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# *Corporate Governance In Islamic Financial Institutions*

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***Abstract***

*Sound corporate governance is important as it ensures that IFIs are operating within the principles of the Sharīʿah in its overall activities and that it is performing its role in disclosing profits motivated by the need to maximize the interest of shareholders. The main objective of this article is to discuss the elements of corporate governance and to build a framework that conceptualises corporate governance from the Sharīʿah perspective. The research has combined the descriptive and analytical methods. The study shows that the model of corporate governance within the premise of the Islamic economic system leans towards being stakeholders-centred as the governance structure in Islam safeguards all rights and interests of all stakeholders and shareholders.*

***Keywords: Corporate Governance, Sharīʿah, Shareholders.***

## حوكمة الشركات في المؤسسات المالية الإسلامية

**ملخص البحث**

تتطلب المؤسسات المالية الإسلامية حوكمة صلبة وذلك لضمان أن جميع معاملاتها وأنشطتها تسير وفقا لقواعد ومبادئ الشريعة الإسلامية، وأنها تقوم بدورها في الإفصاح بدافع الربح والحرص على ازدهار أرباح المساهمين. يهدف هذا المقال الى مناقشة أهم عناصر حوكمة الشركات، وتوضيح بعض الأسس حول الإطار المفاهيمي لحوكمة الشركات من وجهة النظر الإسلامية. وقد جمع البحث بين المنهج الوصفي والتحليلي في الحصول على النتائج. جاءت نتائج الدراسة لتوضح أن حوكمة الشركات في النظام الاقتصادي الإسلامي تميل نحو نموذج أصحاب المصلحة، وذلك لأن نظام الحوكمة في نظام الاقتصاد الإسلامي يجب أن يحفظ ويصون جميع حقوق المساهمين وأصحاب المصالح في المؤسسة المالية.

**كلمات مفتاحية: حوكمة الشركات، الشريعة، المساهمون.**

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## Contents



## 1. Introduction

Sound corporate governance is crucial in IFIs in assuring that all operations and activities comply with the Sharīʿah principles and, at the same time, that they are performing their role in recognition of profit-motives and maximizing the interest of shareholders (Akhtar, 2007, 9). This paper studies the main elements of corporate governance and gives a basic perception of the conceptual framework of corporate governance. In order to give a good understanding of corporate governance, this study will cover the following elements: the definition of corporate governance, role of corporate governance, models of corporate governance, importance of corporate governance, key players in corporate governance, corporate governance from the Islamic perspective, stakeholders-oriented approach, roles of corporate governance in IFIs and the conclusion.

### 1.1 Literature Review

There are some studies that have addressed the issue of corporate governance in IFIs, and the following are some of them. The purpose of this literature review is to provide an overview of previous research that have discussed the relation between corporate governance and IFIs. Lweis (2005) examined Islamic corporate governance, its nature and definition. The aim of his study is to investigate the basic elements of Islamic corporate governance, i.e., corporate governance according to Islamic rules. The findings of the study show that Islamic corporate governance has a wide coverage, and its commitment extends to include suppliers, customers, competitors, employees, and all needs of an Islamic society.

Grais and Pellegrini (2006) discuss on corporate governance and Sharīʿah compliance in institutions offering Islamic financial services. They explored the current issues facing IFIs that carry out certain procedures in order to ensure Sharīʿah compliance in the institution. The paper suggests a framework that emphasizes on market discipline. Moreover, they claim that the SSB should be guided by standardized contracts in issuing fatwas in order to ensure harmonization and consistency.

Grais and Pellegrini (2006) review corporate governance in Institutions offering Islamic Financial Services (IIFS), in terms of challenges and solutions. The authors argue that corporate governance in institutions offering Islamic financial services combines internal and external arrangements and emphasizes on the transparency of market information. The results show that there are shortcomings in the present practice of corporate governance in IIFS and needs a combination of solutions. The corporate governance in IIFS requires more arrangements such as SSB and Sharīʿah audit to ensure consistency of their operations with Sharīʿah principles.

Hasan (2009) investigates corporate governance from the Western and Islamic perspectives. The objective of the study was to examine the main elements of corporate governance in Islam and the West in terms of conceptual definition, objective, the nature of management and the structure. The result shows that the Islamic corporate governance model has distinctive characteristics in comparison with Western corporate governance such as Anglo-Saxon and the European models.

Abu-Tapanjeh (2009) examines corporate governance from the Islamic perspective. The main aim of the study is to compare the Islamic principles of corporate governance with conventional principles of corporate governance. The results show that Islamic principles of corporate governance are broader than the conventional principles. Moreover, "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 Organization for Economic Co-operation and Development (OECD) principles implement a firm with six different issues and obligations. (Abu-Tapanjeh, 2009, 556).

Mizushima (2014) investigates corporate governance and Sharīʿah governance in IFIs by assessing their current practices in Malaysia. The aim of this study was to examine the relationship between corporate governance and Sharīʿah governance in terms of the concept. The study used primary data such as library research in order to clarify the difference between corporate governance and Sharīʿah governance. The sample chosen in the study was restricted to IFIs in Malaysia. The study finds that "Sharīʿah governance is a concept that comes first in Islamic banks." However, the current practice of Sharīʿah governance seems to be limited to ensuring Sharīʿah compliance.

Most of the studies discuss the role of corporate governance in IFIs such as Grais and Pellegrini (2006), Mizushima (2014) and Grais and Pellegrini (2004). On the other hand, there are few studies that examine the level of the relationship between corporate governance and Sharīʿah governance such as Hasan (2009) and Abu-Tapanjeh (2009:556-567). This study is unique because the main aim of the study is to discuss the elements of corporate governance and to build a framework that conceptualizes corporate governance from the Sharīʿah perspective.

## 2. The Definition of Corporate Governance

Corporate governance has a significant role in any corporation. According to Hasan (2011:3) corporate governance as a concept is becoming more popular due to the failure of many corporations because of poor governance. However, there is much debate and discourse on the concept of corporate governance because of various interpretations of the aims of companies regarding various corporate governance models. The literature provides many definitions based on the different models on the concept of corporate governance (Hasan, 2011, 4).

The word ‘corporation’ devises from the Latin word corpus, which is defined by the Oxford English Dictionary as “a group of people authorized to act as an individual and recognized in law as a single entity” (Stevenson, 2010). Similarly, the American Heritage Dictionary (2007) defines the term as “a body that is granted a charter, recognizing it as a separate entity having its own rights, privileges, and liabilities distinct from those of its members.” In sum, from the previous definitions, it can be understood that the term corporation refers to a company represented by a group of people having rights that distinguish them from other members.

According to Cadbury (2002, 1), the term ‘governance’ has its roots from gubernare, a Latin word that connotes to steer or to govern. In English, the word means “an act or manner of governing” in its wide context (Stevenson, 2010). There are some other meanings of governance based on who is involved in the process and how it works. For example, governance can be used in contexts like corporate governance, international governance, national governance, and domestic governance (Mokhtar & Al-Omran, 2011, 43-44; Hassan, 2014).

The term corporate governance has gained popularity in the financial industry in the last two decades because of the crises and scandals that affected the industry (Hasan, 2011). In this respect, there is globally accepted definition of corporate governance (Rezaee, 2009).

Hassan et al. (2011) defines corporate governance as the structure for allocation of rights and duties among the members of the institution, including management team, shareholders, and other stakeholders who are responsible for setting up the principles and processes for making decisions.

Millstein (1998, 2) points out that the concept of corporate governance can be grouped into broad and narrow meanings. The narrow term “concerns the relationships between the corporate manager, directors, and shareholders.” On the other hand, the broad term concerns how “the combination of laws, regulations, listing rules and voluntary private sector practices which enables the corporation to attract capital, perform efficiently, generate profit, and meet both legal obligations and general societal expectations.” Shleifer and Vishny (1997:737) simply define corporate governance as an official regulation of senior management’s accountability to shareholders.

The Cadbury Committee (1992, 4) defines corporate governance as:

The system by which companies are directed and controlled. The Board of Directors is responsible for the governance of their companies. Additionally, the shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate structure is in place.

Bank Negara Malaysia (BNM) (2011) defines corporate governance as:

The process and structure used to direct and manage the business and affairs of the institution towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholder value, whilst taking into account the interests of other stakeholders.

The above definitions of corporate governance can be classified into two main components which are:

1. The structure and the process. This refers to organizational arrangements used to organize the business, duties and rights among the participants.
2. The key participants of the organization or the company. They are the members of the company, such as, management, shareholders and stakeholders. In this respect, corporate governance can be defined as the way in which the company is managed and supervised.

## 3. Definitions of Corporate Governance in The Financial Context

The Organization for Economic Co-operation and Development (OECD) (2004, 11) explains the concept of corporate governance as “a set of relationships between a company’s management, its board, its shareholders, and other stakeholders”. Similarly, the Basel Committee for Banking Supervision (BCBS) (1999,3) describes corporate governance as:

The manner in which the business and affairs of individual institutions are governed by their BOD and senior management affecting how a bank sets its corporate objective, day-to-day business, interest of the stakeholder, align corporate activities, operations and behaviours in a safe and sound manner and to comply with laws and regulations, and to protect the interest of depositors.

Hassan (2011,14) suggests that the term "stakeholder" in the definition by the Basel Committee (BCBS) can be interpreted in a wider perspective to include all respective parties such as depositors, suppliers, supervisors, customers, government and society.

We can see that the definition of (OECD) for corporate governance was general and does not distinguish what is corporate governance in financial sector. On other hand the definition of (BCBS) for corporate governance was more specific which mentions the definition in the financial sector and the key players in corporate governance.

## 4. Role of Corporate Governance

Corporate governance plays a crucial role for the improvement of any company matters, including Islamic banks, Islamic morals, qualities, and administration (Lahsasna & Saba, 2014, 24-25). It is a fact that the experience of scandals and collapse faced by banks worldwide proved that there is a huge effect of weak governance of the bank (Solomon & Solomon, 2004). Therefore, the practice of good corporate governance would play a vital role to guarantee sound business and operation in the financial world.

According to Scott (2003, 527) the primary objective of corporate governance is that it is a mechanism that encompasses a group of the laws, incentives, and morals that amplifies the economic efficiency of a corporation. According to Selvaggi and Upton (2008), Black et al. (2006) and Black (2001, 89), there is a positive correlation between corporate governance behaviour and the performance of corporations. For example, in the UK it was found that corporations with better governance structure have 18% higher returns as compared to those with weaker governance practices. Also, in Russia, a study projected that good governance has a great tendency of adding significant value to companies. In addition, companies with sound governance in Korea have been found to trade at a premium of 160% compared to firms with poor governance system (Hawkamah, 2008, 12).

According to Wolfensohn (1999), the promotion of corporate accountability, fairness and transparency are considered as important functions of corporate governance. Transparency plays an essential role by ensuring fairness for shareholders and stakeholders. In addition, sound transparency and accountability in corporate governance will impact the growth rate, trustworthiness, efficiency, and stability of the corporation positively (Grais & Pellegrini, 2006, 5).

## 5. Corporate Governance in Financial Institutions

Corporate governance plays a significant role in financial institutions. According to Caprio and Levine (2002, 11-18), factors like opaqueness of banks, strict regulatory measures and hindering mechanisms to the corporate governance affect its governance structure which may change the corporate governance equation. The financial institutions differ from other sectors in corporate governance in terms of block share ownership, board size and composition, ownership, CEO compensation and board activity. These distinctive attributes need strong and effective measures for corporate governance in financial institutions. As such, BCBS gives more attention to corporate governance in financial institutions. BCBS provides guidelines that banks can follow to improve the corporate governance structure of the institutions to ensure the safety of financial institution practices (Hassan, 2011, 28).

Stakeholders in financial institutions can be categorised into five groups, namely: the shareholders, the managers, the depositors, the borrowers and the regulator (Yamak and Suer, 2005,114-115). The shareholders that possess ownership rights are majorly concerned on how to get more profit. The managers expect to obtain monetary and non-monetary compensation as specified in the agreement. The depositors will get a profit on their deposits. The borrowers expect fair treatment by the bank. The regulators are concerned with the compliance with the laws and guidelines by all stakeholders. To sum up, the role of corporate governance in financial institutions is crucial in providing the rules and guidelines that ensure the safety of banking practices.

## 6. Key Players in Corporate Governance

There are two types of participants in corporate governance in the financial services sector which are internal and external. The internal key players are the board of directors, senior management and the shareholders (Lahsasna & Alhabshi, 2016, 24-25). The external key players comprise the stock markets, government regulatory agencies, and courts which are responsible for rebalancing contraventions in governance regulations (Salacuse, 2003, 52).

## 7. Internal Key Participants

### 7.1 Board of Directors (BOD)

1. The role of the board of directors in corporate governance is to conduct oversight of the corporation`s business. The BOD has a significant role in watching and assessing the management performance on behalf of the stakeholders (Lahsasna & Alhabshi, 2016).
2. The Board supervises and sets the strategic plans for executing the strategic resolutions.
3. The Board also leads the senior management of the company.
4. It also sets direction for the management and provides other alternative strategies.
5. It is also responsible for setting standards, monitoring the implementation of strategies and giving advice to the CEO.

Besides that, the board of directors has a great responsibility of keeping the company healthy. Therefore, the members of the board of directors must be qualified and have proper moral integrity. The role of the BOD is to act in the best interests of the company as well as putting shareholders` interests ahead of their own interest when making decisions (Hassan, 2011, 30).

### 7.2 Managers

Lahsasna and Alhabshi (2016: 24-25) point out that the management group is comprised of the CEO and other employees who carry out transactions and operations of the company. The management has to report to the BOD on the status of the recent transactions and operations. They add that the management team is appointed by the board of directors. Similarly, the senior management has the responsibility to follow and implement strategic plans of the BOD as well as operating within annual plans with the budget allocated by the BOD. The management in the stakeholder’s model has a fiduciary responsibility to the shareholders and other parties involved in the company such as the community and the public in general (Hasan, 2011, 30).

### 7.3 Shareholders

Mallin (2007:162) simply defines the shareholders as an individual institution, firm or other entity that owns shares in the company. The shareholders are the owners of the company and hence they possess a direct interest in the firm. The board of directors is elected and hired to run and watch the business on behalf of the shareholders (Rezaee, 2009). Shareholders have rights, responsibilities and a voice that can influence the operation of the company (Cowan, 2014, 25). Shareholders hold shares in the company and these shares vary in terms of the class and voting rights. The voting rights can be practiced in allowing the BOD to perform a particular action as proposed at general meetings (Cowan, 2014, 25). According to Monks and Minow (2008:8) the shareholders expect the managers to operate their business in a way that promotes supportive governance and societal climate to capital enterprise. Dube (2009, 50-60) has concluded that the rights of shareholders are as follows: to secure transfer of shares, to engage and participate as voters in shareholders’ general meetings, to elect members of BOD, to share in the profits of the firm, to participate in and to be informed on decisions pertaining to essential corporate changes.

### 7.4 External Key Participants

The main function of external key players in corporate governance is to aid in the smooth execution of corporate governance, which encompasses the judiciary, regulatory authorities and government agencies. The government is responsible of defining the legal environment for the functioning of effective corporate governance that relates to decisions at the managerial level (Caprio & Levine, 2002, 8). The role of the regulatory authorities in corporate governance is to provide strong guidelines for the financial institutions and develop systems for internal control, provide procedures for risk management, standards of transparency and overall monitoring of the banking operations. All aspects of corporate governance have to follow the rules placed by either regulatory authorities or the legislative, while the role of the court is to compel remedies for infringement of corporate regulations (Hasan, 2011, 31).

## 8. Corporate Governance From The Islamic Perspective

So far there is no consolidated meaning in Arabic to describe the concept of corporate governance, although an official translation in Egypt has defined governance as 'an accreditation' by the Egyptian Linguistic Department (Sourial, 2004, 5-29). Corporate governance from the Islamic perspective has its own characteristics and features. Moreover, it is unique in comparison with the Western model of corporate governance such as Anglo-Saxon and the European models. It integrates the elements of *Tawḥīd*, *Shūrā*, *Sharīʿah* principles and safeguards the interests of individual and society (Aji Haqqi, 2014, 112)

The concept of corporate governance from the Islamic perspective could be described as provisions for a company's governance, monitoring, direction, and management, to ensure that stakeholders' interests are protected, the corporation`s aims are achieved, and *Sharīʿah* principles are complied with (ISRA, 2016, 706). The OECD defines these principles as follows (OECD, 2015, 11):

Corporate governance involves a set of relationships between a company`s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined (ISRA, 2016, 706).

The OECD, in its definition, explains that the main objective of corporate governance is to make sure that certain principles, like some important rules in Islam such as fairness, transparency, and accountability, are strictly adhered to. In this respect, the International Financial Services Board (IFSB) explains corporate governance as:

A defined set of relationships between a company`s management, its board of directors (BOD), its shareholders and other stakeholders, which provides the structure through which objectives of the company are set and the means of attaining those objectives and monitoring performance are determined (IFSB-3).

Moreover, in the context of IFIs, IFSB further states that corporate governance is:

A set of organizational arrangements whereby the actions of the management of institutions offering Islamic financial services are aligned, as far as possible, with the interests of its stakeholders; provision of proper incentives for the organs of governance such as the BOD, the *Sharīʿah* supervisory board and the management to pursue objectives that are in the interest of stakeholders and facilitate effective monitoring, thereby encouraging IIFS [IFIS] to use resources more efficiently; and to comply with Shari`ah rules and principles (IFSB-3, 27).

The above definition spells out the framework of corporate governance. The first part of the definition is on the elements of corporate governance while the second part of the IFSB-3 combined the requirements for *Sharīʿah* compliance (ISRA, 2016, 706).

## 9. Foundation of Corporate Governance from the Islamic Perspective

### 9.1 *Tawḥīd* Epistemology and *Shūrā* (Consultation)

Choudhury and Hoque (2006, 50-60) tried to find the relationship between Islamic epistemology of *tawḥīd* and corporate governance, as the substance of Islamic faith is *tawḥīd*. As presented by ISRA (2016:707), foundation of corporate governance framework comes from the concept of *tawḥīd*. Allah (SWT) has mentioned that:

Those who remember Allah standing, sitting, and lying down on their sides, and think deeply about the creation of the heavens and the earth, (saying): 'Our Lord! You have not created this without purpose, glory to You! Give us salvation from the torment of the fire (The Qur'ān, 3:191).

Allah (SWT) mentioned *tawḥīd* as the foundation of Islamic faith in another verse of the

Qur'ān, where He says: "And I created not the *jin* and mankind except that they should worship Me" (The Qur'ān, 51:56).

We can conclude that both verses indicate that Allah has created everything in the world, and both *jin* and humanity must worship Allah (SWT). Therefore, every human being is accountable and answerable to Allah (SWT). This explains the basis for a corporate governance framework in Islam. According to the statement of Hassan (2011:49), who was inspired by the concept of *tawḥīd*, stakeholders should play their role as vicegerents, and the corporation has the responsibility of fulfilling the principle of justice via *shūrā* (consultation). Regarding *shūrā* there are numerous verses in the Qur'ān that show that every Muslim must practice the principle of *shūrā* (consultation) in his life. For example, Allah (SWT) says:

> So, pass over (their faults) and ask for (God's) forgiveness, and consult them in the affairs (of the moment); then, when you have taken a decision, put their trust in God (the Qurān, 3:159).

The above verse implies that all Muslims should practice *shūrā* (consultation) in the affairs of their lives particularly when making decisions. In the context of corporate governance, all stakeholders of the corporation should participate in its affairs, either directly or indirectly. The management, shareholders, BOD, and employees represent the *shūrā* team of participants. Also, they have a duty in ensuring that all business of the company are following *Sharī'ah* rules and principles (ISRA, 2016, 707).

### 9.2 Stakeholders-oriented Approach

According to Iqbal and Mirakhor (2011:43-44), the corporate governance model in the Islamic economic system seems to be a stakeholders-centred model because the governance structure in an Islamic system should safeguard all the rights and interests of all stakeholders and shareholders. The authors add that there are two principal concepts of Islamic law, which are the commitment to implicit and explicit contractual agreements and rights on properties. These two fundamental concepts justify the classification of corporate governance from the Islamic perspective as a stakeholder-based model.

In this respect, Islam encourages people to perform their duties and fulfil their obligations, as Allah (SWT) said, "O you who believe, fulfil contracts" (the Qur'ān, 5:10). This verse of the Qur'ān explains that all Muslims must execute and meet their obligations either as individuals or as groups. In the context of Islamic corporate governance, all parties must perform their duties to carry out their roles in accordance with the conditions stipulated in the agreement/contract (ISRA, 2016, 708).

To sum up, the theory of Islamic corporate governance stipulates that all participants of the company must play their roles in ensuring all rights and interests of other members, regardless of whether these participants have an active or non-active role in making decisions.

## 10. Roles of Corporate Governance In IFIs

Sound corporate governance protects the interests and the rights of its stakeholders. In IFIs, corporate governance includes not only promoting healthy and responsible relationships between the BOD, management, shareholders as well as stakeholders, but also enhancing the relationship with Allah (SWT) (ISRA, 2016, 708).

The role of corporate governance in the context of IFIs is to ensure that all businesses and operations comply with *Sharī'ah* principles and perform its role in fulfilment of profit-making motives and maximizing the interests of shareholders (Akhtar, 2007, 8-16). Grais and Pellagrini (2006, 10-20) state that corporate governance has two main principles in IFIs. First, the shareholders need to ensure that their business and activities follow the *Sharī'ah* rules and principles. Second, the shareholders need to assure that the growth of the business of the IFIs is maintained and can show stability, efficiency, and credibility. The corporate governance in IFIs has to assure that the IFIs meet the *Sharī'ah* requirements and achieve the objectives of profit generation as well as enhance growth, credibility, and efficiency. Corporate governance is crucial in IFIs to gain and enhance the confidence of stakeholders and the general public to reassure them that all activities, operations, and products of IFIs are in compliance with *Sharīʿah* principles and rules (ISRA, 2016, 708). In this respect, all parties of corporate governance in Islamic jurisdiction must play their roles properly. Abdul Aziz (2012, 7-15) pointed out that the manager should play a prominent role in the financial institution as an agent. The management should lead the institute appropriately and staffs are expected to serve their organization. Moreover, the BOD has the responsibility to confirm that the institute is running in line with the intentions of the shareholders. Additionally, the SSB has a duty of ensuring that the organization is operating according to the *Sharīʿah* rules. Moreover, SSB is required to guarantee that the investments of shareholders are being used in a proper way.

## 11. Conclusion

Based on the former discussion, it can be noticed that there are many definitions of corporate governance based on different models of the concept of corporate governance, which reflect the diversity of their perceptions in the field. The main role of corporate governance is to ensure that the business and activities of an organization are run with the highest care and responsibilities. There are three key players in corporate governance: BOD, management, and shareholders. The BOD has a significant role in watching and assessing the management performance on behalf of the stakeholders. The management group is comprised of the CEO and other employees who carry out transactions and operations of the company. The shareholders are the owners of the company and they possess a direct interest in the farm.

The concept of corporate governance from the Islamic perspective could be described as a group of arrangements on how a company is governed, monitored, directed, and controlled. The main role of corporate governance in the context of IFIs is to guarantee that all businesses and operations comply with *Sharīʿah* principles and, at the same time, are maximizing the interests of shareholders. Corporate governance from an Islamic perspective requires an additional layer of governance that emphasises on faith, ethics and *Sharīʿah* principles. The model of corporate governance in the Islamic economic system seems to be a stakeholders-centred model because the governance structure in an Islamic system should safeguard all rights and interests of all stakeholders and shareholders. IFIs' corporate governance needs special arrangements as part of their corporate governance framework that is in accordance with *Sharīʿah* rules and principles.

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