

CORPORATE GOVERNANCE OF ISLAMIC BANKING IN MALAYSIA: A LITERATURE REVIEW

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ABSTRACT

Corporate governance basically involves balancing the interests of the many stakeholders in a company including its shareholders, management, customers, suppliers, financiers, government and the community. Corporate governance also provides the framework for managing a company's objectives; it involves practically every area of management, from action plans and internal controls to performance measurement and corporate disclosure. Given the phenomenal increase in Islamic banking activities globally, it is important that there exists good governance practices of Islamic financial institutions (IFIs). This is primarily to ensure its sustainability in the long run. More importantly, in order for Islamic banks to play an optimum role in the development of Islamic countries, it is imperative to develop regulatory structures which can help to control fraud, exploitation, and non-compliant behavior in banking practices. This paper discusses an overview of corporate governance and shariah governance. Corporate governance challenges to Islamic Financial Institutions are also elaborated.

Keywords: *Corporate Governance, Islamic Banking, Islamic Financial Institutions*

INTRODUCTION

The concept of corporate governance has been recognized since the development of the joint stock of companies and it considered as an important component corporate law and practices. These corporate governance systems were developed over many decades to tackle the systematic crises or the corporate failures. In the past few years, there has been an increasing interest in corporate governance among the developed or less developed nations. After the economic collapse and the financial crises affecting many countries like USA, Russia and other countries in Latin America and East Asia, several corporate governance regulations were presented to deal with the restructuring efforts aimed at corporations (Demirag and Solomon, 2003). The various collapse and crises were attributed to a lack of investor confidence, inadequate corporate transparency or disclosure and a lack of structured corporate governance (Ho and Wong, 2001). In addressing these issues, many reform measures had to be carried out to strengthen the existing guidelines and codes regarding corporate governance.

The corporate governance is vital for the economic development and establishment of financial market stability. In the past few years, increasing global financial crises have highlighted the significance of corporate governance. Due to economic liberalization and globalization, the corporate governance-related components were considered as an important contemporary too.

In order to remain competitive in the changing economic climate, the Malaysian corporations have to implement and adapt the best corporate governance practices for the purpose of fulfilling the arising demands and opportunities. The Malaysian code on corporate governance (MCCG) was amended to reflect the internal standards and universal principles of the corporate governance. In 2017, Malaysia amended their corporate governance codes, for the purpose of promoting accountability, ethical behavior, transparency and stewardship of the investor capital. These amendments also increase the distribution of the responsibilities and rights among the participants in a company. However, there are many areas that require continuous development, especially those related to the independent of the board, gender diversity problems, and impartiality in the decision making process (Naif & Ali, 2019).

OVERVIEW OF CORPORATE GOVERNANCE

Corporate governance is about the procedure and process according to which an organization is directed and controlled (Tricker, 2015). The operational perspective, focusing on the shareholders, the board and the management are the basis for much work in corporate governance. We can assumed that the corporate governance is a set of promises made by corporation, those that make decision for corporation and the corporation stakeholders .As a result, since the birth of the modern corporation in the twentieth century, corporate governance has been, and continues to be, an area of focus for both individual corporations and governmental entities (Samra, 2016). A strong corporate governance practices

can lower the cost of capital for an organization by reducing the risk (perceived or actual) associated with lending to the corporation.

There is also evidence to suggest that strong governance translates to improved operational performance in an organization and increases the ability of an organization to withstand external shocks, including external financial distress (Del, 2014). In addition, a strong, resilient and efficient financial system that raises the level of investment and savings, and enables efficient allocation of funds is also crucial for the economy. It is vital to safeguard financial stability which ensures the process of inter-mediation to continue uninterrupted during the period of recovery. BNM has taken measures to foster a sound and efficient banking system that responds effectively to external shocks and the changing needs of domestic markets (Boon et. al, 2010).

In the corporate governance problem, the equity ownership structure is the foundation, for essentially equity structure decides the company's decision-making mechanism and incentive mechanism, thus affecting the company behavior and business performance. About corporate governance of modern theory originated in Berle and Means (2013), their study of the contract nature and principal-agent problem laid a foundation for the agency theory in economics. Which they also pointed out the relationship of ownership structure and corporate management, considered that in the ownership structure of the scattered, managers and small shareholders have potential conflicts of interest, and make the company performance can't achieve optimal.

Ownership structure is a deep-seated problem for governance structure since it may make big effects on business incentives, mergers and acquisitions, competition and oversight of agency; and the concept is discussed by different views. Ownership structure of an economic unit is explained through two main dimensions. First, the degree of ownership concentration: units may differ because their ownership is more or less dispersed. Second, the kind of owners: given the same degree of concentration, two units may differ if the government holds a majority stake in one unit; similarly a stock firm with dispersed ownership is different from a mutual firm (Iannotta et al., 2017).

Ownership structure is considered an important factor that affects a firm's health (Zeitun and Tian, 2017). If ownership structure affects a firm's health, it is possible then to use the ownership structure to predict firm profitability. The effect of ownership structure and concentration on a firm's performance is an important issue in the literature of finance theory (Zeitun and Tian, 2017). However, there is an increasing awareness that theories originating from developed countries such as the USA and the UK may have limited applicability to emerging markets. Emerging markets have different characteristics such as different political, economic and institutional conditions, which limit the application of developed markets' empirical models.

Banks, as the critical part of financial system, play an important role in contributing to a country's economic development. If the banking industry does not perform well, the effect to the economy could be huge and broad. They are 16 Islamic bank in Malaysia can contribute in development the standard of corporate governance to lead a better performance in future.

OVERVIEW OF SHARIAH GOVERNANCE ON ISLAMIC BANKING SYSTEM

The Islamic finance industry, which “had worked effectively for centuries during the Muslim civilization, (Chapra, 2002) has made resurgence on the global stage. As Islamic financial institutions (IFIs) expand and seek to compete with conventional finance beyond the Islamic world more attention is being given to the underlying structure of these institutions. Improving corporate governance in IFIs is an “indispensable” measure that must be taken for the industry to continue to grow and remain competitive (Samra, 2016) .

Shariah governance is integral to Islamic financial system stability. The institutionalization of a sound Shariah governance framework strengthens public confidence in the integrity, management and business operations of the Islamic financial institutions. The Shariah governance system is a set of institutional and organization arrangements through which IFIs ensure that there is an effective independent oversight of Shariah Compliance over the issuance of relevant Shariah Pronouncements, dissemination of Information and an internal Shariah compliance review (Zubir, 2014). The main principles of Islamic finance include: (1) prohibition on *riba*, commonly referred to as interest, but which actually translates to “an unjustified increase”; (2) prohibition of *gharar*, or excessive uncertainty; (3) prohibition on financing *haram*, or prohibited, industries (for example sales of alcohol); and (4) quest for justice and an ethical society, which includes paying of *zakat* (Samra, 2016).

According to Grais and Pellegrini (2006), corporate stability, financial performance and the ability to intermediate sources of finance depend on stakeholders’ confidence in individual institutions and the industry. A particular confidence feature in respect of Islamic financial institutions is the requirement of conveying to stakeholders the information that their financial business is conducted in conformance with Shariah (Ahmed et al., 2013). As advocated by Chapra and Ahmed (2002), the primary concern in Shariah relates closely to the notion of equitable protection of the rights of all stakeholders irrespective of equity holders or otherwise.

From the perspective of IFIs, conformity with Shariah is the priority. For instance, the governance which particularly addresses issues pertaining to the role and conduct of the Shariah Supervisory Boards (SSB) is important. The Corporate Governance of IFIs is also important for the following reasons:

1. It safeguards the interests of Investment Account Holders;
2. Its compliance with Shariah requirements;
3. Governance and risk management of *Mudaraba* and *Musharaka* contracts; and
4. Establishment of a comprehensive Corporate Governance framework articulating the fiduciary responsibilities of the board and senior management.

Proper management of the above will lead to an improvement in public’s level of trust and confidence within the Islamic banking industry (Iqbal &

Greuning, 2008). More importantly, strong governance practices will win stakeholders' confidence and thereby promote trust among their equity holders, investors and other parties dealing with them (Chapra & Ahmed, 2002). Subsequently, this would ensure the sustainability of the industry.

CORPORATE GOVERNANCE CHALLENGES TO ISLAMIC FINANCIAL INSTITUTIONS

I) Sharia Supervisory Board

One of the defining features of Islamic Financial Institutions is the Sharia Supervisory Board (the "SSB"). The SSB is separate from the Board of Directors for the IFI, but works with the Board to ensure the IFI is complying with Islamic law. The SSB covers five main areas (Zubir, 2014):

1. ensuring compliance with overall Islamic banking fundamentals,
2. certifying permissible financial instruments through fatwas,
3. verifying that transactions comply with issued fatwas, calculating and paying zakat,
4. disposing of non-Sharia compliant earnings, and
5. advising on the distribution of income or expenses among shareholders and investment account holders.

The SSB has substantial influence and control over IFIs and present unique challenges to IFIs. In order for members of the SSB to be effective they must be both Sharia scholars and financial experts. Unfortunately, this is not a common pairing of expertise. Sharia scholars with the requisite financial knowledge are in high demand and as a result many scholars sit on the boards of multiple institutions (Ahmed, 2013). This presents concerns about the independence and potential conflicts of SSB members, as they are able to obtain crucial proprietary financial information from multiple institutions. Additionally, if there are disagreements between management, the Board and the SSB it is not clear how those disagreements should be resolved or who is overseeing whom for the sake of having the "final word." Need for independent oversight to avoid capture of the Sharia board by the institutions for whom they work.

II) Multiple Stakeholders

Under American law, the corporation is primarily viewed as the property of the shareholders, and therefore the driving force behind corporate governance is shareholder value maximization. The rest of the world tends to think of corporations more as social entities that have obligations beyond merely maximizing profits for the individual shareholders (William, 1992). IFIs fall much more closely into the social entity view of a corporation view such as Bank Islam Malaysia Berhad (BIMB). One of the challenges that come with viewing the corporation as a social entity is lack of clarity on how directors should make decisions. When directors know that shareholders are their primary focus, it helps

them prioritize competing interests that arise when making significant decisions for the organization.

Conversely, for IFIs stakeholders include not just the shareholders, but customers that are involved in a profit-sharing mechanism, recipients of the IFIs zakat, members of the broader Islamic community, and the local communities where the IFI does business (Ahmed, 2013). Scholars have noted that *“the most important stakeholder in the case of Islamic finance is Islam itself”* (Chapra, 2002). One of the challenges for IFIs developing Corporate Governance is to provide guidance to the directors as to the key stakeholders for the corporation and how the directors should prioritize their interests when faced with difficult decisions. Not only is the priority of these varying interests unclear, it is also not clear what rights of the stakeholder would have if they disagree with actions taken by the IFI.

III) Conflicting Schools Of Islamic Thought

According to Samra (2017), another challenge for IFIs is that Islam does not have one single set of legal principles. As a result, there are differing views as to what qualifies as Islamic finance. There are five major schools of Sunni Islam: hanafi, maliki, shafi'i, hanbali, and zhairi. While there is overlap among the varying schools, there are substantial differences regarding the novel products being created in Islamic finance. Depending on which school a specific country follows may dictate what standards exist for IFIs. For companies seeking to operate in multiple countries throughout the Islamic world, this presents even more challenges.

IV) Accountability

An additional challenge of corporate governance for the IFIs is the lack of institutional structures available to ensure that board members are held accountable. This need for accountability applies both to members of the SSB and the general board of directors (Zubir, 2014). Because of many of the challenges discussed above, there are minimal controls available to ensure that a Bank that claims its products are Shari'a compliant are actually providing Shariah compliant products. Additionally, the role of governments and central banks in developing and enforcing Corporate Governance standards is most important in IFIs industry.

CONCLUSION

It is necessary to create stronger standards for corporate governance in IFIs in order to legitimize the Islamic finance industry and allow Islamic finance to continue to develop on a global scale. It is clear that policymakers, industry experts and academics are aware of the importance of corporate governance and are actively working to improve the governance of IFIs, but there is more that they can do. The establishment of good corporate governance standards requires

collaboration among the corporations themselves, regulators, policy makers, and the courts. Need to develop the Islamic Act for Financial industry that are able to set a strong and legal standards.

One of the most important steps that policy makers can take to improve governance in IFIs is to provide a means for adjudicating disputes over whether an Islamic Financial Institution is behaving in methods compliant with Shari'a principles. Providing such a mechanism would lend substantial legitimacy to the Islamic finance industry and would also help create the transparency that is vital to good corporate governance. In order to create such a mechanism, policy makers must determine who would have to standing to raise concerns regarding the Sharia compliant status of IFI products.

Additionally, they would need to provide a reputable place to adjudicate such concerns. Finally, the courts or policymakers would need to determine what the appropriate remedy should be in the event an IFIs product is deemed non-Shariah compliant. If the liability faced by SSB board members is too high, it would only magnify the scarcity problem IFIs face in finding individuals to serve on the boards. However, some level of accountability is necessary to help legitimize the fatwas issued, especially in the eyes of the international community. Here, policy makers in these countries may be able to glean helpful lessons of liability for directors alleged to breach the fiduciary duty.

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