



THE MANAGEMENT COMMUNICATION ON
SHARĪ'AH COMPLIANCE: THE CASE OF MALAYSIAN
TAKAFUL OPERATORS' (TOS)

BY

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ABSTRACT

Sharī'ah governance organs within any Islamic Financial Institutions are profoundly accountable to ensure the compliance to the requirement of Islamic principles. Management is one of the key governance organs who are expected to integrate *Sharī'ah* governance considerations in business and risk strategies as well as promoting a *Sharī'ah* compliant culture within their institution. Under the supervisory and regulatory jurisdiction of Bank Negara Malaysia, Takaful is subject to comply with this requirement. The discovery on how management adheres to the relevant regulations and espouses the organizational culture is worth to be assessed. Therefore, the aims of this study are to assess the management's assurance of compliance to the relevant regulations and examine the organizational cultures and values adopted by Malaysian Takaful operators. The assessment on the contributing factors towards effective management communication has also been focused to complement the accuracy of the study. Semi-structured interview method was administered involving 11 Malaysian Takaful operators. The findings show that Malaysian Takaful operators are observant to the *Sharī'ah*, regulatory and compliance requirements at all times. The overall culture that shapes Malaysian Takaful operators internally is universal values which are not against *Sharī'ah* principles. The management is also expected to adopt excellent top-down communication skills which is crucial for Malaysian Takaful operators' growth and sustainability. Most significantly, this study serves as a material reference to other Islamic Finance sectors in assessing the effectiveness of management communication of *Sharī'ah* compliance to other organs in *Sharī'ah* Governance Framework. Accordingly, this finding facilitates the Regulator in formulating a comprehensive parameter strengthening the role and function of management as one of the key organs of *Sharī'ah* Governance.

ملخص البحث

إن جهاز الحوكمة الشرعية في أي مؤسسة مالية إسلامية مسؤول عن ضمان الالتزام أو الموافقة لمتطلبات المبادئ الإسلامية. وتعتبر الإدارة في المؤسسة المالية إحدى الأجهزة الرئيسية للحوكمة التي من المتوقع أن تدمج اعتبارات الحوكمة الشرعية في استراتيجيات الأعمال والمخاطر داخل المؤسسات المالية، فضلاً عن الترويج لثقافة التوافق مع أحكام الشريعة الإسلامية في مؤسساتها. وتحت إطار الجانب الاشرافي والتنظيمي لبنك المركزي الماليزي، يخضع التكافل الإسلامي لمثل هذه المتطلبات. ولذلك من الجدير تقييم كيفية التزام الإدارات بمختلف الأنظمة واللوائح ذات الصلة وكيفية بناء هذه الثقافة داخل المؤسسات. لذلك، وتهدف هذه الدراسة إلى تقييم ضمان الإدارة الإلتزام لمختلف الأنظمة واللوائح ذات الصلة وفحص الثقافة التشغيلية داخل المؤسسة والقيم التنظيمية المعتمدة من قبل شركات التكافل الماليزي. كما ركزت الدراسة على العوامل المساهمة والمؤثرة في تحقيق التواصل الفعال للإدارة. وللحصول على البيانات اللازمة تم تطبيق طريقة المقابلة شبه المنظمة، وقد تم إجراء ٣١ جلسة على جميع الأشخاص الذين تمت مقابلتهم والذين كانوا يمثلون ١١ شركة تكافل تعمل حالياً في ماليزيا. وبناءً على البيانات التي تم تحليلها، أظهرت النتائج أن شركات التكافل الماليزية ملتزمة بمتطلبات الشريعة الإسلامية في جميع الضوابط الشرعية و التنظيمية المتوافقة مع المبادئ الشرعية الإسلامية في جميع الأوقات. وقد تم التوصل إلى أن ثقافة التشغيل العامة داخل مؤسسات التكافل الماليزية هي قيم عالمية لا تتعارض مع مبادئ الشريعة الإسلامية. ومن المتوقع أيضاً أن تعتمد الإدارة مهارات التواصل الممتازة من أعلى الهرم الاداري إلى الأسفل والتي تعتبر حاسمة ومساعدة لنمو شركات التكافل الماليزي بشكل مستديم. وستساهم هذه الدراسة في توفير مرجعية يمكن الرجوع إليها واعتمادها في قطاعات أخرى من التمويل الإسلامي. واستناداً إلى ذلك، فإن نتائج هذه الدراسة سوف تساهم في تسهيل عمل الجهات الإشرافية في وضع معايير شاملة تساهم في تقوية مختلف أنشطة الإدارة بوصفها إحدى أهم لبنات الحوكمة الشرعية.

APPROVAL PAGE

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DECLARATION

I hereby declared 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 constitutions.

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I dedicate this thesis to my beloved late parents; Harun bin Marzuki and Zainab binti Marto who taught me about Islam, Iman and Ehsan, my dearly loved husband, Muhammad Fadzli bin Abdullah Halim for his perpetual support, motivation and unconditional love. The dedication also goes to my 3 astonishing angels, Layla Farha, Nuha Faqihah and Muhammad for standing by my side at all times.

“Man Jadda Wajada” (Whoever strives shall succeed) - Arabic Quote

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization of Islamic Financial Institutions
BOD	Board of Directors
BNM	Bank Negara Malaysia
CG	Corporate Governance
ICG	Islamic Corporate Governance
ICM	Islamic Capital Market
IFI(s)	Islamic Financial Institution (s)
IFSA	Islamic Financial Services Act
IFSB	Islamic Financial Services Board
OECD	Organization for Economic Co-operation and Development
SAC	<i>Sharī'ah</i> Advisory Council
SC	<i>Sharī'ah</i> Committee
SG	<i>Sharī'ah</i> Governance
SGF	<i>Sharī'ah</i> Governance Framework
TO(s)	Takaful Operator (s)
TOF	Takaful Operational Framework

CHAPTER ONE

INTRODUCTION

Chapter 1 presents a simplified overview of the present study on *Shari'ah* Governance (SG) practice in Malaysia. It emphasizes the problem statement and the rationale of the study. The research problem is formulated based on the research gaps identified through an exploration of the issues highlighted and how the previous studies were addressed. To illustrate the purpose of the study, this chapter continues to outline the research questions and research objectives developed through a comprehensive literature review. Subsequently, the chapter also deliberates the significance followed by limitation and assumption of this study. In highlighting the main concern of this study, the outline for next chapter is explained accordingly. Last but not least, the chapter concludes with the key terms to develop an understanding of concepts as well as terminologies used in this study.

1.1 BACKGROUND OF THE STUDY

The rapid growth of Islamic finance at the global level leads this industry to form robust governance system for its overall survival. Institutions that exist, be it conventional or Islamic, require solid corporate governance which serves as its basic foundation. Corporate Governance (CG), in this sphere, is related to a dedicated practice of legal and organizational arrangement in ensuring the key aspects of risk management and compliance are being observed internally by any organization.

Historically, cases related to the failure of corporate governance in the financial industry have emerged around the world. These include subprime cases which hit the

United States (US) in the mid of 2008 and the case of the bank run in the United Kingdom (UK) which has triggered the existence of internal governance weaknesses and failure. Kirkpatrick (2009) in a report published by Organization for Economic Corporation and Development or OECD asserted that several factors led to the economic turmoil which began at the end of 2006. One of them is the corporate governance glitches and weaknesses in mitigating financial risks and compliance measures related to them. Other factors are related to legislations and accounting issues as well as the mismatch in the arrangement of compensation schemes. Based on the analysis and discussion compiled in the report, one of conclusions made by Kirkpatrick (2009) include that a robust CG should involve a complete trio of controlling, governing and implementation authorities.

As mentioned above, another lesson recorded in the financial industry was the event of the severe liquidity issue faced by Northern Rock bank. After its failure in 2007, Northern Rock was taken into public ownership in 2008. Since 2012 however, the bank was owned by Virgin Money up to now. Shin (2009) in his case study of the crisis concluded it as a financial ruling failure. The requirement of risk based-capital under the BASEL¹ process is regarded as significant in mitigating such financial risk. The same requirement of Risk-Based Capital (RBC) Framework was extended to the insurance industry in Malaysia in 2009. This was reiterated by Malaysian regulators by mentioning that “under the risk-based regulatory regime, the responsibility for the implementation of risk management, market conduct governance and assessment of risks and management of the financial conditions of an insurer will increasingly rest with its board of directors and senior management” (liam.org.my). This action is

¹ “The Basel Process refers to the role of the Bank for International Settlements (BIS) in hosting and supporting the work of the international secretariats engaged in standard setting and the pursuit of financial stability”.

considered as a proactive measure taken by the respective regulatory body, which was what exactly transpired after the global financial turmoil befell the Western countries.

Additionally, Erkens, Hung and Matos (2012) carried out their investigations on 296 financial institutions from over 30 countries which were affected by the 2007-2008 crisis. The conclusion drawn on CG stated that, “Further exploration of this finding suggests that this is because: (1) firms with higher institutional ownership took more risk prior to the crisis, which resulted in larger shareholder losses during the crisis period, and (2) firms with more independent board members raised more equity capital during the crisis, which led to a wealth transfer from existing shareholders to debt holders. Overall, our study provides insight into why some financial firms were much more affected by the 2007–2008 crisis than others. Our results suggest that corporate governance had an important impact on firm performance during the crisis through firms' risk-taking and financing policies”.

All the above cited examples assemble some of the effects on CG’s failure within conventional financial institutions around the globe. It is important to take note that Islamic Financial Institutions (IFIs) still require a robust and comprehensive governance to remain stable and competitive. The *Shari’ah* principle serves as the foundation to guide organizations to stay in compliance at all times. Ginena (2014) emphasized this in a study on cases related to governance breaches which had subsequently lead to IFIs failure. The study asserted that, “The collapse of the Islamic Bank of South Africa in 1997, the demise of Ihlas Finance House in Turkey in 2001, and various cases of fraud which have led to losses at Dubai Islamic Bank between 2004 and 2007 serve as reminders of the importance of corporate governance for Islamic banks”. This historical fact is useful for IFIs in benchmarking their financial

progress besides maintaining sound, robust governance for immediate and future survival.

Most previous studies on *Sharī'ah* Governance emphasized principles and practical implementation from macro perspective. This could be found in Grassa (2013), Hamza (2013), Nathan Garas and Pierce (2010) and Hasan (2010). However, none of the previous studies have concentrated on other SG's organs besides *Sharī'ah* Committees or *Sharī'ah* advisors. Studies conducted by Hasan (2014), Othman et al. (2013) and Malkawi (2013) specifically focused on issues and challenges faced by *Sharī'ah* scholars under the ambit of key issues in Corporate Governance. Farook and Farooq (2013) however, specified their focus on the scarcity of *Sharī'ah* qualified practitioners to support Islamic finance growth and challenges.

For the purpose of achieving the objective of a thorough analysis, in term of jurisdiction, the study focuses only in Malaysia. In this study, Takaful Operators or TOs were selected to be the central subject of analysis in gathering very specific empirical data which will be useful for future research and reference.

Since the subject matter of discussion and research found in most literatures on Islamic Financial Institutions (IFIs), particularly in Malaysia focuses on Islamic banks, this fact has served as another motivational factor for choosing TOs. As one of the IFI sectors, TOs are obliged in ensuring the highest level of compliance in its overall business aspects, predominantly *Sharī'ah* compliance.

1.2 PROBLEM STATEMENT

For any Islamic Financial Institution (IFI), ensuring effective management leads to optimum *Sharī'ah* compliance in every aspect of business activities. The regulatory requirements under the *Sharī'ah* Governance Framework (SGF) implemented in 2011

and empowered by the Islamic Financial Services Act (IFSA) enacted in 2013 demand that management team or senior management to be accountable and responsible to each stipulated function assigned. Takaful Operational Framework (TOF) was also issued in 2013 with the objective to boost the overall takaful business as well ensuring the interests of participants are well served.

The functions basically require them to interact, communicate and remain connected with other organs of the institutions such as the Board of Directors (BoDs), *Sharī'ah* Committees (SCs) and internal as well as external stakeholders in ensuring effective, yet efficient *Sharī'ah* governance processes and implementation. Hasan (2011) summarized in his findings that there are a lot of deficiencies in the implementation of *Sharī'ah* governance which require further improvement. Additionally, Hasan (2014) highlighted that *Sharī'ah* scholars in various Malaysian IFIs, Gulf Cooperation Countries (GCC) and United Kingdom (UK) have affirmed on the weaknesses as well as the obstacles in the practical application of *Sharī'ah* governance. The opinions of interviewed *Sharī'ah* members were examined covering six (6) concerned areas i.e. elements related to *Sharī'ah* governance, internal framework, the accountability of *Sharī'ah* scholars, the perceptions of *Sharī'ah* members on corporate governance (CG) issues, IFI's operations and finally, the performance review of *Sharī'ah* members which is usually being conducted on annual basis. The most crucial highlight deliberated by Hasan (2014) is that there exists communication gap among the key organs of IFI. Another distressing issue revealed is that the current implementation of *Sharī'ah* governance fails to propagate the Islamic spirit and commendable values which are supposed to be inculcated in it.

Based on the above analysis and by focusing on one (1) essential perspective, this study attempts to assess the implementation of SG particularly from the lens of

management communication among the Malaysian Takaful Operators. It is anticipated that the empirical findings of such an extensive study on this subject would fill the gaps on the existing studies related to management. At the same time, some proposed recommendations pertinent to *Sharī'ah* governance implementation, particularly in management communication for Malaysian Takaful Operators (TOs) are highlighted in this study which would be a point of reference for further improvement of other SG organs within Islamic finance industry.

1.3 RESEARCH QUESTIONS

This study specifically attempts to answer the following research questions:

- i. How does the management assure the compliance to the relevant regulations?
- ii. What are the organizational cultures and values adopted by Malaysian Takaful operators?
- iii. What are the contributing factors to effective management communication for Malaysian Takaful operators?

The above questions form the basis or the foundation of this study.

1.4 RESEARCH OBJECTIVES

The aim of this study is to assess and examine the practical implementation of *Sharī'ah* governance; specifically from management communication perspective among Malaysian Takaful Operators. It is crucial for IFIs such as TOs to ensure their governance and operations are driven by the principles required by *Sharī'ah* at all times. Therefore, the specific objectives of this study are:

- i. to assess the management assurance of compliance to the relevant regulations
- ii. to examine the organizational cultures and values adopted by Malaysian Takaful operators; and
- iii. to discover the contributing factors towards effective management communication for Malaysian Takaful operators.

Guided by the functions stipulated in SGF, management needs to recognize their accountability to ensure that *Sharī'ah* practices are applied in all the operations run by the organization. *Sharī'ah* practices do not focus on product and business only; it needs to be fully embedded in a holistic manner. Specific studies focusing on management communication from SG implementation's perspective is rare. As a practitioner in this industry, is the researcher hopes the result and data obtained from this study would be useful evidence in assisting IFIs, especially Malaysian TOs in enhancing and improving their management communication practices to an optimum level which would simultaneously lead to globally accepted practices of *Sharī'ah* corporate governance and standards.

1.5 SIGNIFICANCE OF THE STUDY

This study is empirical in assessing the actual practical implementation of *Sharī'ah* governance in ensuring *Sharī'ah* compliance; specifically from management communication perspective by all Malaysian Takaful Operators. The contribution of this study can be categorized as follows:

- i. Towards Policymaker/Regulator: This study provides recommendation and insights from management communication area which allows regulator to tackle the existing issue related to SGF, IFSA and TOF. As

the management communication practice from all Malaysian Takaful Operators (TOs) have been compiled, this study proposes a framework of effective management communication for TOs which is viable to be implemented.

- ii. Towards Profession/Institution: This study allows TOs to develop their own organizational practices which are in line with *Sharī'ah* precepts and governance at all times. As for the researcher, the outcome of this evaluation would be useful in assisting the organization to achieve the highest level of compliant with *Sharī'ah* and yet outstanding within the competitive takaful industry.
- iii. Towards Knowledge: This study provides additional literatures and research findings on management in particular on takaful operational area.

All interviewees from 11 Malaysian TOs' have positively shared their insights and experience on the implementation processes relevant to regulatory accountabilities, values and operating principles. The outcome of this study is beneficial for future research to other sectors in Islamic finance. In setting up a direction, a conceptual framework was developed through key components gathered from both experiential knowledge and literature review that might answer all research questions as well as meeting the objectives set in this study. Based on data collection and evaluation, a finalized conceptual framework is established that is derived from the actual *Sharī'ah* compliance practices which are currently adopted by Malaysian TOs through their management functions and accountabilities.