resilient to study a problem and its demands of time and resources (Creswell, 2013). Moreover, it explains routine and problematic moments and meaning in individual lives through empirical materials such as an interview, observational, case study, personal experience, visual text and many more. The main reason of choosing qualitative research because of a need to study a group or population that refers to IFIs Malaysia (Creswell, 2013). Besides, to have a deeper understanding about the case study in detail.

In particular, this research had chosen case study to review the current principles of corporate governance in IFIs and hence to interview directly with people (group of experts in IFIs), going to their places of work and allowing them to explain the issues and gives an opinion about the current practice of corporate governance in IFIs based on the corporate governance principles unencumbered by what the researcher supposed to find or what the researcher have read in the literature (Creswell, 2013). As defined by Yin (2014), case study research comprises the study of a case within a real-life context and examines a contemporary event or case in depth. Case study is not a methodology (Creswell, 2013), but it is a bounded system bounded by time and place or multiple bounded system which the researchers set off boundaries and make clear statements about the focus and extent of the research (Stake, 1995; Merriam, 1998; Yin, 2014). Indeed, the definition of case study commonly derived from these three respective scholars (Harrison, Birks, Franklin & Mills, 2017) although there are many definitions of case study were established across the literature.

Given the fact that to obtain the data from the top management is quite tough, thus snowball technique will be used as a sampling strategy in this case study. Snowball or chain technique is an approach for locating information-rich key informants or critical cases (Patton, 2002; Creswell, 2013). The process begins by asking well-situated people; " Who knows a lot about_________? Whom should I talk to". By asking a number of people who else to talk with, the snowball gets bigger and bigger because it can accumulate new information-rich cases (Patton, 2002).

Subsequently, the researcher had identified five experts from various banks in Malaysia which it is believes they can provide enlighten opinions, views and knowledge constitute a rich data source about the principles and to propose the Islamic core values of corporate governance in IFIs Malaysia. Although the sample being investigated is quite small, but the main goal is to focus on specific characteristics of a population that are of interests, which an able to answer the research questions (Jamil & Ahmad, 2015).

CONCLUSION

A need for an efficient and effective governance system is very important in corporate governance, especially after the high-profile falls of many IFIs (such as *Ihlas* Finance House in Turkey, the Islamic Bank of South Africa and the Islamic Investment Companies of Egypt) and the difficulties some of the others face (Dubai Islamic Bank and Bank Islam Malaysia Berhad, to name a few). Islamic institutions are no less vulnerable to crises and issues that arises from governance-related problems like other organizations. With this in mind, corporations must see the interests of stakeholders and shareholders as their most important objective in their efforts to structure their *Sharia'* corporate governance. Therefore, it is important to embed the Islamic core values such as *hisbah, tawhid, khalifah, syura* and others under the Guidelines on Corporate Governance for Licensed Islamic Banks (BNM/GP1-i) to ensure maintaining Sharia' compliancy, and adhere to the values and ethics of Islam

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