



**THE SHARIAH GOVERNANCE PRACTICES AND
ISLAMIC BANKS PERFORMANCE IN MALAYSIA**

BY

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ABSTRACT

Despite the extensive research on the significance of corporate governance in firms and its well-established relationship with performance and also its role in the recent financial crisis, there is still a gap in the literature in terms of highlighting the practical aspects of Shariah governance in IFIs and also translating its functions into actual performance. In order to fill this gap, this research was an attempt to first, evaluate the impact of Shariah Governance Framework-2010 (SGF-2010) on improving the Shariah governance practices and addressing its issues; then look into the two aspects of overall performance namely efficiency and effectiveness and examine any significant change before and after enforcement of SGF-2010 and finally investigate impact of Shariah governance practices on the performance of Islamic banks in Malaysia. In order to fulfill these objectives, a questionnaire was developed based on the items in SGF-2010. In order to evaluate any improvements before and after the regulations a comparative analysis was done based on questionnaire scores. For the purpose of performance measurement, quantitative analysis focused on DEA to examine the efficiency of Islamic banks and CAMEL rating to measure their effectiveness. T-test was run to investigate any changes in these two performance measures. Additionally, Pearson's correlation analysis was used to check the consistency between these measures. Finally, to fulfill the last research objective through qualitative analysis, 11 interviews was conducted with Shariah governance key players to investigate the practical implications of Shariah governance on actual performance. The findings achieved in this research suggest that BNM regulations particularly SGF-2010 have significantly improved the Shariah governance practices in Islamic banks in Malaysia. The results of performance analysis indicated a significant change in efficiency of all Islamic banks after SGF-2010 which signifies the impact of regulations in banking efficiency. However, the results did not support any significant change in the effectiveness of Islamic banks as measured by CAMEL scores. Finally, the results of interview with industry practitioners suggest that all five components of Shariah governance can significantly impact the performance of Islamic banks. The findings of present research provide insight for regulatory bodies in terms of the impact of regulations on Shariah governance practices. Performance measurement results provides Islamic banking practitioners with the opportunity to review and compare their performance and to determine the causes of their success and failure to achieve excellence. The research findings augment the extant literature through theoretical development new methodology.

خلاصة البحث

على الرغم من الأبحاث الشاملة و الواسعة ، فيما يتعلق بأهمية حوكمة الشركات وأهميتها لدورها ووظائفها في الأزمة المالية الأخيرة ، لم يعتبر الجوانب العملية لسيادة القانون في المؤسسات المالية حتى الآن. من أجل سد هذه الفجوة ، تحاول هذه الدراسة أولاً تقييم تأثير اطار حوكمه الشريعه (SGF-2010) على تحسين ممارسات الحوكمة ، بعد ذلك، النظر إلى جانبيين من جوانب الأداء ، هما الاستغلال والكفاءة ، وأية تغييرات هامة ، وتم فحصهما قبل وبعد تنفيذ برنامج SGF 2010 .لتحقيق هذه الأهداف ، تم إعداد الاستبانة وفقا لأحكام SGF-2010 . وتم استخدام DEA لتقييم الأداء. لقياس الأداء ، يركز التحليل الكمي على DEA ، لتقييم فعالية ورتبة CAMEL لقياس فعاليتها. تم إجراء اختبار T لفحص أي فرق في هذين المؤشرين. وبالإضافة إلى ذلك، لتقييم و التحقق من العلاقة بين هاتين الطريقتين، تم استخدام تحليل الارتباط Pearson .في النهاية ، أجريت 11 مقابلة لتحقيق هدف البحث الأخير من خلال التحليل النوعي. النتائج التي تم الحصول عليها تظهر أن برنامج SGF-2010 قد أدى إلى تحسن كبير في سيادة القانون في البنوك الإسلامية في ماليزيا. وتشير نتائج تحليل الأداء إلى تغييراً كبيراً في أداء جميع البنوك الإسلامية بعد SGF 2010 . ومع ذلك، فإن النتائج لا تظهر أي تغير ملموس في كفاءة البنوك الإسلامية. وفي النهاية ، فقد بينت نتائج المقابلة أن جميع العناصر الخمسة لسيادة القانون يمكن أن تؤثر على أداء البنوك الإسلامية. وتعتبر نتائج هذه الدراسة مهمة للهيئات التنظيمية من حيث تأثير اللوائح على سيادة القانون الشرعي. توفر النتائج فرصة لمراجعة ومقارنة أداء البنوك وتحديد أسباب نجاحها وفشلها. ويمكن للنتائج أن تحسن من الأدبيات من خلال تطوير نظريات ومناهج جديدة.

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DECLARATION

I hereby declare that this dissertation 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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LIST OF ACRONYMS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
AFB	Asian Finance Berhad
AIB	Affin Islamic Bank
AIA	American International Assurance
ABPM	Accounting-Based Performance Measurement
BAFIA	Banking and Financial Institutions Act
BCBS	Basel Committee on Banking Supervision
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia (Central Bank of Malaysia)
BOD	Board of Directors
CBMA	Central Bank of Malaysia Act 2009
CEO	Chief Executive Officer
CIMB	CIMB Islamic Bank Berhad
DFE	Development Finance and Enterprise
DEA	Data Envelopment Analysis
DMU	Decision Making Unit
GCC	Gulf Cooperation Council
HLIB	Hong Leong Islamic Bank
HSBC (M)	HSBC Amanah Malaysia Berhad
IAH	Investment Account Holders
IRR	Investment Risk Reserve
IBA	Islamic Banking Act in 1983
IBs	Islamic Banks
IFH	Ihlas Finance House
IFIs	Islamic Financial Institutions
IFSB	International Financial Services Board
IIBF	Institute of Islamic banking and finance
INCEIF	International Centre for Education in Islamic Finance
IDB	Islamic Development Bank
KFH (M)	Kuwait Finance House Malaysia Berhad
LUTH	Lembaga Urusan Tabung Haji
MFRS	Malaysian Financial Reporting Standards
MENA	Middle East and North Africa
MIB	Maybank Islamic Bank Berhad
OECD	Organization for Economic Co-operation and Development
OIC	Organization of the Islamic Conference
PER	Profit Equalization Reserve
PLS	Profit and Loss Sharing
RHB	RHB Islamic Bank Berhad
SAC	Shariah Advisory Council
SC	Shariah Committee
SFA	Stochastic Frontier Analysis
SG	Shariah Governance
SGF	Shariah Governance Framework

SSB
TA

Shariah Supervisory Board
Takaful Act 1984

CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND OF THE STUDY

The industry of Islamic banking has undoubtedly undergone a considerable growth during the past decade both physically and financially (with nearly \$1.89 trillion total assets and annual growth rate of 17.4 percent in 2016 and this growth is expected to continue in the future (IFSB, 2017)). However, despite this remarkable growth, the issue of corporate governance in Islamic Financial Institutions (IFIs) has not received due attention in the academic as well as the professional fields of Islamic finance (Mollah & Zaman, 2015; Alnasser & Muhammad, 2012; Ahmad & Pandey, 2010). It is worth noting that there are inherent differences between Islamic and conventional banking systems due to the fact that the functions of Islamic banks must be in consonance with the spirit, ethos and value system of Islamic rules and principles (Shariah) which comes from the Holy Quran and Sunnah (Bhatti & Bhatti, 2009). While Islamic banking has a broader scope and meaning, it is generally referred to the transformation of conventional money lending system into Asset-backed financing transactions conducted by the Financial Institutions; it also operates based on the profit and loss sharing principle which stipulates that banks as well as the investors share the risks associated with business ventures (Beck, Demirgüç-Kunt & Merrouche, 2013).

Nevertheless, the scope of corporate governance in Islamic financial institutions (IFIs) extends beyond the conventional corporate governance, which operates largely in the interests of management and shareholders, to include the spiritual aspects as well as the worldly needs of people. In other words, while the western systems of corporate

governance are based on self-interest, the ultimate goal in corporate governance in IFIs is *Maqasid al Shariah* (objectives of Islamic law) (Bhatti & Bhatti, 2009). *Maqasid al Shariah* is defined as a tool to protect and preserve the benefits and interests of society. It is also to facilitate the needs of human beings and ensure that wealth is circulated in the society in a fair manner. Therefore, *Maqasid al Shariah* requires that Islamic banks, apart from maximization of profit, take into account the justice as well as welfare of members of society (Chapra, 2000).

In the meantime, a sound and effective Shariah governance is believed to act as an assurance system which continuously monitors the operations of Islamic banks and ensure their compliance with Shariah principles (IFSB, 2009). This assurance system not only can ensure sound performance of Islamic banks according to Shariah rules but also it can build trust and confidence among Muslim Ummah through its transparency and disclosure (Chapra, 2000). However, considering the undeniable role of Shariah governance in addressing the issues in Islamic banking, it is still in the early stages of development and faces numerous challenges which require more attention. Among these challenges are the issue of competence, independence, confidentiality, consistency, transparency and disclosure.

Aspiring to be the global Islamic finance hub, Malaysia has proven to be a role model in this field and one step ahead of the rest of the world in regulating its Islamic finance industry and Shariah governance in particular (Omar, 2013). Since the enforcement of Islamic banking act in 1983, the Malaysian regulatory bodies have constantly upgraded the regulatory framework for Islamic finance. In this regard, Bank Negara Malaysia (BNM) have played a significant role by issuing Shariah governance related guidelines such as Guidelines on Shariah committee for IFIs (2004)”, “Shariah resolutions in Islamic finance (2007)”, “Shariah governance framework for IFIs (2010)”

(SGF-2010), “Islamic Financial Services Act (2013)” and more recently “Financial reporting for Islamic Banking Institutions (2016)”.

In the meantime, SGF-2010 which was updated on 25 November 2014, is one of the most remarkable attempts towards designing and establishing an effective Shariah governance mechanism in Islamic banks which was first issued on 2010 and was made effective from 1st January, 2011. The significance of SGF-2010 has been emphasized by BNM governor Tan Sri Dr. Zeti Akhtar Aziz who mentioned in the Financial Stability Report 2010 that this framework aims to provide comprehensive guidance on the Shariah governance structure and highlight the roles and responsibilities of its key functionaries (Hassan & Hussain, 2013). SGF-2010 is considered to be a milestone in the course of evolution of Shariah governance regulatory framework in Malaysia (Lahsasna & Saba, 2014; Omar, 2013; Ramli, Majid, Muhamed & Yaakub, 2014; Hasan, 2012). However, after almost four years since its enforcement, there is limited research on the impact of this framework and its success in addressing the current challenges of Shariah governance in banking industry. Therefore, the present study is an attempt to evaluate the impact of regulations (SGF-2010) in addressing the current issues in Shariah governance. For this purpose, a questionnaire is developed and distributed among the key players in Shariah governance framework including Board of directors (BOD), Shariah Committee members and senior managers in which they evaluate the impact of SGF-2010 in addressing and resolving the current challenges in Shariah governance.

As mentioned earlier, the ultimate goal of Shariah governance is to fulfil the *Maqasid al Shariah* which requires the IFIs to not only strive for better performance but also take into consideration the requirements of a larger number of society members and to ensure the equitable distribution of wealth among them (Chapra, 2000). Justice

and fairness to the members of society is one of the hallmarks of Islamic socio-economic system, the proof of which is that the word justice is the third most repeated word in the holy Quran after the word “Allah” and “Knowledge” (Kahf, 2003). On the other hand, it is well established in the literature that the overall performance of banking industry can have implications on the welfare of society, due to the fact that banks function as intermediaries to link the surplus funds to the deficit points including industries as well as household individuals (Gulati, 2011; Seçme, Bayrakdaroğlu & Kahraman, 2009).

On the other hand, the recent global financial crisis, has greatly drawn the attention of researchers to the issue of the relationship between governance and banking performance. Although their results are mixed but the majority of them imply a significant relationship between these two concepts. In case of IBs, despite the fact that Shariah scholars stressed that SG process has to be pragmatic to ensure practical and tangible results in actualization of socio-economic objectives of Shariah (*Maqasid al Shariah*) (Moisseron, Moschetto & Teulon, 2015); however, it was until recently that researchers in IB considered the practical impact of SG on performance. Their studies are in line with the early statement made by Sulaiman (2001) who mentioned strong Shariah governance can minimize the transaction cost arising from incentive issues and it also reduces the inefficiency cause by asymmetric information and moral hazard. Therefore, the practical implications of Shariah governance must be traced in the performance of IFIs. Sound and effective performance in Islamic banking is thus of great importance to a wide range of stakeholders from government authorities to public.

Hence apart from evaluating the impact of regulations on addressing the challenges in Shariah governance practices, the present study also aims at evaluating the performance of Islamic banks in Malaysia. For this purpose, it is inevitable to

elaborate the main components of performance measures. It is well established in the literature that there are two main aspects that should be appraised simultaneously while considering the performance evaluation namely efficiency and effectiveness which together define the overall performance in any organization (Kumar & Gulati, 2009). While these two terms may seem identical to many, they have different meanings and are mutually exclusive. In general terms, efficiency is the measure of operational excellence and reflects the fact that how good the organization is in attaining the outputs using the minimum level of inputs. On the other hand, effectiveness measures the ability of the organization in achieving its goals and objectives. Consequently, both measures of efficiency and effectiveness are considered in this research to provide a thorough picture of overall performance in Islamic banks in Malaysia; whereby enabling this research to further examine the relationship between the overall performance and Shariah governance practices to shed light on practical implications of SGF-2010.

1.1 PROBLEM STATEMENT

Banks are the backbone of the economy in every country. Having an intermediary role in channelling the surplus funds to deficit points, banks are the main providers of capital for innovation, infrastructure, job creation and also household individual requirements. Therefore, any disturbance in the operations of banking system has direct impact on the economic as well as well-being of the society. Islamic banks are on the other hand based on the Shariah and its principles are mainly derived from the Holy Quran and Sunnah. Islamic banks are prohibited from charging interest (*Riba*), not allowed to engage in speculation (*Gharar*) and forbidden transactions (such as alcohol and pork industry). They are also based on profit and loss (risk) sharing model (Chapra, 2000).