Governance from Islamic economic perspective: A Shari'ah governance framework

Uddin, Md Akther

INCEIF, Malaysia

29 May 2015

Governance from Islamic Economic Perspective: A Shari'ah Governance Framework

Md Akther Uddin

INCEIF, Malaysia, INCEIF, Malaysia

7 November, 2015

Governance from Islamic Economic Perspective: A Shari'ah Governance Framework

Md Akther Uddin[1]

Abstract

This paper attempts to give a brief overview of existing Shari'ah Governance framework in Malaysia, compare with AAOIFI and IFSB standards and guidelines, identify current issues, and recommend measures to improve existing practices. The study finds that a great number of research have been carried out to study Shari'ah Governance framework in Malaysia, Indonesia, GCC, MENA, UK, and other OIC member countries. It can be concluded that the plurality in Shari'ah Governance practice across regions and countries may ensure success and support innovation in the short run, but, in order to establish credibility and promote Islamic Finance as a comprehensive financial system in the long run uniformity is desirable. A sustainable and viable Shari'ah Governance framework, which will not only provide credibility to IFIs but also ensure transparency, trust, ethical behavior, underlying faith and belief and ethics and also help protecting the stakeholders right and fulfill the broader principle of Maqasid al-Shari'ah (foundational goals of the Shari'ah)..

Key words: Shari'ah Governance, Corporate Governance, Islamic Banks

[1] **Corresponding author,** Graduate student in Islamic finance at INCEIF, Lorong Universiti A, 59100 Kuala Lumpur, Malaysia. Phone: +6 01112549795 Email: 1400225@student.inceif.org

Introduction

Good corporate governance has become a prime issue again among industry practitioners and academia since 2008 financial crisis, when corporate fraud, poor governance and manipulation in earnings happen to widespread. In a recent award winning Harvard Business Review article, William Lazonick criticizes existing Anglo-Saxon Corporate Governance (CG) model, which is based on the shareholder's wealth maximization theory, as this instigates many top executives in the U.S. to manipulate earnings, he highlights the issue of buying back of shares in order to artificially inflate the share price to gain lucrative incentives: bonus and right shares (Lazonick, 2014). Even though this model of corporate governance has been highly criticized, Franco-German model of CG has so far failed to find valid logic to include stakeholders' interest in decision making (Iqbal & Mirakhor, 2004).

Islamic finance has shown tremendous potential for the last two decades and it has become a formidable and sustainable counterpart of conventional banking system in many Muslim dominated countries. At the same time, the importance of Shari'ah Governance (SG) has come up and over the past few years, many countries have developed a comprehensive governance framework for Shari'ah issues responding to the needs of Islamic Financial Institutions (IFIs). However, the absence of well conceptualized framework hinders the development of unified, universal, and formalized system. If Islamic financial institutions are to be acceptable to their clients, IFIs need to have a formalized system to ensure all their activities are Shari'ah compliant (Wilson, 2009; Hassan, 2010; Grassa, 2013).

Shari'ah Governance

In order to define Shari'ah Governance, first, we need to define Corporate Governance as they exist side by side in Islamic Banks (IBs). The OECD has defined Corporate Governance as the "set of relationships between a company's management, its board, its stakeholders and other stakeholders" (OECD, 1999). The dimension of Islamic perspectives of corporate governance has broader horizon and cannot compartmentalize the roles and responsibilities in which all actions and obligations fall under the jurisdiction of the divine law of Islam, whereas, the OECD principles implements a firm with six different issue and obligation (Abu Tapanjeh, 2007; Hassan et al., 2014). Shari'ah governance is a unique characteristic of corporate governance in financial architecture and it is concerned with the religious aspects and the Islamicity of the activities and conducts of IFIs (Hasan, 2010).

According to IFSB standard 10, Shari'ah Governance System refers to the set of institutional and organizational arrangements through which an IFIs ensures that there is an effective independent oversight of Shari'ah compliance over issuance of relevant Shari'ah pronouncements, dissemination of information, an internal and annual Shari'ah compliance review (IFSB, 2009: 2-3)

The definition above illustrates the extensive duties of Shari'ah Supervisory Board (SSB) to oversight and supervises the Shari'ah compliance of the Islamic financial institutions, as such, their competence is essential to form a robust Shari'ah board. It also implies that the institution of the Shari'ah board is crucial to the Shari'ah governance system as an authoritative body ensuring Shari'ah compliance (Haqqi, 2014).

A Conceptual framework of Shari'ah Governance framework

Principle 3.1 of the IFSB Guiding Principles on Corporate Governance states that an appropriate mechanism must be created to ensure compliance with the Shari'ah principles. The foundational dimension of Islamic corporate governance is rooted in the fundamental principles of tawhid (the Oneness of Allah), the process of shura (Consulation), property rights and contractual obligations (Travers, 2010).

While explaining the conceptual framework of corporate governance from Islamic perspective, Iqbal & Mirakhor (2004) argues that Shari'ah Governance covers overall governance issues, protection of stakeholders rights and compliance with the divine rules guided by Shari'ah, which actually broaden the area of governance issue from merely stakeholders model, where scholars have not yet found the logical foundation to include various interest groups in corporate governance model which are indirectly affected by corporations' activities, while Shari'ah governance affirms the inclusion of not only human well-being but also surroundings and environment. Moreover, the foundation of stakeholder model is found in Islam's principles of property rights, commitment to explicit and implicit contractual agreements and implementation of an effective incentive system (Iqbal and Mirakhor, 2004).

By analyzing stakeholder model of corporate governance from Islamic perspective proposed by Iqbal & Mirakhor (2004), Zulkilfi Hasan concludes that little work has been done on corporate governance from Islamic economic perspective (Hasan, 2008). It seems logical as Islamic economics had been in hibernation for unexpectedly long time and only four decades ago it woke up and has got some kind of momentum for the last few decades.

Existing Shari'ah Governance Practice

As the importance of Shari'ah Governance is recognized a great number of research has been conducted to study Shari'ah Governance framework, existing practice of SG in Islamic Banks and IFIs, contemporary issues and how to improve Shari'ah Governance system in leading Islamic Finance hub like in Malaysia, Indonesia, GCC, MENA, UK, and other OIC member countries.

Ginena (2014) states that (as cited in Alhabashi and Bakar, 2008) variations in sharı'ah governance practices between IFIs in 11 countries to be significantly different; thus, they recommended the establishment of a comprehensive Sharı'ah Governance framework that would promote good governance. Corroborating Alhabashi and Bakar's results, Hasan's (2011) survey on Shari'ah Governance Practices found that operational aspects were significantly different between IFIs with only 39 per cent in Malaysia, 3 per cent in the UK (UK), and none in the Gulf Cooperative Council reporting having standard Shari'ah Governance operating procedures.

As confirmed earlier, different Shari'ah Governance structures exist in different jurisprudence depending on different legal frameworks governing Islamic banks and financial operations and can be divided into two broad categories: centralized and decentralized. The countries approaches on SG can either be strict, moderate or flexible; Malaysia and Pakistan belong to the first category, characterized by the provision of comprehensive guidelines on detailed implementations of SG. Countries like, Bahrain, Brunei and the UAE have adopted the moderate approach, providing the main provisions on the process but still leaving some aspects to the discretion of institutions or the authorities. On the other hand, Singapore and the U.K tend to adopt the flexible approach in this matter whereby most aspects of SG are left to the discretion of Islamic banks (Hassan et al., 2014). Wilson (2009) discusses the merits of centralized versus devolved Shari'ah governance and considers what competences and experience Shari'ah Board members should have. He mentions the four key attributes identified by the IFSB for sound and effective Shari'ah Governance are competence, independence, confidentiality and consistency (Wilson, 2009).

The OECD has issued Guidelines on Corporate Governance, the IOSCO on capital market and the BCBS on Basel Committee I, II and III. Nevertheless these standards and guidelines failed to address specific issues of Islamic finance (Dusuki, 2011). However, Hassan et al. (2009) argue that Shari'ah Governance structure must be in line with internationally recognized corporate governance standards such as those issued by the OECD in order to ensure effective implementation, in addition to that, conserve the fulfillment of fiduciary duties that include good faith, care, skill and diligence towards all their stakeholders. Moreover, it is necessary to appreciate the comprehensive nature that Shari'ah Governance provides to supervise the services of IFIs, the policy makers of a country have to focus on its key elements.

In the following section, a brief description of Bank Negara Malaysia Shari'ah Governance Framework (BNM SGF) 2010 is going to be discussed.

A Brief Overview BNM SGF 2010

The Bank Negara Malaysia Shari'ah Governance Framework (SGF 2010) for IFIs was introduced by BNM in October 2010, which is expected to solve the basic problems and can be a Shari'ah corporate governance model for the rest of the world (Muneeza & Hassan, 2011). The framework works in accordance with the Malaysia's two-tier Shari'ah Governance infrastructure which consists of BNM's central Shari'ah advisory body along with the individual boards, committees or advisories of each institution. Hassan et al. (2014) argue that this framework has been introduced at a critical juncture where concerns are being voice across the industry regarding the role and function of Shari'ah advisories and debating whether, and to what extent, Shari'ah advisory should be regulated.

The objective of the SGF 2010 is to provide comprehensive guidelines to the board and the Shari'ah committee of the IFIs in discharging their responsibilities in relation to Shari'ah matters. It also sets out the expectations of BNM on the IFI's Shari'ah Governance process, structure and arrangement in order to ensure that all business activities and operations are Shari'ah compliant. The new scope of this framework is the formation of functioning outlines for Shari'ah review, Shari'ah audit, Shari'ah risk management and Shari'ah research, which are the four significant functions that provide a system of checks and balances within the organization.

Omar et al. (2014) conducted a survey on 25 Islamic Banks and 12 Takaful Institutions to identify the problems and constraints in implementing BNM SGF 2010 in Malaysia and find that Shari'ah Governance Framework 2010 is well received by IFIs. They further argue that introduction of Shari'ah audit and review function in BNM SGF 2010 has enhanced the institutions product development. Under BNM SGF 2010 any product has to undergo several steps before it is finally approved which helps to improve the professional monitoring for Islamic financial products. It is also found in their study that Shari'ah non-compliance issue has been reduced after SGF 2010. Interestingly, a common perception regarding difficulties of the Board of Directors in making decisions due to Shari'ah Committee resolution has been found not correct. However, difficulty in getting qualified Shari'ah officer is acknowledged by the industry practitioners and they further explain that this may be due to difficulty in finding a person who is well versed both in Shari'ah and modern financial transaction.

Comparative Analysis of Shari'ah Governance Framework

In order to have a clear idea about differences in Shari'ah Governance practice across the region and countries, a comparative analysis is used in this section. Kasim et al. (2013) compare AAOIFI, IFSB and BNM Shari'ah Governance guidelines and argue that all the guidelines discuss and emphasize on independence, competence, responsibility, accountability, confidentiality of Shari'ah board members, also, the importance of Shari'ah review and audit functions is highlighted in all the guidelines although AAOIFI discuss in more detail, Shari'ah risk management and research function have been discussed only in BNM Shari'ah Governance framework (Kasim et al., 2013). The difference between the IFSB Prudential Standards and the AAOIFI Governance Standards is that the IFSB approach is more concerned towards regulators while the AAOIFI, to individual IFIs (Dusuki, 2011). Shari'ah Governance framework provided by AAOIFI has seven sections, the framework of IFSB includes scope and approach of SG system and the qualitative characteristics of Shari'ah Supervisory Committee, at the same time, BNM provides the general requirements of the framework, qualitative characteristics and provide the guidelines on Shari'ah review and Shari'ah audit, in addition to that, BNM provides the guideline on the functions of Shari'ah risk management and Shari'ah research in Islamic Finance (Kasim et al., 2013). As Shari'ah Governance is new, they propose that respective regulators should implement the prescriptive approach like the first approach taken by the U.K while implementing the corporate governance code. They conclude by suggesting standardized and comprehensive guideline or framework for easy reference for industry practitioners, regulators, Shari'ah advisors and investors.

Table 1

Comparative analysis among Shari'ah Governance guidelines

No	Discussion	AAOIFI*	IFSB†	BNM¥
1.	Definition of shari'ah governance	Not provided	Provided	Not provided
2.	Independence, competence, responsibility of Shari'ah Supervisory Board	Discussed	Discussed	Discussed
3.	Shari'ah review and Shari'ah audit	Discussed	Discussed	Discussed
4.	Risk Management	Not discussed	Not discussed	Discussed
5.	Research function	Not discussed	Not discussed	Discussed

**Accounting and Auditing Organization for Islamic Financial Institutions* AAOIFI
† Islamic Financial Services Board and ¥ Bank Negara Malaysia Shari'ah Governance Framework 2010

Note: From Kasim et al. (2013). *Comparative Analysis on AAOIFI, IFSB and BNM Shari'ah Governance.* International Journal of Business and Social Science. 4(15), p. 226

Current issues in Shari'ah Governance

In a recent working paper, Shamsher et al. (2015) state that in addition to shareholders right protection, IFIs must also protect interests of all stakeholders and ensure justice. They further argue that to do so IFIs would face challenges in the real markets that could adversely affect its effectiveness in mitigating Shari'ah risk and identify such issues as degree of independence of Shari'ah committee, confidentiality, competence, consistency, and information disclosure (Shamsher et al., 2015; Wilson, 2012;).

Hasan (2014) finds that there are gaps and shortcomings in the existing Shari'ah Governance practices of IFIs, particularly the aspects of the general approach to SG, the internal SG framework, the attributes of the Shari'ah board in terms of mechanisms of competence, independence and transparency and confidentiality, operational procedures and Shari'ah board's assessment. He also finds that regulatory framework has positive influence on Shari'ah scholars' views towards Shari' ah governance.It was also found that 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 (Magalhaes & Al-Saad, 2013).

Investment account holders right in Islamic banks has been widely discussed and debated. Wilson (2012:213) argues that investment account holders have a much greater stake in an Islamic bank than depositors with a conventional bank as they share in its profits rather than being paid interest. It is appropriate therefore that there should be more direct corporate responsibility to investment-account holders in an Islamic bank which will be reflected in the corporate governance structure. Magalhaes & Al-Saad (2013) confirm that that the current practices implemented by IFIs in protecting the rights of Unrestricted Investment Account Holders are not effective enough, in the light of standard corporate governance principles. Wilson (2012) further argues that as the mudaraba account holders are not the owners of the Islamic banks, as a result, they cannot benefit from ownership rights. By comparing responsibility of Islamic banks to unrestricted and restricted investment-account holder, he concludes that restricted-investment depositors cannot be regarded as stakeholders in the Islamic bank.

Recommendation to Improve Shari'ah Governance Practice

Grassa (2013) argue that even if Southeast Asian model of Shari'ah supervision seems to be most efficient and effective in achieving the Shari'ah compliant purpose than the GCC model, it cannot be considered as a perfect model. A lot of works are required to improve **it (Grassa, 2013).** Hassan et al.

(2014) recommend the following mechanisms in order to ensure a sound Shari'ah Governance system: a) a Shari'ah board with qualified members; b) a well-defined and adequately qualified and staffed organizational structure; c) clear lines of authority and accountability; d) policies and procedures pertaining to the approval of products and activities that require adherence to Shari'ah rules and principles; and e) an independent and regular review of Shari'ah compliance (Hassan et al., 2014).

Muneeza & Hassan (2014) argue that IFIs need sound "Shari'ah Governance Code" based on the principle of Islamic Law in addition to good governance rules like their conventional counterpart.

While analyzing four key attributes identified by IFSB: competence, independence, confidentiality and consistency Wilson (2009) recommends followings to improve Shari'ah Governance practice: professional development with modern finance and contemporary legal contract (Ghayad, 2008), renewable contract with Shari'ah board members, compensation of Shari'ah board members by the government but not idealistic for all countries, consistency between IFIs within a single jurisdiction, and coordination between AAOIFI, OIC Fiqh Academy, IFSB. Moreover, clear organizational charts, showing the remit and accountability of different stakeholder groups would help explaining role and workings of Shari'ah boards. In addition, scholars from economics, finance, law and political science should be included in Shari'ah board as practised in Sudan in order for making well-informed decisions, while there exist arguments for and against this as well.

A framework including structures and processes internal and external to the IIFS can be expected to enhance public understanding of the requirements of Shari'ah. It would be conducive to the development of market discipline as it would permit an effective utilization of exit and participatory actions (Grais & Pellegrini, 2006).

Conclusion

In the recent past Shari'ah Governance has got a considerable attention from not only academia but also from Islamic Financial Institutions (IFIs). Consequently, a great of number of research has been carried out in countries where Islamic Finance (IF) has been playing a significant role in economy or where it has just started to emerge. The study indicates that the plurality in Shari'ah Governance practice across regions and countries may promote innovation but in order to establish credibility and promote Islamic Finance as a comprehensive financial system uniformity is desirable. Against a backdrop of global financial crisis in 2007-2008, the issue has even become more vital for IFIs to uphold its uniqueness, sustainability, credibility and transparency in doing business for its Muslim as well as non-Muslim stakeholders. In order to develop a comprehensive governance system it is necessary to ensure active involvement of Shari'ah scholars with industry practitioners and regulators. A sustainable and viable Shari'ah Governance framework, which will not only provide credibility to IFIs but also ensure transparency, trust, ethical behavior, credibility, underlying faith and belief and ethics (Thomas et al., 2005 cited in Nathan & Ribieri, 2007) and also help protecting the stakeholders right and fulfill the broader principle of Maqasid al-Shari'ah (foundational goals of the Shari'ah).

References

AAOIFI. (2005). *Governance Standards for IFIs*, No 1-5. Bahrain AAOIFI

Abu-Tapanjeh, A. M. (2009). *Corporate governance from the Islamic perspective: A comparative analysis with OECD principles.* Critical Perspectives on accounting, 20(5), 556-567.

Bank Negara Malaysia. (2010). *Shari'ah Governance Framework for Islamic Financial Institutions.* Kuala Lumpur. Bank Negara Malaysia

Dusiki, A. W. (2011). *Ethical and Social Responsibility Models for Islamic Finance.* Kuala Lumpur: ISRA.

Ghayad, R.(2008). *Corporate governance and the global performance of Islamic banks*. Humanomics, 24(3), 207 – 216.

Ginena, K. (2014). *Shari'ah risk and corporate governance of Islamic banks.* Corporate Governance, 14(1) 86 – 103.

Grais, W., & Pellegrini, M. (2006). *Corporate Governance and Stakeholders' Financial Interest in institutions Offering Islamic Financial Services.* Word Bank Policy Research Working Paper 4053.

Grassa , R. (2013). *Shari'ah supervisory system in Islamic financial institutions: New issues and challenges: a comparative analysis between Southeast Asia models and GCC models.* Humanomics, 29(4), 333 – 348.

Haqqi, A. R. A. (2014). *Shari'ah Governance in Islamic Financial Institution: An Appraisal.* US-China L. Rev., 11, 112.

Hasan, Z. (2008). *Stakeholders Model of Governance in Islamic Economic System.* Islamic Economic Studies. Paper presented for Finance, Business and Economic Discussion Group of School of Government and International Affairs, Durham University, UK.

Hasan, Z. (2010). *Regulatory framework of Shari'ah governance system in Malaysia, GCC Countries and the UK.* Kyoto Bulletin of Islamic Area Studies, 3(2), 82-115.

Hasan, Z. (2011). *A survey on Shari'ah governance practices in Malaysia, GCC countries and the UK.* International Journal of Islamic and Middle Eastern Finance and Management, 4 (1), 30 – 51.

Hasan, Z. (2014). *In search of the perceptions of the Shari'ah scholars on Shari'ah governance system.* International Journal of Islamic and Middle Eastern Finance and Management, 7(1), 22-36.

Hassan, R., Arifin, M., Othman, A.A., Mohd Napiah, M.D., Omar, M.N., & Yusoff A. (2014). *An Empirical Study of the Effectiveness of the Shari'ah Governance Framework (SGF 2010).*

ISRA Research Paper No.68. 1-79.

IFSB. (2009). *Guiding Principles on Shari'ah Governance System in Institutions Offering Islamic Financial* Services. Kuala Lumpur: IFSB.

Iqbal, Z, and Mirakhor, A. (2004). *Stakeholders Model of Governance in Islamic Economic System.* Islamic Economic Studies. IRTI: Islamic Development Bank, 11(2), 43-64.

Kasim, N., Ibrahim, M., Hameed, S., & Sulaiman, M. (2009). *Shari'ah auditing in Islamic financial institutions: exploring the gap between the" desirable" and the" actual".* Global Economy & finance journal, 2(2), 127-137.

Lazonick, W. (2014). *Profits Without Prosperity.* Harvard Business Review.

Magalhães, R. & Al-Saad, S. (2013). *Corporate governance in Islamic financial institutions: the issues surrounding unrestricted investment account holders.* Corporate Governance: The international journal of business in society, 13(1), 39 – 57.

Muneeza, A., & Hassan, R. (2014). *Shari'ah corporate governance: the need for a special governance code.* Corporate Governance, 14(1), 120 – 129.

Muneeza, A., & Hassan, R. (2011). *Legal obstacles in Shari'ah corporate governance of Islamic financial institutions in Malaysia.* The Journal of King Abdulaziz University (JKAU): Islamic Economics, 24(2), 207-210.

Nathan, S. & Ribiere, V. (2007). *From Knowledge To Wisdom: The Case Of Corporate Governance In Islamic Banking.* The Journal of Information and Knowledge Management Systems, 37(4), 471 483.

Omar, M.N., Hassan, R., Arifin, M., Mohd Napiah, M.D., Othman, A.Z., Abdullah, M.A., & Yusoff, A. (2014). *The Implementation of Shari'ah Governance Framework of 2010: Advantages and Constraints.* Aust. J. Basic & Appl. Sci., 8(13): 684-687.

Organisation for Economic Co-operation and Development. (1999). *OECD principles of corporate governance.* OECD. Paris.

Shamsher, M., Sori, Z.M., & Shah, E. (2015). *Shari'ah Governance: Effectiveness of Shari'ah Committees in Islamic Banks in Malaysia.* INCEIF, Kuala Lumpur.

Travers, T. J. (2010). *Shari'ah Governance Systems: International Comparative Study of IFIs.* Cass Business School.

Wilson, R. (2009). *Shari'ah Governance for Islamic Financial Institutions.* ISRA International Journal of Islamic Finance, 1(1), 59-75.

Wilson, R. (2012). *Legal, regulatory and governance issues in Islamic Finance.* Edinburgh: Edinburgh University Press Ltd.

1

1