

SHARĪ'AH GOVERNANCE PRACTICES QUALITY
INDEX IN MALAYSIAN ISLAMIC FINANCIAL
INSTITUTIONS

BY

NOR ASILA BINTI NAZMI

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International Islamic University Malaysia

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ABSTRACT

Sharī'ah compliance is essential to enhance confidence among stakeholders of Islamic financial institutions. In this regard, the Bank Negara Malaysia (BNM) provides a comprehensive framework to ensure the operations of Islamic financial institutions fully comply with the *Sharī'ah* and provide sound *Sharī'ah* governance practices. This study, by using the *Sharī'ah* Governance Framework 2010 (SGF 2010) issued by BNM as the main source instrument, first examines the extent of the quality of *Sharī'ah* governance practices in Islamic financial institutions in Malaysia. Secondly, it evaluates the extent of the effectiveness of the Board of Directors (BOD) in influencing the quality of *Sharī'ah* governance practices; thirdly, this study evaluates the extent of effectiveness of the *Sharī'ah* Committee (SC) in influencing the quality of *Sharī'ah* governance practices; and fourthly, it examines the influencing characteristics of the quality of *Sharī'ah* governance practices. The study employed a questionnaire survey by using the SGF 2010 as the main source to measure *Sharī'ah* governance practices. The respondents consisted of Heads of *Sharī'ah* Departments from 12 Islamic banks, 8 *Takāful* operators, 4 *ReTakāful* operators, and 6 Development Financial Institutions (DFIs) in Malaysia. From the findings, the study illustrates that overall, Islamic financial institutions in Malaysia have implemented reasonably good and sound *Sharī'ah* governance practices. The study then further examined the various impacts of the types of Islamic financial institutions (IFIs), and found that Islamic banks have comparatively better *Sharī'ah* governance practices compared to *Takāful* (including *ReTakāful*) and DFIs. The positive growth of the Islamic banking industry coupled with the nature of the industry are found to be the main factors in influencing good *Sharī'ah* governance practices. The study found that the *Sharī'ah* Committee is comparatively more responsible for driving *Sharī'ah* governance practices than the management or the BODs. Furthermore, the study also found that out of four *Sharī'ah* compliance functions as required by the SGF 2010, only two are implemented very well, which are the *Sharī'ah* review and *Sharī'ah* research function, while the two others (*Sharī'ah* audit and *Sharī'ah* risk management) are not. In addition to the above findings, among the main factors contributing towards sound *Sharī'ah* governance practices are the size of the market and the firms. Finally, the study also found that only the *Sharī'ah* Committee's effectiveness has a positive and significant effect on *Sharī'ah* governance practices. This indicates that the *Sharī'ah* Committee members are effective in exercising their role in the implementation of SGF 2010. From the above findings, it can be concluded that the SGF 2010 has significantly enhanced *Sharī'ah* compliance among Islamic financial institutions after 10 years since it was its implementation. Going forward, there are a few other areas that need to be improved, such as the role of the BODs and the management, as well as the functions of *Sharī'ah* audit and *Sharī'ah* risk management to ensure better *Sharī'ah* governance practices.

ملخص البحث

الامتثال للشريعة أمر أساسي لتعزيز الثقة بين أصحاب المصلحة في المؤسسات المالية الإسلامية. وفي هذا الصدد، يوفر البنك المركزي الماليزي إطاراً شاملاً لضمان امتثال عمليات المؤسسات المالية الإسلامية امتثالاً تاماً للشريعة الإسلامية، وتوفير ممارسات سليمة في مجال الحكم الشرعي. وتتناول هذه الدراسة، باستخدام إطار حوكمة الشريعة لعام 2010 الذي أصدره البنك المركزي الماليزي بوصفه أداة المصدر الرئيسي، مدى جودة ممارسات الحوكمة الشرعية في المؤسسات المالية الإسلامية في ماليزيا. ثانياً، تقييم مدى فعالية مجلس الإدارة في التأثير على نوعية ممارسات الحوكمة الشرعية؛ ثالثاً، تقييم هذه الدراسة مدى فعالية لجنة الشريعة في التأثير على نوعية ممارسات الحوكمة الشرعية؛ ورابعاً، يدرس الخصائص المؤثرة في نوعية ممارسات الحوكمة الشرعية. استخدمت الدراسة استبياناً باستخدام إطار حوكمة الشريعة لعام 2010 كمصدر رئيسي لقياس ممارسات حوكمة الشريعة. تألف المبحوثون من رؤساء إدارات الشريعة من 12 مصرفاً إسلامياً و 8 مشغلين تكافل و 4 مشغلين إعادة التكافل و 6 مؤسسات مالية إنمائية في ماليزيا. من النتائج، توضح الدراسة أن المؤسسات المالية الإسلامية في ماليزيا قد طبقت بشكل عام ممارسات جيدة وسليمة في إدارة الشريعة. ثم درست الدراسة الآثار المختلفة لأنواع المؤسسات المالية الإسلامية، ووجدت أن البنوك الإسلامية لديها ممارسات حوكمة شريعة أفضل نسبياً مقارنة بالتكافل (بما في ذلك إعادة التكافل) والمؤسسات المالية الإنمائية. يُوجد أن النمو الإيجابي للصناعة المصرفية الإسلامية إلى جانب طبيعة الصناعة هي العوامل الرئيسية في التأثير على ممارسات الحوكمة الشرعية الجيدة. ووجدت الدراسة أن لجنة الشريعة مسؤولة نسبياً عن قيادة ممارسات حوكمة الشريعة أكثر من الإدارة أو مجلس الإدارة. علاوة على ذلك، وجدت الدراسة أيضاً أنه من بين أربع وظائف للامتثال للشريعة كما يقتضي إطار حوكمة الشريعة لعام 2010، يتم تنفيذ اثنتين فقط بشكل جيد للغاية، وهما مراجعة الشريعة ووظيفة بحث الشريعة، بينما لا يتم تنفيذ الوظيفتين الأخريين (مراجعة الشريعة وإدارة مخاطر الشريعة). بالإضافة إلى النتائج المذكورة أعلاه، من بين العوامل الرئيسية التي تسهم في ممارسات حوكمة الشريعة السليمة حجم السوق والشركات. أخيراً، وجدت الدراسة أيضاً أن فعالية لجنة الشريعة فقط لها تأثير إيجابي وهام على ممارسات حوكمة الشريعة. وهذا يدل على أن أعضاء اللجنة الشرعية فعالون في ممارسة دورهم في تنفيذ إطار الحكم الشرعي لعام 2010. ومن النتائج المذكورة أعلاه، يمكن استنتاج أن إطار حوكمة الشريعة لعام 2010 قد عزز إلى حد كبير الامتثال للشريعة بين المؤسسات المالية الإسلامية بعد مرور 10 سنوات على تنفيذه. للمضي قدماً، هناك عدد قليل من المجالات الأخرى التي تحتاج إلى تحسين، مثل دور مجلس الإدارة والإدارة، فضلاً عن وظائف تدقيق الشريعة وإدارة مخاطر الشريعة لضمان ممارسات حوكمة أفضل للشريعة.

APPROVAL PAGE

This thesis of Nor Asila Binti Nazmi has been approved by the following:

Rusni Hassan
Supervisor

Abdul Rahim Abdul Rahman
Co-Supervisor

Syed Musa Bin Syed Jaafar Alhabshi
Internal Examiner

Zurina Shafii
External Examiner

Shahida Binti Shahimi
External Examiner

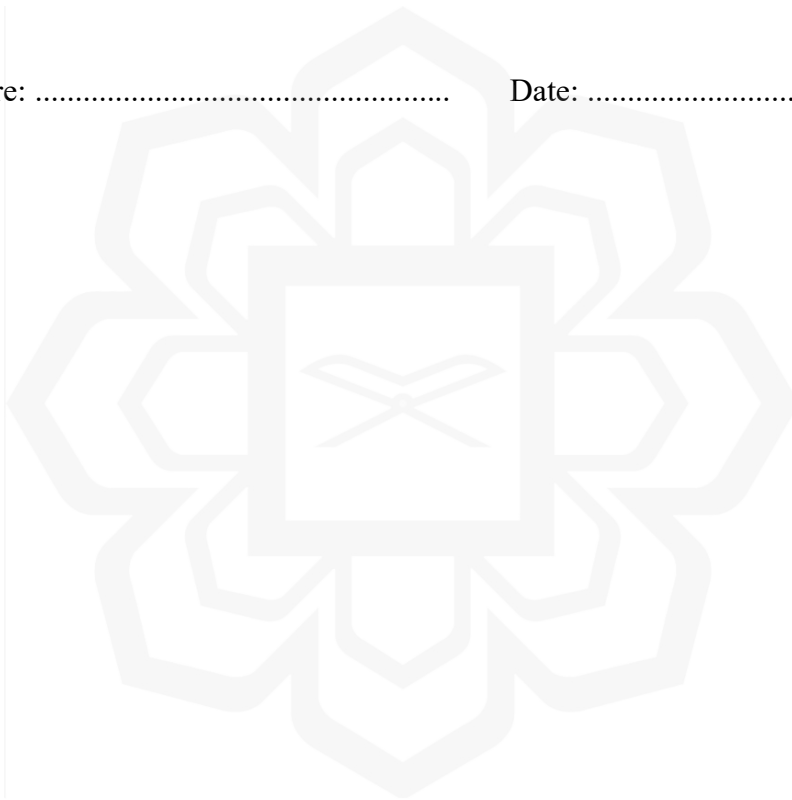
Mohamad Fauzan Bin Noordin
Chairman

DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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This thesis is dedicated to these special people for their endless love, support and encouragement:

My husband:

ALIFF BIN BASRI

My parents:

NAZMI BIN MOHD NOOR

NOR AINI BINTI HUSAIN

My children:

RUMAISHA AZ-ZAHRA

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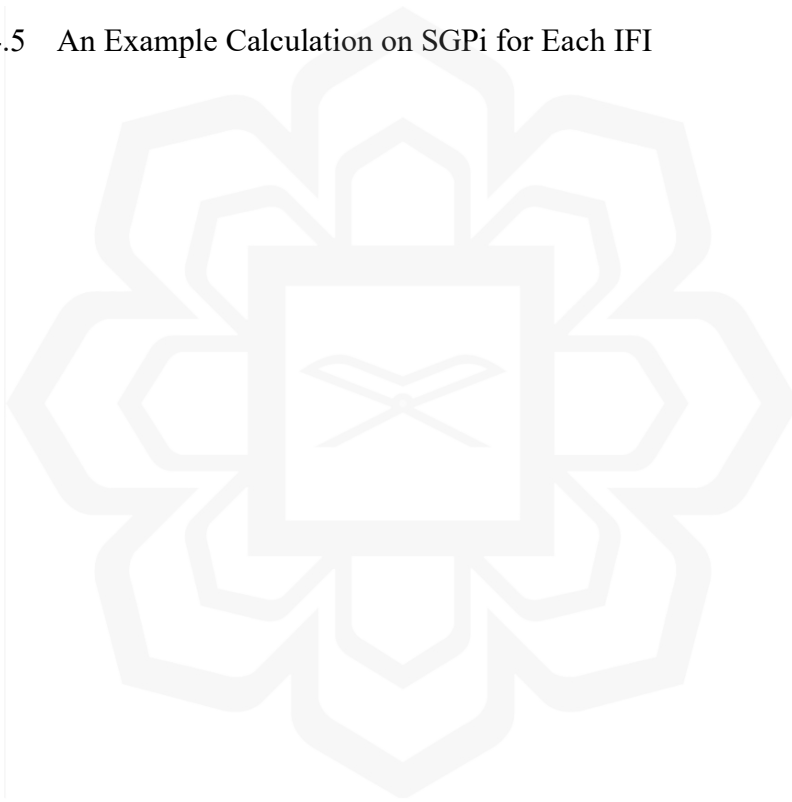
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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization of Islamic Financial Institutions
BAFIA	Banking and Financial Institutions Act 1989
BOD	Board of Directors
BNM	Bank Negara Malaysia
COSO	Committee of Sponsoring Organizations
DFI	Development Financial Institutions
DFIA	Development Financial Institutions Act 2002
FSA	Financial and Services Act 2013
IBA	Islamic Banking Act 1983
IBS	Islamic Banking Scheme
IAHs	Investment Account Holders
ICGN	International Corporate Governance Network
IDB	Islamic Development Bank
IIFM	Islamic International Financial Market
IIRA	International Islamic Rating Agency
IFIs	Islamic Financial Institutions
IFSA	Islamic Financial and Services Act 2013
IFSB	Islamic Financial Standard Board
LMC	Liquidity Management Centre
OECD	Organization for Economic Co-Operative and Development
OIC	Organization of the Islamic Conference
NACD	National Association of Corporate Directors
SAC	<i>Shari'ah</i> Advisory Council
SB	<i>Shari'ah</i> Board
SEC	US Securities and Exchange Commission
SOX	Sarbanes-Oxley Act
SGF	<i>Shari'ah</i> Governance Framework
SSB	<i>Shari'ah</i> Supervisory Board
SSC	<i>Shari'ah</i> Supervisory Committee
UIAHs	Unrestricted Investment Account Holders

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE RESEARCH

The Islamic financial system in Malaysia can be considered as one of the most progressive and robust financial systems compared to other banking systems in Muslim countries. The establishment of Bank Islam Malaysia Berhad (BIMB) as the first full-fledged Islamic bank in 1983 made a significant contribution to the development of the Islamic financial system. The existence of Islamic financial institutions (IFIs) has become a platform to cater to Muslim needs all over the world by offering a wide range of *Shari'ah*-compliant products. Throughout the years, the Islamic financial system in Malaysia has shown positive achievements, thus proving to be comparable to conventional banking. In line with the rapid growth of Islamic finance all over the world, various organisations have been established such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic International Financial Market (IIFM), and the Islamic Financial Standard Board (IFSB) to standardise and harmonise the practice of corporate governance in Islamic financial institutions.

Corporate governance acts as a framework to govern public and private sector firms to ensure the interests of shareholders and other stakeholders are protected. According to the Organization for Economic Co-Operative and Development (OECD) principles, corporate governance can be defined 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. It is referred to as the method by which a corporation is directed, administered, or controlled (Hassan et al., 2005). A good corporate governance mechanism encourages the proper management of risks and also provides a framework of disclosure that allows the market to discern the risks choices of the banking institutions (Soon & Koh, 2007).

The development of Islamic finance all over the world indicates that we need a proper framework to govern all the activities in IFIs, thus ensuring it is compliant with the *Sharī'ah* principles in terms of its products, instruments, operations, practices, management, and others. Islamic financial institutions such as Islamic banks are radically different from conventional banking and from the viewpoint of corporate governance, Islamic banks have several interesting features since they are based on principles of Islamic financing such as equity participation, risk, and profit and loss sharing arrangement. Unlike conventional banking which can charge any fixed return in advance, Islamic banks can only participate in the yield resulting from the use of funds. Depositors in Islamic banks will be rewarded profits in return for assuming risks based on the predetermined ratio. Furthermore, conventional banking acts as a borrower and lender of funds. However, for Islamic banking, they are essentially a partner with its depositors and also a partner with entrepreneurs when employing depositor's funds for direct investment.

Therefore, Islamic banks and other IFIs must have an additional layer of corporate governance since all their activities must conform to *Sharī'ah* principles. In 2010, the Central Bank of Malaysia (BNM) took initiative to issue a *Sharī'ah* Governance Framework (SGF 2010) for Islamic financial institutions with the primary objective to enhance the roles of the board, the *Sharī'ah* Committee, and the management to deal with *Sharī'ah* matters, including enhancing the relevant key organs with the responsibility to execute *Sharī'ah* compliance and research functions aimed at the attainment of a *Sharī'ah*-based operating environment¹. This framework was effective starting from January 2011. All Islamic financial institutions were given six months to comply with the new regulation and to confirm all their activities and operations met the requirements in accordance with this framework. Apart from these, all the IFIs are required to establish several key functions, including the *Sharī'ah* review function, *Sharī'ah* audit function, *Sharī'ah* risk management function, and *Sharī'ah* research function to ensure the successful implementation of the *Sharī'ah* Governance Framework. All of these key functions have their roles and objectives; for example, the role of *Sharī'ah* review is to conduct a regular assessment of the activities and

¹ *Sharī'ah* Governance Framework, 2010.

operations of the IFI to ensure all the activities and operations comply with *Sharī'ah* principles. Furthermore, the *Sharī'ah* audit's role is to conduct a periodical and independent assessment, and design objective assurance to ensure a sound and effective internal control system for *Sharī'ah* compliance². Another function of *Sharī'ah* risk management is to systematically identify, measure, monitor, and control *Sharī'ah* non-compliance risks to mitigate any possible non-compliance events, thus enabling the IFI to continue its operations and activities effectively. The final key function in the SGF 2010 is the *Sharī'ah* research function, which refers to the conduct of performing in-depth research and studies on *Sharī'ah* issues, including providing day-to-day *Sharī'ah* advice and consultancy to relevant parties, such as those involved in the product development process. All of these key functions are fundamental to meeting the objectives of the SGF 2010. According to BNM, SGF 2010 is designed to meet three main objectives: first, to set out the expectations of the BNM on the IFI's *Sharī'ah* governance structure, process, and arrangements to ensure that all its operations and business activities are in accordance with the *Sharī'ah* ; second, provide comprehensive guidance to the board, *Sharī'ah* Committee, and management of the IFI in discharging its duties in matters relating to *Sharī'ah* ; and third, outline the functions relating to *Sharī'ah* review, *Sharī'ah* audit, *Sharī'ah* risk management, and *Sharī'ah* research.

The SGF 2010 also highlights several issues regarding accountability and responsibility to the key parties involved in the implementation of the SGF 2010 such as the board of directors, the *Sharī'ah* Committee, and the management. In addition, the framework also highlights the issues of independence among the *Sharī'ah* Committee, competency of the person involved, and the confidentiality of all the information while discharging their duties. All the important issues which led to the successful implementation of the SGF 2010 have been addressed in this framework.

² *Sharī'ah* Governance Framework, 2010.

1.2 PROBLEM STATEMENT AND MOTIVATIONS FOR THE STUDY

Malaysia is among the most advanced countries in the development of the Islamic financial system with the goal of becoming the leading international Islamic financial hub. Beginning with BIMB as the first Islamic bank in 1983, Malaysia currently has significant and comprehensive numbers of Islamic financial institutions, including *Takāful* operators, full-fledged Islamic banks, subsidiary Islamic banks, and Islamic windows in conventional financial institutions. The need to adhere to *Sharī'ah* principles in all activities, products, and operations requires an additional layer of corporate governance for Islamic financial institutions. With this aspiration, the *Sharī'ah* governance system was introduced exclusively to Islamic financial institutions. The Central Bank of Malaysia has endeavoured to fully support the development of the Islamic banking and finance industry by issuing various standards, frameworks, and guidelines. Among the greatest achievements of the BNM was the issuance of the *Sharī'ah* Governance Framework in 2010 as the first comprehensive governance framework for Islamic financial institutions in the world.

Despite the importance of Islamic banking, few studies have been conducted that focus on the area of *Sharī'ah* governance. Most of the studies focus on conceptual papers discussing the issues, challenges, and the theoretical framework of *Sharī'ah* governance systems (Syed Ismail al-Qudsi et al., 2008; Farook and Farooq, 2013; Muneeza and Hassan, 2011; Ahmad Alkhamees, 2013; Grassa, 2013; Mizushima, 2013; Mohd Arif and Markon, 2013; Sheikh Obid and Naysary, 2014; Ginena, 2014). Meanwhile, there are also empirical studies focusing on *Sharī'ah* governance practices in selected countries (Abdallah and Bahloul, 2021; Alam et al., 2021; Mansoor et al., 2020; Alam et al., 2020; Alama et al., 2020; Hilmy and Hassan, 2019; Hasan, 2014; Ramli et al., 2014; Ahmed and Khatun, 2013; and Hasan, 2011). However, most of the research focuses on the *Sharī'ah* governance system based on international frameworks like IFSB and OECD principles. In addition, some of the previous literature adheres to secondary data, which may not address some contemporary issues.

An effective *Sharī'ah* governance practice is very important to strengthen the credibility of the Islamic financial system (Grassa, 2013). The requirement of *Sharī'ah*

compliance is not only demanded by the customers of IFIs, but also other stakeholders like institutional investors, shareholders, and Muslim societies who are directly and indirectly involved with the institutions (Ramli et al., 2014). Comprehensive compliance with *Sharī'ah* governance is significant to boost confidence in the development of Islamic financial institutions (SGF, 2010, para 1.1). Further, an efficient and effective *Sharī'ah* supervisory system is considered one of the important factors in supporting the stability of the Islamic finance industry. The elements include transparency, trust, ethical behavior, credibility, values underlying faith and beliefs, as well as attitude (*akhlaq*), which make it more valuable to the existing corporate governance framework (Nathan and Ribieri, 2007). The implication of poor *Sharī'ah* governance practices may expose the IFIs to *Sharī'ah* non-compliance risk, which may have numerous impacts, both from a financial and non-financial aspect. Furthermore, it may negate the public's confidence in the credibility and image of the IFIs. Therefore, ensuring comprehensive compliance of *Sharī'ah* is important for the forward progress of the Islamic finance industry, not only to obtain public confidence in the authenticity of the conduct and practice of IFIs, but also to minimise the fiduciary and reputational risks to IFIs (Kunhibawa, 2012). In light of the above discussion, realising the importance of IFIs' compliance with *Sharī'ah* coupled with the lack of extensive research in the *Sharī'ah* governance area in Malaysia, this thesis examines the extent of the quality of current *Sharī'ah* governance practices, particularly within the Malaysian context.

On the other hand, it is an undeniable fact that *Sharī'ah* scholars are very important and have become the backbone of the growth of Islamic finance. They are responsible for ensuring the end-to-end process, starting from product restructuring to product offering and marketing, is all compliant with the *Sharī'ah*. The complexity of Islamic finance products and services together with the global growth of Islamic finance makes the role of *Sharī'ah* scholars more challenging, making them the most important factor in the implementation of the *Sharī'ah* governance system. The establishment of the *Sharī'ah* Committee in every Islamic financial institution is mainly to guarantee that all operations and activities conform with Islamic laws and *Sharī'ah* principles, thus becoming a unique characteristic of IFIs compared to conventional financial institutions (Haji Besar et al., 2009). The success of Islamic finance all over the world largely

depends on the belief that all components must comply with *Sharī'ah* rules and principles (Hassan, 2010). Meanwhile, Mollah and Zaman (2015) found that the *Sharī'ah* Committees and Board of Directors (BOD) have a significant influence on the performance of Islamic banks.

In addition, the BOD plays a significant role in bank governance (Andres and Vallelado, 2008). They are the main internal mechanism for solving governance issues as they are the ultimate decision-making body in an organisation. Previous literature has shown that the board as an active body is an important factor that contributes to corporate success (Nicholson & Kiel, 2004). Also, it was suggested by Sierra et al. (2006) that strong boards improve bank performance. On the other hand, Anders and Vallelado (2008) demonstrated that BOD significantly affects bank performance in terms of board size and independent directors. However, research on the BOD in the field of *Sharī'ah* governance is still limited. Therefore, this thesis also attempts to fill the gap by highlighting two important components of internal governance mechanisms such as the *Sharī'ah* Committee and Board of Directors in assessing the quality of the *Sharī'ah* governance practices in Islamic financial institutions in Malaysia.

Past literature has illustrated that firms with strong corporate governance are associated with strong financial performance (Peni & Vähämaa, 2012). The literature on corporate governance also suggests that the level of corporate governance has become a determiner of bank performance in Islamic banks based on the understanding that the enforcement of high-level corporate governance will result in better management, thus improving the decision-making for overall bank performance, including financial and non-financial performance (Wasiuzzaman & Gunasegavan, 2013). The positive development and performance in Islamic finance have attracted non-Muslims to do business with Islamic banks, thus making it vital for Islamic banks to further assess their capabilities, particularly on their financial health and performance (Bacha, 2004). On the other hand, the failure of banking institutions in the United States has resulted in the assessment of financial health and performance becoming an important aspect of bank evaluation (Barr, Seiford, & Siems, 1994). The relationship between corporate governance and financial performance has been examined from a conventional view, but the perspective of Islamic finance requires more investigation,

especially in the context of *Sharī'ah* governance where *Sharī'ah* matters have been taken into consideration (Nasser, 2009). To date, there is no comprehensive study that focuses on financial performance of *Sharī'ah* governance practices. This thesis, therefore, undertakes to fill the gap in the literature by providing new empirical research on the relationship between the quality of *Sharī'ah* governance practices with financial performance in Islamic financial institutions. Therefore, by using the *Sharī'ah* governance practices index, the present study attempts to examine the extent of the quality of *Sharī'ah* governance practices in Islamic financial institutions in Malaysia.

1.3 RESEARCH OBJECTIVES AND RESEARCH QUESTIONS

Based on the problem statement and review of the literature, four research objectives are identified:

- RO1: To develop a *Sharī'ah* governance practices index (SGPi) to measure the *Sharī'ah* governance practices in Islamic financial institutions in Malaysia.
- RO2: To evaluate to what extent the effectiveness of the Board of Directors of Islamic financial institutions in Malaysia in influencing the quality of *Sharī'ah* governance practices.
- RO3: To evaluate the extent of effectiveness of the *Sharī'ah* Committee of Islamic financial institutions in Malaysia in influencing the quality of *Sharī'ah* governance practices.
- RO4: To examine the characteristics influencing the quality *Sharī'ah* governance practices of Islamic financial institutions in Malaysia.

To fulfil the research objectives, a few research questions (RQ) were developed as follows: