CORPORATE GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS

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Abstract

The crisis that swept the financial markets and economies of the major Asian countries in 1997 and the failure of several famous names (e.g., Enron, WorldCom, and Parmalat) that have occurred in the last 20 years led to questions over the importance and significance of good corporate governance practices. Global governance is at crossroads and appears incapable of overcoming the current gridlock in the most significant global negotiations. The repurposing of global governance to meet the new challenges is a vital and massive undertaking.

Therefore, interest in corporate governance has grown and attracted considerable attention in both developed and less developed countries. Hence, the study takes a theoretical approach, and reviews the existing literature on traditional and Islamic corporate governance, analyzing the set of rules and processes, which form the governance mechanism of a firm, in each of these models. Corporate governance models in the non-Islamic economy are divided into two models: the Anglo-American model (Unitary system) and the German model (Dual system). In the Unitary system, the "Corporation" concept is based on a fiduciary relationship between shareholders and management. Based on the concept of market capitalism, the Anglo-Saxon system is founded on the notion that self-interest and decentralized markets can function in a self-regulating, balanced manner. Moreover, the study analyzes the causes of failure of

the non-Islamic economy, and the connection with the recent financial crisis. It is important to mention that corporate governance failures in the USA and Europe have resulted in massive problems faced by the companies over the years, because of the scandals. Meanwhile, in China, despite recent reforms made in corporate governance several problems remain, mainly, because of state concentration ownership, and the lack of a well-defined concept for fiduciary duty.

In the Islamic corporate governance model, it is important to emphasize the notion of "Tawhid" because it is the foundation of Islamic faith, and the basis for the corporate governance framework emanates from this concept. The principle of "Tawhid" derives important concepts of vicegerency (Khilafah), trust (Amanah), and justice or equilibrium (adl wal Ihsan). The stakeholders as vicegerent of God have a fiduciary duty to uphold the principle of distributive justice via the shuriatic process. The practice of Shura is not an option but it is rather an obligation. Shari'a governance is heavily concerned on the Shari'a compliance, and because of this, Islamic financial institutions have Sharia supervisory as required in the Sharia governance framework.

Comparing the Western and Islamic models of corporate governance, considerable differences are noted. The most important divergence between the two models rooted from the fact that the Islamic perspective sees the corporate governance practice as a Muslim's obligation to God thus placed God and Islam as key players in it. This is in contrast to the conventional point of view that focuses on the material aspects and the main objective is to create and increase shareholders' value throughout the time. However, a significant factor of convergence between Islamic and conventional systems is Corporate Social Responsibility (CSR), going beyond the logic of sustainability in short-term marketing policy and implementing medium- and long-term sustainability.

To conclude, the current traditional corporate governance framework is not wrong in general (OECD, 2009), but the failure was mainly associated with the lack of implementation of corporate governance codes and principles. Unfortunately, the Western model continues to have problems still today, even if it has been resized. Regarding this, Al'Faruqi points out the need to apply the worldview and paradigm of "Tawhid", in the context of contemporary socio-political realities and challenges. It assures an optimal corporate governance system, by improving the process of accountability, transparency, and disclosure, responsibility, fairness, and protects the rights of stakeholders.

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