**Introduction**

Corporate governance refers to the method by which a corporation is directed, administered or controlled. It includes the laws and customs affecting that direction, as well as the goals for which it is governed. Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. Corporate governance is also viewed as a process of monitoring performance by applying appropriate counter-measures and dealing with concepts such as transparency, integrity and accountability.

Corporate governance requires corporations to exercise immense accountability to shareholders and the public, and also monitors the management of organisations in running their businesses. Corporate governance is normally divided into two categories, that is, self and statutory. Self-regulation involves aspects of corporate governance that are difficult to legislate. The issues in this category involve the human element, ie the independence of the board of directors, the relationship with the management and appraisal of the director’s performance. Statutory regulation, on the other hand, is the framework of corporate governance that can be explained in legal terms. The legislative and regulatory rules include:

1. Duties, obligations, rights and liabilities of directors, controlling shareholders and company officers.
2. Disclosure and transparency.

Today, good corporate governance is considered vital as it promotes morality, honesty, integrity, trust, openness, performance orientation, responsibility and accountability, as well as mutual respect and commitment to the organisation from all parties in an organisation. Corporate governance does not only does apply to directors and executives, but to all players in the organisation.

**Banks and the Corporate Governance Concept**

Having established a broad understanding of the Islamic notion of governance, let us attempt to fit this into an Islamic banking paradigm. Even within the conventional system, corporate governance became a thornier issue with respect to banks. This is because banks have certain unique characteristics. Three main characteristics that lead to an independent discussion of the governance of banks are: first, banks are generally more opaque than other financial institutions, which intensifies the agency problem. Secondly, banks are exposed to extreme regulations; and thirdly, government ownership of banks makes the governance of banks different from other types of organisation.

When banks face sound governance mechanisms, they will efficiently mobilise and allocate funds, this lowers the cost of capital to firms, boosts capital formation and stimulates productivity growth. Thus, weak governance of banks reverberates throughout the economy with negative ramifications for economic development.

**Islam and Corporate Governance**

Strong corporate and bank governance are essential ingredients for the development of a vibrant and sound Islamic finance industry.

Corporate governance is not new to Islam. The Islamic concept of corporate governance stresses the three main areas of accountability, transparency and trustworthiness.

The need to strictly follow these corporate governance requirements is given greater weight, more so for god-fearing persons, by linking the practices to God. One commandment for Muslims is the concept of tawhid, which promotes the need to submit fully to God. It highlights the unique and distinguished relationship between man and Allah. This relationship also prevents man from behaving in any manner that is harmful to other living things. By enforcing full submission to the Creator and by insisting that the Creator expects trustworthiness, transparency and responsibility in all dealings, corporate governance is given a spiritual backing.

**Elements of Corporate Governance in Islamic Banking**

The statutory corporate governance in Islam witnesses Islamic financial institutions abiding to a set of rules called the Islamic law or Shariah. The Shariah governs the bank’s operations and transactions in accordance with Islamic principles derived from the Quran and Hadith. It needs to be reiterated here that Shariah in Islamic banking has a crucial role not only in governing bank transactions and operations, but also in monitoring and supervising the roles of all players within the banking system.

Shariah is a blueprint for Islamic banks to operate in accordance with the laws outlined, for instance eliminating riba (interest) in all its forms, and ensuring that banking procedures do not exploit nor do injustice to the bank’s shareholders.

To ensure that Islamic banks comply with the appropriate Shariah rulings, the services of religious boards known as Shariah boards are employed. These boards comprise of Shariah scholars or a committee of religious scholars. The Shariah board plays the dual role of supervision and consultation.

**Governance Structures**

Islamic banks must have regard to the pronouncements of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Service Board (IFSB). All banks have to take account of risks and this is where it is essential to have good corporate governance and risk management. As mentioned above, Islamic banks employ Islamic scholars on an advisory or consultancy basis to ensure that the bank’s policies and activities comply with Shariah rulings. The ulamas have played a crucial role in the movement of Islamic finance and investment. They observe sources of the Islamic law and from these derive the principles of Islamic finance and investment.

The religious board, comprising largely of ulamas, is responsible for ensuring that financial institutions comply with the Shariah rulings, and this is done in two phases. In the first phase, the religious board reviews the operations of the financial institution to ensure its Shariah compliance. The second phase involves answering queries as to whether proposals for new transactions or products conform to the Shariah. The board also offers constructive and creative recommendations in all matters pertaining to the Shariah.

Apart from that, dialogues with economists and bankers are held to develop new financial products that comply with Shariah. These dialogues are important so as to keep Islamic banking in line with market demands. Strict adherence to the Shariah and frequent dialogues with financiers will also assist in minimising agency problems, as discussed below.

**Financial Governance**

Like conventional banks, an Islamic financial institution is an intermediary and trustee of other people’s money, with the difference that it shares profit and loss with its depositors. Extrapolation of this concept means that businesses should act as “responsible” trustees to shareholders and investors. “Responsible” in this context means managing the business according to the principles of Shariah. Hence, application of the concept of amanah (trust) to a business situation demands that the business be managed by those responsible as a trusteeship for the stakeholders. In view of this reliance on amanah, financial governance is ensured and unethical behaviour is avoided.

Islamic banks operate on the concept of interest-free banking with Musharakah (partnership) and Mudarabah (profit-sharing) as their basic products. Mudarabah financing involves projects managed by a client where the bank shares the risk with the client. The bank acts as a partner and is entitled to monitor, supervise and access books and records. As a consequence, the management of Islamic banks tends to confront an ethical dilemma when faced with a conflict of interest between shareholders and Mudarabah partners. However, the company management still has the authority to conduct the company’s affairs.

However, in a Musharakah set-up, losses are borne proportional to the capital invested. Here Islamic banks provide funds that are combined with funds of the enterprise. Profits are distributed in pre-determined ratios among partners. Contributors have the option to be involved in the project management, but this is not compulsory.

**Agency Theory**

In Islamic banking, the stakeholders are shareholders, account holders, Musharakah financing partners, Mudarabah investment account holders, its employees and the Islamic community (ummah). Agency problems arise from differences in economic interests between the agent (the bank management) and the principal (the bank’s investor). There is therefore ample room for agency problems to occur within the context of Islamic banking. However, conscientious coherence to the Shariah can counter these agency problems. This would in turn allow Islamic banks to maintain investors’ confidence and assist in the establishment of a financial system which is stable and secure.

**Corporate Governance Practices in Selected Countries**

Corporate governance principles and codes in Islamic banks have been developed in different countries and issued from stock exchanges, corporations, institutional investors, or associations (institutes) of directors and managers with the support of governments and international organisations. As a rule, compliance with these governance recommendations is not mandated by law, although the codes linked to stock exchange listing requirements may have a coercive effect. There is, of course, no single recognised best model of corporate governance.

***Malaysia model*** On 30 July 1981, a 20-member National Steering Committee of Islamic Banks was established. The committee proposed recommendations to the government on 5 July 1982:

1. An Islamic bank should operate under Shariah principles.
2. An Islamic bank should be incorporated as a limited company under the Companies Act 1965.
3. The Central Bank should monitor and supervise the Islamic bank.
4. An Islamic bank should have a Religious Supervisory Council to ensure that the bank’s operations are in accordance with the Shariah.

Following these recommendations, the Islamic Banking Act 1983 was promulgated. Under this Act, it was compulsory for Islamic banks to have their own Religious Supervisory Council with a minimum of three and a maximum of seven Muslim religious scholars. The Council’s role was to advise the Islamic bank on its operations and transactions. The first Islamic bank in Malaysia (Bank Islam Malaysia) was established in July 1983. The distinct Islamic principles that govern its operations are as follows:

1. Prohibition of riba
The profit and loss sharing concept replaces interest as the central mechanism that governs the deposit-taking and loan-making transactions.
2. Muamalah (Islamic transaction)
All banking transactions and management efforts must comply with Shariah.
3. Avoidance of contradictory activities
Activities that do not conform to the Muslim society’s interest are equivalent to the abuse of wealth entrusted by God.

In view of the Shariah board being given such a prominent role in the management of Bank Islam, one can be assured that good corporate governance will be practised at the bank.

***Bahrain model*** Bahrain has over 30 Islamic financial institutions with a wide range of activities, including Islamic insurance. Bahrain is a major player in the world of Islamic banking and finance. To maintain a strong, stable and secure financial system, all Islamic banks in Bahrain need to comply with Shariah supervisions. All Shariah supervisory boards (SSBs) conduct annual reviews and produce reports to shareholders. The shareholders in turn provide input on the satisfaction level of their investments and the manner in which projects were handled by the bank. Should a bank breach the Shariah tenets, the SSB undertakes the following:

1. To find alternatives to transactions that comply with the Shariah.
2. If no alternative is found, the transaction will not be allowed to proceed further.
3. If a transaction is already executed and the breach is found at a later stage, the SSB will advise the management and shareholders to distribute the income generated from the breached transaction to a charity account.

In addition to the SSB, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established to concentrate on defining Islamic financial instruments and designing accounting standards. This organisation set up a 15-member Central Shariah Board in 1995 to harmonise and converge concepts and applications amongst SSBs of various Islamic financial institutions. Its objective is to prevent inconsistencies between SSBs of different banks and assist with developing new products. By establishing all these bodies, Bahrain has moved ahead of many other countries offering Islamic banking services.

***Bangladesh model***

It has been reported that of the 39 Islamic banks in Bangladesh, only five operate according to stringent Islamic principles. These institutions offer a full range of banking services, but most importantly have Shariah councils to guide their operations. These councils consist of fuqahas (Islamic jurists), Islamic economists and lawyers. The monitoring and supervisory roles of these Shariah councils see to it that all activities operate according to the tenets of Shariah, thus ensuring good corporate governance. In some instances these Shariah councils conduct audit operations and produce a report that highlights deviations, if any, and make suggestions for the further purification of banking transactions.

***Saudi Arabia model***

The Saudi Arabian Islamic banking scene is dominated by the Islamic Development Bank (IDB), which was established in 1974. It is an international financial institution, similar to World Bank or the Asian Development Bank. Its main task is to encourage member countries and Muslim communities to implement policies leading towards Islamic economic development and social progress. Besides that, IDB participates in equity capital and grants loans for project and enterprises. IDB has diverse operations that are strictly governed by the following Shariah principles:

1. Dynamic usage of resources without riba
Interest charges on loans are strictly prohibited in line with the excerpt from the Holy Quran which states that: “Allah has permitted trade and forbidden riba (interest).” IDB prides itself for being involved in trade and not in riba.
2. Constant use of financial resources
Resources should not be wasted, as Islam encourages owners to put resources in a productive process to enable distribution among members of the society. Islam discourages wastage.
3. Equitable sharing of risk and gains
As mentioned in the Holy Quran, “Let it be a trading among you by mutual agreement,” financial contracts such as Mudarabah, Musharakah and Murabahah are all based on profit and loss sharing arrangements.
4. Securing due benefits/income for owner
IDB emphasises the ethical use of financial resources in a manner that would secure maximum benefits in the form of a return or mark-up.
5. Benevolent loans
The Holy Quran stresses the importance of qard hasan (benevolent loans) in Surah Al-Mozammil, verse 20, “Attend your prayers, pay your alms and grant benevolent loans.” IDB provides qard hasan to achieve Islamic social, moral and spiritual goals. This is carried out even for Muslim communities of non-member countries.
6. Lawful investment
The Shariah does not recognise profit maximisation as the solitary goal of an enterprise that neglects social and ethical principles. In Islam, operations involving financial profit may need to be sacrificed in the interest of the community at large. Morals and ethics are given a greater weight relative to profits.

***Complication in corporate governance of Islamic banks*** The law states that corporations and their management owe fiduciary duties to their shareholders only, in contradiction to fiduciary duties of Islamic banks towards their shareholders and stakeholders. Compared to the shareholders’ interest, it is the stakeholders who seem to be the party whose rights might be compromised. This is not due to the governance of the Mudarabah contract, but rather to the context in which it is used.

**Recommendations**

In addressing corporate governance in Islamic banking, it is seen that Islamic banks have a SSB that deals with both self and statutory regulation. The SSB may have to extend their jurisdiction to cover governance issues of this nature.

With regard to statutory regulation, SSB members must be knowledgeable in the Arabic language to interpret the Holy Quran and Hadith correctly. It may perhaps be a good idea to establish a central SSB to oversee the rulings of independent SSBs, as different SSBs may have varying interpretations. This central SSB can monitor and advise individual SSBs from time to time. As for self-regulation, SSBs play an important role in creating the awareness among players of Islamic financial institutions, such as directors, shareholders and the staff, on the concepts like tawhid and other Islamic ethics. These individuals must remember that performing their tasks honestly is a form of worship to God.

Islamic banks should establish training centres where prospective clients are taught to observe aspects of good governance, especially with respect to providing full and honest disclosures of their business dealings, and also run their business in an ethical manner. Some sound corporate governance rules may help Islamic banking to fulfill its mission and emphasise the need to supplement general corporate governance principles to Islamic banking.

**Conclusion**

The need for good corporate governance practices is vital in all banking sectors, and even more so within the Islamic banking paradigm. It also has to be noted here that the question of governance issues are well placed in all aspects of Islamic banking operation. Although these governance issues may not be so sophisticated to meet the ever-growing changes in Islamic business dealings, the Shariah Council needs to play an even more crucial role in monitoring and ensuring a well-adapted governance practice in Islamic banking. Again we have to remember that the responsibility of practising ethical governance in Islamic banking does not only fall in the hands of the Shariah Council, but also all other parties involved in the industry.