CORPORATE GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTIONS

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How to cite this paper: Istrefi, V. (2020). Corporate governance in Islamic financial institutions. *Journal of Governance & Regulation, 9*(2), 75-82. http://doi.org/10.22495/jgrv9i2art5

ISSN Print: 2220-9352
ISSN Online: 2306-6784

Received: 17.02.2020
Accepted: 08.05.2020

JEL Classification: G30, G38
DOI: 10.22495/jgrv9i2art5

Abstract

The most recent and severe financial crisis followed by the failure of the most important financial players in the world economy has raised doubts about the way the government system works. This has been crucial to understanding the significance of good corporate governance practices, able to sustain the current blockage in the most vital financial negotiations. Therefore, interest in corporate governance has grown and attracted considerable attention in both developed and less-developed countries (Mallin, 2004; Solomon & Solomon, 2004; Sternberg, 2004). Hence, the study is based on a theoretical approach, and confronts the traditional and Islamic corporate governance, analyzing the essential differences that have highlighted the necessity of finding an alternative model to the traditional one. Comparing the two models of corporate governance, in their authentic form, it easily gives rise to discrepancies. The most important divergence between the two models derived from the fact that in the Islamic model the corporate governance practice is based on the religious principles and God and Islam are the main participants in it. This is in contrast to the conventional philosophy that focuses on the material aspects and the main objective is to create and increase shareholders' value throughout the time.

Keywords: AAOIFI, Corporate Governance, Islamic Corporate Governance Model, Shari'a Law, Traditional Corporate Governance Model, Tawhid

Authors' individual contribution: The Author is responsible for all the contributions to the paper according to CRediT (Contributor Roles Taxonomy) standards.

Declaration of conflicting interests: The Author declares that there is no conflict of interest.

1. INTRODUCTION

The recent financial crisis has demonstrated that the traditional corporate governance has been not enough 'equipped' to the front financial crisis.

The main models of corporate governance, unitary and dual system, not to mention the Chinese system, which doesn't leave much margin for comment, have become obsolete in coping with crises like this.

After the financial crisis, the concept of corporate governance has had to be reshaped, reformulating certain aspects under the guise of alternative definitions, increasingly geared towards ethics and social responsibility. Islamic finance is an alternative that works based on religious-moral principles. Specifically, in terms of corporate governance, Islamic finance, marginalized before the financial crisis, has shown to act with more immunity and to withstand or prevent situations of a similar financial crisis. This because it does not consider the maximization of profit only for a few, but being an inclusive field, it assures the wellbeing for all society, thanks to the concept of "Tawhid".

The structure of this paper is as follows: the second section analyzes the characteristics and problems of the traditional corporate governance models, the third section explores the fundamentals of Islamic finance, Islamic corporate governance model, the fourth section compares the traditional and Islamic corporate governance models, and the last section determines the possible ideal model to be re-designed, as a point of convergence between the two models.

2. CORPORATE GOVERNANCE MODEL IN THE CONVENTIONAL SYSTEM

This paragraph will briefly analyze the corporate governance model in the Western system and China, to better understand the causes of the failure of these models in parallel with the progress of the financial crisis. In the traditional economy, corporate governance is fractionated into two models: 1) Anglo-American model (unitary system) and 2) German model (dual system).

The unitary system is based on a fiduciary relationship between shareholders and management. The U.S. corporate system is best understood as the set of fiduciary and managerial responsibilities that binds a company's management, shareholders, and the board within a larger, societal context defined by legal, regulatory, competitive, economic, democratic, ethical, and other societal forces. Until recently, the U.S. government relied on the status to be the primary legislator for corporations. The existence of a corporation is not dependent upon whom the owners or investors are at any one time. Once formed, a corporation continues to exist as a separate entity, even when shareholders die or sell their shares, or a shareholder decides to dissolve it or merge it with another business.

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 (Cernat, 2004).

Weber writes that the "spirit of capitalism" is the pursuit of wealth as an end in itself, to the point of being irrational (Weber, 1930, Chapter 2).

As can be seen, in the unitary system, corporate governance is to take over the role of the shareholders, stakeholders, vendors, suppliers, and employees who have invested their money, material, effort, and faith in the company.

The dual system has been characterized by a pyramidal ownership structure, with companies owning each other through a series of cross-shareholding, extensive bank proxy voting, and family ownership (Solomon & Solomon, 2004). In this corporate governance model, the supervisory board, even it does not have much decision-making, has the power to elect the management board.

In China, where the economy is based on state-owned enterprises and the state command and controls almost every aspect of the economy, a corporate governance model is also under the overwhelming state-control. Western-style corporate governance did not exist in China.

2.1. Problems of traditional corporate governance model

The three traditional models of the corporate governance system, as it can be seen differ between countries, reflecting contrasts of legal systems, cultural systems, and economic environments.

However, there are some common "obstructive" attributes:

- Minor shareholders that have a marginal impact on the stock price, are not considered.
- Ethically, these models of corporate governance consist in exploiting the workforce, through outsourcing and underpaying.
- These corporate governance models are extreme examples of *Ponzi scheme1,* which is based on dishonest and unethical dealings.

The traditional corporate governance model in the conventional system has persistent problems; In the U.S.A., the main problem persists from the separation of ownership from control, because corporate governance is taking over the role of stakeholders, shareholders, vendors, suppliers by the top managers and CEO.

In Europe, a corporate governance model is a dilemma; it is still searching for the *best practices.*

In China, the power of the government system is state property. This leads to the lack of a relationship between the board of directors and the non-definition of fiduciary duty, as well as the false financial disclosure which is another problem for Chinese companies.

Traditional corporate governance has failed to prevent the current financial crisis, but as if that were not enough, it has also provided encouragement for companies to abuse corporate accounting standards in order to create short-term profit maximization, instead of incentivizing greater corporate responsibility so that huge disasters are avoided before they occur.

This suggests an ethical behavior for corporations, and for the whole economic system, which is captured in the definition of corporate governance adopted by the World Bank:

> *"Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations, and society".*

3. CORPORATE GOVERNANCE IN ISLAMIC SYSTEM

3.1. Fundamentals of Islamic finance

Shari'a (or Islamic) law are religious regulations that guide all aspects of a Muslim's conduct.

It is important to specify that Shari'a law means "the way" and does not refer to a body of law. Shari'a is divided into two major guidelines: the first one is mandatory and refers to the obligatory worship of God (ibadah) and the second one (muamalat), is not obligatory. It consists of the rules including commercial and financial dealings.

Shari'a consists of general rules and principles derived from the *Qur'an* (the Muslim holy book), the practices (Sunnah) and sayings (ahadith) of the Prophet Mohammed a.s. The objective of Shari'a is to promote the wellbeing of all mankind, which lies in safeguarding their faith (din) their human self (nafs), their intellect (aql), their property (nasl), and their wealth (mal).

Kamali (2008) argues that unlike Islamic jurisprudence, Shari'a objectives are "not burdened with methodological technicality and literalist reading of the text". For example, Shari'a scholar Yusuf Al-Qaradawi added human dignity, freedom, social welfare, and fraternity as important objectives of Shari'a. In a similar vein, Kamali (1999) has advocated adding economic development and science and technology to the list of objectives.

The Shari'a is divine and immutable, it is the perspective of justice and equity to the empirical and spiritual advantage of the individual and *the Ummah* (society).

The Ummah is ruled neither by its rules nor by its people, the ruled. Both of them are under the law. The ruler is a mere executor of the law. Hence, the Ummah is a nomocracy, a republic where rule belongs to the law, and not a "democracy", or "oligarchy", or an "autocracy" since nobody, whether the individual, a group, or the totality of people enjoys as such any right to rule.

Sources of Shari'a law

Shari'a law is derived from four sources in Islam. The primary sources are the Qur'an and the Sunnah, and the secondary sources are Consensus (Ijmaa) and Analogical deduction (Qiyaas). All sources must be in essential agreement with the Qur'an, the most fundamental source of Islamic knowledge. It is only when the Qura'an itself does not speak directly to or in detail about a certain subject that Muslims turn to alternative sources of Islamic law. The sources of Shari'a law are used in order, where if one source fails to provide a direct solution to a problem, the subsequent one is used (Alarefi, 2009).

The Qur'an presents the intellectual and moral bases of the Islamic Shari'a and strengthens them with arguments and appeals to the heart. It clearly defines and limits the bounds of every aspect of life. The Qur'an forms the ultimate basis of Shari'a (Makdisi, 1986). It is deemed to be the collection of inimitable verses revealed by God to Prophet Muhammed a.s. during the 7th century Arabia. Of the entire 114 chapters of the Qur'an, only eighty verses can be considered as legal prescriptions. The Qur'an is comprised of a total of 6.239 verses in which 500 of them contain legal content. The legal verses concern family and inheritance laws, criminal laws, obligations, and contract laws and procedures (Alarefi, 2009).

The Sunnah is a collection of writings documenting the traditions or known practices of the Prophet Muhammad, many of which have been recorded in the approval of the Prophets. It also applies to the actions or sayings of any of the Prophet's companion (Sahabah) or their immediate successors.

Ijma (consensus) is based on collective opinion and unanimous consent of the *mujtahidun* (Muslim divines of the higher degree of learning). Judicial decisions must have complementary support from acceptable documentary sources; otherwise, it will be a nullity. It must be pointed out that consensus is not arrived at through a democratic process. The opinion of the community is not determined democratically through the views of the majority, but the conscious realization of the common will on a particular issue.

Qiyas (analogical reasoning) is the extension of Islamic law based on a likeness in two situations. It is defined as "...the way a belief or practice gains official credence and support on grounds that is similar to practice or belief embodied in the Qur'an, Sunnah or Ijma" . Some argue that *qiyas* should be restricted to the area of 'material similarity', while others preferred its application only in the area of similarity in motive or cause that was not properly defined.

Ijtihad and other judicial sources. Ijtihad technically means "enterprise" or "initiative". It was developed as a vehicle to *ijma* and to resolve the controversies, which the application of consensus and analogy has posed. Ijtihad requires mental alertness and ingenuity to comprehend and identify the right decision in a complex situation. Other judicial options for interpretation of Shari'a included *ra'y* which means expert private opinion. There is also *istishan* (juristic preference), or *maslahah* (juristic analysis of the commonweal), *magasid al-Shari'a* (interpretation of the general purposes of law). Another viable and commonly used option is *istislah*, in which judicial reasoning is based on logical soundness and clarity, not based on consensus, but in the interest of public good. There is also *istishab*, in which decisions are based on analogical reasoning with a concomitant validation and linkage with the provision of the Holy Qur'an or the Hadith.

3.2. Principles of corporate governance in the Islamic financial system

The global financial crisis of 2007-2008, opened the possibility to consider other alternatives to heal the empty of the 'black holes' of the traditional finance. Since conventional finance has failed to consider the religious moral principles, which are not held count because they are in conflict with material objectives. Islamic finance, even it is subject to many debates, seems to give the answers, missed by traditional finance because its philosophy considers finance as a servant and not a master of the real economy where goods and services are produced. The main rule in business activity in Islam is honesty and fair dealing, so Muslim business people should have moral values, and the market should be free. The business activity must be carried out by seeking the right balance between profit economic and moral. Islamic financial institutions should consider the money a means of change and not a traded economic good, therefore the payment of passive or active interest (Rib'a) is prohibited. Next, to the prohibition of Rib'a, many prohibited economic practices are contained in the concept of *Gharar* (irrational uncertainty), *Maysir* (speculation), and other behaviors and activities *Haram* (not permitted as tobacco, arms trade, alcohol, pork, and gambling). Instead of interest as a source of remuneration of its financial intermediation, activities of Islamic banks have the basic principle of profit and loss sharing in financial transactions. Islamic values require company management and board of directors to perform their duties with satisfying the needs of the shareholders, other stakeholders, and God. Therefore corporate governance in Islam aims to enhance accountability, transparency, and fairness value.

3.3. Corporate governance model in Islamic financial system

Tawhid conceptualization (unification of God)

To analyze the model of corporate governance in Islamic financial institutions, it is important to emphasize the concept of "Tawhid", because it's the foundation of Islamic faith, and also the basis for corporate governance framework emanates from this concept (Al-Faruqi, 1982).

He created man and established him on earth as vicegerent, to worship Him.

He says in the Qur'an*:* "I created man and jin to worship Me…" (Qur'an, Ed-Dharijat, 56)

The Worship of God includes all acts that man manifest to obtain His pleasure, for whatever man gains or losses, it is all a matter of God's will.

As the Qur'an expresses it:

God; there is no God but He – the Living, the Eternal One.
Neither slumber nor sleep overtakes Him.
His is what the heavens and the earth contain.
Who can intercede with Him, unless by His leave?
He is cognizant of men's affairs, now and in the future.
Men can grasp only that part
of His Knowledge which He wills.
His throne is as vast as the heavens and the earth,
and the preservation of both does not weary Him.
He is the exalted, the Immense One.
(Qur'an, 2:255)

Taqi (2002) explains the importance of divine guidance by noting that "there are areas in which human reason cannot give proper guidance or at least, is susceptible to errors" and God has provided guidance through His Prophets, who have built their governance upon the Tawhidic view.

Below will be explained how corporate governance philosophy functions in the Islamic economy.

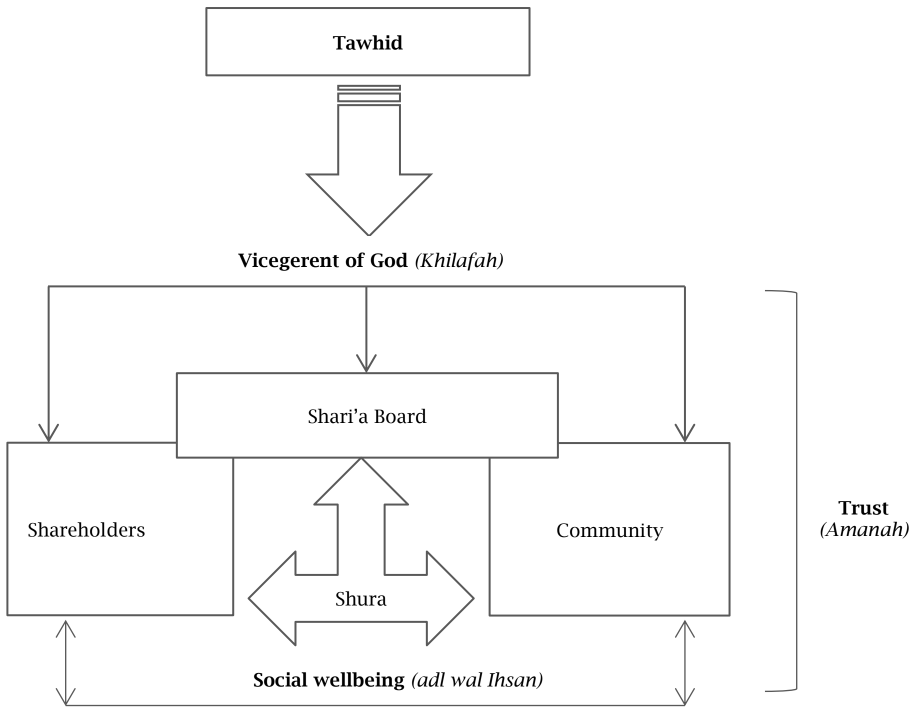
First of all, each part involved in the corporate governance process should behave with responsibility and reckoning towards the company without ignoring the duty of social welfare, rejecting rationality and rationalism. According to Chapra, the Islamic economy is contrary to the selfish *l'homo economicus*. Islamic economy does not recognize the distinction between material and spiritual goals. All humans have material goals, but the personal interest must be guided by moral values, in the frame of social interest, ad this defines the *homo islamicus*. The human wellness does not depend only on wealth maximization and consumption. As the Islamic economy is based on the primordial objective that is the socio-economic justice so that the distribution of resources should be assigned to everyone without exception.

Islam does not suppose the natural existence of behavior guided by moral values. It must be created, actualizing a favorable and motivating environment through a social structure, based on their moral values, to address their behavior versus the ideal one.

In this way, it is possible to avoid the agonies of failure in every government's structure, both economic and political, and at any level.

Therefore, Tawhid is the primary pillar for the function of the corporate governance model in Islam as every mankind is answerable and accountable to Him.

Figure 1. Tawhid and Shura model



Source: Own elaboration

The figure shows that the Islamic corporate governance approach is premised on the Tawhid epistemological model from which derived important concepts of vicegerency (Khilafah), trust (Amanah), and justice or equilibrium (Adl wal Ihsan). The stakeholders are considered as vicegerent of God, and their main responsibility is to generate social justice through virtuous cooperation in respect of the Shari'a principles. Chapra mentions that the practice of Shura is not an option but it is rather an obligation. The Islamic corporate governance model is composed by Shari'a board and stakeholders. Shari'a board is the most important organic institution and should guarantee the regular process of activities under the control of Shari'a law. On the contrary of conventional finance, all shareholders, even the minor ones are incorporated as active stakeholders *au pair* with the major ones. So, the decision making and policy framework consider the interest of all stakeholders. Besides, in this model, there is no maximization of profit in the hands of the few majority shareholders but fairly divided among all. In light of justice or equilibrium (Adl wal Ihsan), it has a vital significance to promote cooperation between shareholders and the community. Islam does not accept the profiteering that creates negative externalities for society. This is the only way that seeks to establish the distribution of wealth in an even manner between all. All these processes are centered on fulfilling the ultimate objective of Islamic corporate governance of complementing the private and social goals via upholding the principle distributive justice (Choudhury & Hoque, 2004, pp. 85-88).

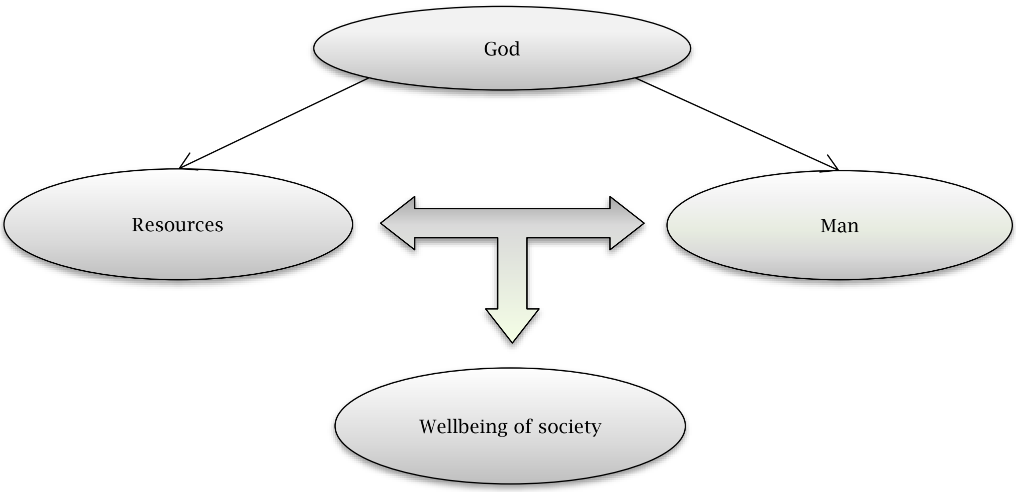
3.4. The notion of "vicegerency" (Khilafah)

First of all, it is necessary to emphasize the fact that man is God's vicegerent in the earth (Qur'an, 2:3), which arises as to the primary strong concept and plays a crucial role in making the social equity work rigorously and permanently. From here came up the divine duty to use God's resources with trustfulness (Amanah), for the wellbeing of society. In this way, in respect of the *universal pax islamica* it is possible to promote social justice and equity, eliminating excessive consumption, and unfair trade practices.

The Qur'an states, "God raised up the heavens and established the Scales of balance" (Qur'an, 55:7), which means "He established justice *(athbata al-ʿadl).*"

In fact, this concept is central to the notion of Islamic justice, which two important principles; First, that no individual or group may exploit another; and, second, that no group may insulate and separate itself from the rest of mankind with a few restricting their economic conditions to themselves, be it one of misery or affluence.

Figure 2. The illustration of the notion of "vicegerency"



Source: Own elaboration

3.5. Shari'a governance framework

"…Shari'a governance framework is a set of organizational arrangements through which Islamic financial institutions ensure effective oversight, responsibility, and accountability of the board of directors, management and Shari'a committee".

Based on the *Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)* standards, the Shari'a governance framework is designed to meet the following objectives:

1. Sets out the expectation of the Bank in an IFIS's Sharia governance structures, processes, and arrangements to ensure that all its operations and business activities are in accordance with Shari'a.
2. Provides comprehensive guidance to the board, Shari'a committee, and management of the IFI in discharging its duties in matters relating to Shari'a.
3. Outlines the functions relating to Shari'a review, Shari'a audit, Shari'a risk management, and Shari'a research.

To achieve these objectives Shari'a governance should follow seven important principles.

Table 1. The seven principles of Shari'a governance framework

Principle 1	The board of directors should establish their own IFI's Shari'a governance framework, where they are expected to understand the Shari'a non-compliance risks associated with Islamic finance business and its possible implications to the respective IFIs.
Principle 2	The ultimate responsibilities on Shari'a compliance lie on the board of directors through the Shari'a Committee plays a key role to ensure its compliance, where the Shari'a Committee should comprise of a minimum of 5 members of which the majority is Shari'a experts.
Principle 3	Outlines the importance of observing the independence of the Shari'a Committee in exercising their duties to make objective and informed decisions.
Principle 4	Pointed out the importance of right competency, understanding, and continuous knowledge enhancement on the Shari'a as well as keep abreast of the latest developments in Islamic finance.
Principle 5	Outlines the importance of confidentiality treatment of information obtained by the Shari'a Committee.
Principle 6	Illustrates the professional ethics, judgement, and consistency to be maintained in ensuring Shari'a compliance.
Principle 7	Outlines on the need for a robust Shari'a compliance function that comprised of review and audit functions, supported by risk management control process and internal research capacity.

Sharia supervisory board has the duty to direct, review, and supervise the activities of the IFIs in order to ensure that they are in compliance with Shari'a principles. The importance of Shari'a supervision is derived from five different resources namely religious, economic, legal, and governance. To tackle the problems of agency theory the members of shari'a board should be of maximum three IFIs simultaneously, and also the members should not be chosen among directors and majority shareholders of the IFI.

4. COMPARISON OF ISLAMIC AND CONVENTIONAL CORPORATE GOVERNANCE MODELS

The main difference between conventional and Islamic corporate governance models consists of the ideological view because as we have seen previously, the traditional model is based on rationalism and rationality, but the Shari'a model, embodied on the Tawhidic view is the diametrical opposite of it. The Islamic model is predictably irrational and it is contrary to the selfish *l'homo economicus*, and the pure ideal example model to be followed is *homo islamicus* who does not recognize the distinction between material and spiritual goals. Thereby, in fulfilling the material needs, personal interest must be guided by moral values, in the frame of social interest. The human wellness does not depend only on wealth maximization and consumption. As the Islamic economy is based on the primordial objective that is the socio-economic justice so that the distribution of resources should be assigned to everyone without exception.

This fact is based on the principle according to which man was created as God's vicegerent and the resources on earth will be used with trust so that they will be distributed equally throughout society. The goal of this is to achieve God's pleasure, because this is the main goal of every Muslim, acting in such a way as to maximize God's pleasure and not only maximize material pleasure.

While the conventional model prioritizes and favors the few majority owners, the Islamic corporate governance objective protect the interest and rights of all stakeholders, and not only to the majority in accordance with the Shari'a compliance.

5. CONCLUSION

The main objectives of this study were to briefly analyze and compare conventional corporate governance models and Islamic corporate governance, to explore their differences and to bring out the weaknesses that have affected the failure of the traditional system. However, the objective of this study was to find other alternatives, and Islamic finance seems to be a good example that could remedy the problems left open by the traditional system. Anyway, the traditional corporate governance system shouldn't be blamed as a whole, as its 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. For example, the Anglo-American corporate governance model has given priority, and tolerated excess power and wealth at the hand of CEOs and cultivated a "greed is good" culture in bankers, corporations, financial markets and financial capitalism, and incentivized investment bank executives to pursue vast securitization and high leveraging to enrich themselves at the severe cost of shareholders, investors and stakeholders (Clarke, 2008; Visser, 2010). According to the Keynesian idea, that "*first we must become wealthy, then we can afford to be moral – first, we must worship the gods of greed and usury, to become free of economic necessity – is at the heart of modern western economic systems and thought*".

This philosophy states the fact that the problem is not the way it was structured, but its "poor" exaggerated philosophy to make uneven wealth at the hand of the few at the cost of the rest of society.

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 (Kamali, 2013). It assures an optimal corporate governance system, by improving the process of accountability, transparency, and disclosure, responsibility fairness, and protects the rights of stakeholders. On the strength of these prescriptions, our visionary leaders promise a just system, which would end exploitation and misery, provide equal economic opportunities to all, end the evils of both Capitalism and Communism, and provide justice in all dimensions of live, social, political, and economic (Al-Faruqi, 1982).

Therefore, an ideal and functional model should be re-designed and it may be possible for the conventional model too. This can come true by recalling moral values, which have been lost, as demonstrated by the latest financial crisis.

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