

ISSUES IN CORPORATE AND SHARI'AH GOVERNANCE PRACTICES IN ISLAMIC FINANCIAL INSTITUTIONS: WHAT WENT WRONG?

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Abstract

The concept of corporate governance which is founded upon the principles of accountability, transparency, responsibility and fairness is an essential element in the context of Islamic banking and finance. The Shari'ah compliance requirements have introduced a new dimension of governance which falls under the corporate governance framework which is unique to the Islamic system of financial management, that is Shari'ah governance. The issue of whether or not the existing corporate governance principles and standards for financial institutions are adequate to regulate the industry, especially at the time of the recent financial crisis is a matter of debate. History has recorded a long list of high profile corporate collapses and corporate malpractices caused by weak and inefficient corporate governance practices, for instance, the cases of Bank of Credit and Commerce International, Barings Bank, Enron, WorldCom, Sime Darby, Transmile, Pelabuhan Klang Free Zone etc. As far as Islamic banking and finance industry is concerned, the list includes the cases of Ihlal Finance in Turkey, Islamic Bank of South Africa, Islamic Investment Companies of Egypt, Dubai Islamic Bank and Bank Islam Malaysia Berhad. The past financial scandals underscore the need for better practices of corporate governance, not only in the conventional banking industry but also the Islamic banking and finance industry. The objective of this paper is to analyse the cases of corporate collapse and malpractice in the Islamic and finance industry which relate to weak and inefficient corporate governance practices. Being a legal research, this study applies qualitative research methodology which is mainly library research. The analysis highlights the corporate and Shari'ah governance issues, and its effects on the institutions involved.

Keywords: Islamic banking and finance, corporate governance, Shari'ah governance, malpractices.

1.0 INTRODUCTION

Corporate governance is 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 (Finance Committee Report on Corporate Governance, 1999). It relates to the manner in which the business of the financial institutions is conducted, aligning corporate activities and behavior with the expectation that the management will operate in a safe and sound manner (Iqbal & Mirakor, 2011). The importance of corporate governance lies on the need to maintain the confidence of the stakeholders especially the depositors of the financial institutions, be it conventional or Islamic financial institutions.

However, history has recorded a long list of high profile corporate collapses and corporate malpractices caused by weak and inefficient corporate governance practices, for instance, the cases of Bank of Credit and Commerce International, Barings Bank, Enron, WorldCom, Sime Darby, Transmile, Pelabuhan Klang Free Zone etc. As far as Islamic banking and finance industry is concerned, the list includes the cases of Ihlas Finance in Turkey, Islamic Bank of South Africa, Islamic Investment Companies of Egypt, Dubai Islamic Bank and Bank Islam Malaysia Berhad (ISRA, 2016). The cases indicate the need for better practices of corporate governance, not only in the developing countries but also worldwide. (Abidin & Hashim, 2010).

Thus, the objective of this paper is to analyse the cases of corporate collapse and malpractice in the Islamic and finance industry which relate to weak and inefficient corporate governance practices. Being a legal research, this study applies qualitative research methodology which is mainly library research. The analysis highlights the corporate and Shari'ah governance issues, and its effects on the institutions involved. This paper is structured as follows: Section 2 reviews the available literature on corporate and Shari'ah governance of Islamic financial institutions. Section 3 identify the existing corporate and Shari'ah governance principles and standards set by international standard setting organisations applicable to Islamic financial institutions in general. Section 4 analyses five cases of corporate and Shari'ah governance issue in the history of Islamic banking and finance industry. Section 5 concludes the paper.

2.0 LITERATURE REVIEW

The term corporate governance is reasonably new as it became the focus of corporate world within the last two decades (Muneeza & Hasan, 2011). The concept of corporate governance is diverse and it has been defined in various manners (Iqbal & Mirakhor, 2011). Malekian and Daryaei (2010), for instance, defines corporate governance as “the way in which the boards oversee the running of a company by its managers, and how board members are, in turn, accountable to shareholders, stakeholders and the company.” Corporate governance is a vital aspect in the management of a company that is meant to help the company to achieve its objectives and enable the company to run in proper manner. This is the main reason why the companies need to have good corporate governance practice which consists of three major components; which are transparency, disclosure and accountability (Muneeza & Hasan, 2011).

Discussions on corporate governance from Islamic perspective are relatively new as opposed to the well-established conventional corporate governance (Alnasser & Muhammed, 2012). The concept of corporate governance in Islam refers to a set of organisational arrangements on how a corporation is directed, managed, governed and controlled with the aim to protect the interest of the stakeholders, to achieve the objectives of the organisation in compliance with the Shari'ah rules and principles (ISRA, 2016). The corporate governance framework from the Islamic perspective integrates the Shari'ah concepts of *shura*, *hisbah* and Shari'ah audit as the major elements of a corporate governance framework (Abdul Rahim, 1998). The practice of *shura* which comprises of the management, board of directors, shareholders, employees, customers and other interested parties, may ensure the effectiveness of any corporate decisions while *hisbah*, plays the function of monitoring the corporations on regulatory and moral aspects (ISRA, 2016).

The Shari'ah governance system was introduced to complement the existing corporate governance framework in the Islamic financial institutions to deal with the Shari'ah compliance-related issues (ISRA, 2016). The requirements of Shari'ah compliance have

introduced a new feature of governance which falls under the corporate governance framework which is unique to the Islamic system of financial management, that is Shari'ah governance (Kassim, Htay & Salman, 2013). The earlier literatures mostly focus on the concept of Shari'ah governance in comparison with the established concept of corporate governance (Kasri, 2009; Choudhury & Alam, 2013).

In relation to Shari'ah governance of Islamic financial institutions such as the Islamic banks, Hamza (2013), Hasan (2011), Muneeza (2014), Garas & Pierce (2010) and Hassan et al (2013) among others, discuss the characteristics of the Shari'ah governance framework, its component and the current practices. Shari'ah governance is essential to deal with Shariah compliance risk, which refers to the risk of non-compliance resulting from a failure of an Islamic bank's internal systems and personnel (Archer & Haron, 2013). The practice of sound Shari'ah governance is crucial for the enhancement of the potential role of Islamic finance in contributing towards corporate reform and to mitigate certain types of risk exclusive to Islamic financial institutions namely Shari'ah non-compliance risk (Hasan, 2011).

3.0 CORPORATE AND SHARI'AH GOVERNANCE STANDARDS

The Organisation for Economic Co-operation and Development (OECD) defines corporate governance in its G20/OECD Principles of Corporate Governance as 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. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy (OECD, 2015).

In reference to banking sector, according to the Basel Committee for Banking Supervision (BCBS) corporate governance involves the manner in which the business and affairs of banks are governed by their boards of directors and senior management, which affects how they set corporate objectives; operate the bank's business on a day-to-day basis; meet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders; align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and protect the interests of depositors (BCBS, 2006).

Thus, to complement the corporate governance standards issued by the OECD and BCBS, the IFSB and AAOIFI have introduced several guidelines and standards to meet the needs of Islamic financial industry. The list of corporate and Shari'ah governance standard introduced by the IFSB is given in Table 1.

Table 1: List of IFSB Governance Standards

No.	Standards
IFSB-1	Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering only Islamic Financial Services
IFSB-2	Capital Adequacy Standard for Institutions (Other Than Insurance Institutions) Offering only Islamic Financial Services
IFSB-3	Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Fund)

IFSB-4	Disclosure to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)
IFSB-5	Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (<i>TakāFul</i>) Institutions and Islamic Mutual Funds)
IFSB-10	Guiding Principles on Shariah Governance System for Islamic Institutions offering Islamic Financial Services
IFSB-17	Core Principles for Islamic Finance Regulation (Banking Segment) (CPIFR)

As far as Islamic banking and finance is concerned, the Islamic Financial Services Board (IFSB) defines corporate governance as a defined set of relationships between a company's management, its board of directors, its shareholders and other stakeholders, which provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined. (IFSB, 2006). The IFSB goes further by describing corporate governance in the context of the IFIs as a set of organisational arrangement whereby the actions of the management of institutions offering Islamic financial services are aligned, as far as possible, with the interests of its stakeholders, provisions of proper incentives for the organs of governance such as the board of directors, the Shari'ah supervisory board and management to pursue objectives that are in the interests of stakeholders and facilitate effective monitoring, thereby encouraging IFIs to use resources more efficiently, and to comply with the Shari'ah rules and principles (IFSB, 2006).

In relation Shari'ah governance system, the IFSB defines Shari'ah governance system as a set of institutional and organisational arrangements through which IFIs ensure that there is an effective independent oversight of Shari'ah compliance over the issuance of relevant Shari'ah pronouncements; dissemination of information on such Shariah pronouncements to the operative personnel of the institution who monitor the day-to-day compliance; an internal Shari'ah compliance review or audit to verify that Shari'ah compliance has been satisfied, during which any incident of non-compliance will be recorded, reported, addressed and rectified; and an annual Shari'ah compliance review or audit to verify that the internal Shari'ah compliance review or audit has been appropriately carried out and its findings have been communicated and duly noted by the Shari'ah Supervisory Board (IFSB, 2009). Table 2 illustrates how Shari'ah governance complements the existing corporate governance framework in the IFIs.

Table 2: Shari'ah governance vis-a-vis corporate governance framework

Function	Conventional Financial Institutions	Additional to IFIs
Governance	BOD	Shariah Board
Control	Internal Audit, external audit	Internal Shariah review, Shariah audit
Compliance	Regulatory and financial compliance officers, unit or department	Internal Shariah compliance officer, unit or department
Risk management	Risk management department (credit, market and operational risk)	Shariah compliance risk

Source: Adapted from IFSB-10 (2009)

The IFSB in its Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering only Islamic Financial Services provides that in dealing with Shariah non-compliant risk, the IFI is required to establish adequate systems and controls including Shari'ah Board or Advisor, to ensure compliance with Shari'ah rules and principles. (IFSB, 2005)

The Core Principles for Islamic Finance Regulation (CPIFR) was introduced in 2015 with the objective to provide a set of core principles for the regulation and supervision of the

Islamic financial service industry, taking into consideration the specialities of the IIFS in the banking segment and the lessons learned from the financial crisis, and complementing the existing international standards, principally the BCBS's *Core Principles for Effective Banking Supervision* (Basel Core Principles, or BCPs). The CPIFR is expected to offer some assistance to regulatory and supervisory authorities in those sectors in areas common across Islamic finance, for instance, Shari'ah governance.

Among the relevant core principles are contained in CPIFR15, CPIFR16 and CPIFR17. The CPIFR15 requires that the supervisory authority determines that institutions offering Islamic financial services in banking segments demonstrate that they have adequate corporate governance and address the relevant aspects of corporate governance from the perspective of Islamic financial institutions. The supervisory authority also determines that Islamic financial institutions and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the Board of Director and senior management, and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the respective Islamic financial institutions. (IFSB, 2015)

In relation to Shari'ah governance, CPIR16 requires that the the supervisory authority determines that an Islamic financial institution must have a robust Shari'ah governance system in order to ensure an effective independent oversight of Shari'ah compliance over various structures and processes within the organisational framework. The Shari'ah governance structure adopted by an Islamic financial institution is commensurate and proportionate with the size, complexity and nature of its business. The supervisory authority also determines the general approach to Shari'ah governance in its jurisdiction, and lays down key elements of the process. (CPIFR, 2015)

In dealing with risk management process, CPIFR17 also requires that the supervisory authority determines that an Islamic financial institution must have a comprehensive risk management process (including effective Board of Directors and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions. The process must be done by taking into account appropriate steps to comply with Shari'ah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority. This extends to development and review of contingency arrangements (including robust and credible recovery plans where warranted) that take into account the specific circumstances of an Islamic financial institution. The risk management process is commensurate with the risk profile and systemic importance of the Islamic financial institution.

The AAOIFI has also taken the steps to introduce basic guidelines for governance framework in its governance standards. Table 3 provides the list of governance standards issued by AAOIFI.

Table 3: List of AAOIFI Governance Standards

GS No.	Standards
GS No.1	Shariah Supervisory Board: Appointment, Composition and Report
GS No. 2	Shariah Review
GS No. 3	Internal Shariah Review
GS No. 4	Audit and Governance Committee for Islamic Financial Institutions
GS No. 5	Independence of Shariah Supervisory Board
GS No. 6	Statement on Governance Principles and Disclosure for Islamic Financial Institutions
GS No. 7	Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions

The issue of whether or not the existing corporate governance principles and standards for financial institutions are adequate to regulate the industry, especially at the time of the recent financial crisis, is a matter of debate. According to OECD, the standards were sufficient but, there exist a gap between theory and implementation. However, there is no urgent need to revise the OECD corporate governance principles and weaknesses has been identified to rectify the situation (Ginena & Hamid, 2015). The financial crisis can be, to an important extent, attributed to the failure and weaknesses in corporate governance arrangements (OECD, 2009). The financial crisis is not simply the result of market failure, it is to some extent, related to a gradual deterioration of business leadership, lapses in governance and in the regulatory framework and lack of effective risk management process (Ginena & Hamid, 2015).

4.0 CASE ANALYSIS: WHAT WENT WRONG?

This section analyses five cases which illustrate corporate governance failure due to weak and inefficient corporate governance practice. The analysis highlights the corporate and Shari'ah governance issues, and its effects on the institutions involved.

4.1 Ihlas Finance in Turkey

Ihlas Finance was a subsidiary of Ihlas Holding, established in the 1970s as a social-oriented business organisation and eventually growing into a large holding company. Ihlas Finance was formed with the objective of providing interest free investment opportunities to investors. Being a financial house, Ihlas Finance is not recognised as part of the regular banking sector but was given the status of Special Finance House which was not subject to the same regulations as other institutions in the banking sector. In the wake of the banking crisis that developed in Turkey between the last quarter of 2000 and early 2001, Ihlas Finance face a run on its deposits which resulted in the intervention by the Banking Regulation and Supervision Agency (BRSA). The licence of Ihlas Finance was eventually cancelled on 10th February 2001 and Ihlas Finance was closed by the authority

The reason was failure of corporate governance and lack of internal checks and balances. It was found that the bank was operating without a proper system of internal control. Among the factors that specifically contribute to the failure are mainly related to corporate governance of the institution. It was found that Ihlas Finance was not following the best practices in corporate governance. This can be seen from the fact that the members of the Board of Directors showed a lax attitude towards governance and some of them did not possess the required experience and qualification (Askari. Iqbal & Mirakhor, 2009).

4.2 Islamic Bank of South Africa (IBSA)

The bank was closed in November 1997 with debts amounting to ZAR70 million due to lack of supervision from the regulatory authority, bad management, weak risk management and numerous loans to insider. (ISRA, 2016). It was found that the management of the bank hid behind the self regulatory position accorded to true Islamic banks but the bank abused this special trust. It was discovered that numerous loans were made to the directors and there was evidence of connected lending, self-dealing and insider lending through an overextension of credit to directors and substantial shareholders. There was no risk committee to assist the board, thus management and decision making were performed within an extremely informal framework (Askari. Iqbal & Mirakhor, 2009).

In pursuant to section 417 and 418 of the Companies Act, an investigation led by a commissioner appointed by the Master of the High Court with the support of the accounting firm Deloitte and Touche was carried out. The investigation revealed that a large amount of insider unsecured lending has taken place which has resulted in a large proportion of non-performing assets in the balance sheet. Meanwhile, the Reserve Bank has agreed to compensate the investors up to a maximum of R50 000 per depositor. This covers 80% of depositors since the primary depositor base of IBSA is small depositors; mostly Muslim people who saw the IBSA as a community bank and saved their money there to perform hajj. Given the size of the bail out package, while the Reserve Bank solution will compensate most depositors fully, it will not compensate all depositors fully so is seen as insufficient. A series of court cases against the directors of IBSA has been lodged by depositors who were not fully compensated. There is also a significant debate as to the decision of the Reserve Bank to only partially compensate depositors (Okeahalam, 1998).

4.3 Islamic Investment Companies of Egypt (IICE)

The company was an investment company that offered interest free services. The investment company was established in the 1980s on the profit sharing principle by accepting deposits from the public and investing funds in Shari'ah compatible modes. It was closed due to the weak corporate governance, irresponsible management and improper regulatory framework and engagement in Shari'ah non-compliant activities. The situation had caused over one million small investors lost their investments when the company and its related investment companies collapsed in 1998 (ISRA, 2016).

It was revealed that the investment companies were not following Shari'ah approved modes of investment despite their claims. The companies were paying high returns by drawing on a continuing high level of deposits as opposed to actual profits. The investments made by the companies were found to be made in international currencies and financial markets which were of speculative nature. Official audit reports found many irregularities and funds unaccounted for, partly in complex transactions with subsidiaries (Askari, Iqbal & Mirakhor, 2009).

4.4 Dubai Islamic Bank (DIB)

Dubai Islamic Bank was founded in 1975 as a fully-fledged Islamic financial institution offering a range of Shariah-compliant products and services. The corporate scandal involving DIB centres on CCH, an Islamic trade finance company, which received financing of about \$440m, of which the bank says it provided about \$330m. DIB has made provisions of \$135m related to this transaction. The alleged crimes were committed between 2004 and 2007 by two former employees of the bank and five businessmen linked to trade finance company CCH and a real estate project in Dubai, the Plantation. The seven defendants mainly British and Pakistani nationals, are either linked to CCH or were former employees of DIB, and are accused of taking bribes to facilitate the alleged fraud. (Financial Times, 2010). It was the biggest case in Dubai Court, in terms of the amount of financial irregularities involving US\$501 million (ISRA, 2016).

4.5 Bank Islam Malaysia Berhad (BIMB)

Bank Islam Malaysia Berhad was established in 1983 as the first Islamic Bank in Malaysia. It was originally established with the sole purpose of assisting with the financial needs of the

Muslim population of Malaysia. Since then, Bank Islam has extended its services to the wider, non-Muslim, population fulfilling its “Banking-for-All” principle.

In 2005, BIMB suffered losses amounting to RM457 million due to the provisioning of RM77.4 million as a result of bad financing and investments incurred by its Labuan branch. It was found that the composition of the board of directors was not appropriate as there were no board members who were familiar with the banking sector and there was no sound and proper credit and debt collection system (ISRA, 2016). The losses were attributed to non-performing loans (NPLs) which stood at RM2.2 billion. It was declared that the RM2.2 billion in bad financing were due to irregularities arising from “weak client origination and credit structuring; inadequate account monitoring, and ineffective problem recognition processes”. From the RM2.2 billion bad financing, 35% were from the Labuan unit, 30% from the commercial unit, 20% consumer and the balance 15%, corporate clients. With the provisions, the bank's NPLs stood at RM1.2bil that represent a net ratio of 12.5% against the industry average of 5.1% (The Star, 2005). Financial and operational restructuring was initiated during the year involved a cash injection of RM1.014 billion and improvements to Bank Islam's credit and risk management framework to enhance controls and efficiency. Bank Islam's capital adequacy has since been rectified by the capital injection from Dubai Investment Group (DIG), United Arab Emirates and Lembaga Tabung Haji (LTH), giving them a 40% and 9% stake in the bank, respectively. BIMB Holdings Berhad now holds 51% stake of Bank Islam (BIMB, 2008).

The five cases highlight the importance of corporate and Shari'ah governance principles in Islamic banking and finance industry. Irresponsible management, bad supervision and governance are identified as the main causes of the financial failure. The public trust was broken, regulators became more suspicious and cautious, and opponents were given valid excuses to criticise the Islamic financial institution which makes it highly publicised financial failure (Askari, Iqbal & Mirakhor, 2000).

5.0 CONCLUSION

The importance of corporate and Shari'ah governance can never be overemphasized. Effective corporate and Shari'ah governance practices that enhance corporate accountability are key elements in the working of market discipline and transparency in the Islamic financial institutions around the globe. Effective internal controls and procedures are essential for accurate and transparent financial reporting that will eventually enhance public confidence on the operation of the global Islamic banking and finance industry as a whole.

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