

## **Corporate Governance Practices and Performance of Financial Institutions: From Islamic Critical theory view**

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**ABSTRACT:** Despite the importance and applicability of corporate governance practices in financial institutions, the literature indicates very few studies have attempted to investigate the effect of corporate governance practice on the performance of financial institutions, specifically base on the Islamic critical theory view. The literature reveals that there is not only limited information on corporate governance practice of Islamic financial institutions (IFIs) but also little research in this important area. Drawing from the review of the literature and past studies, this paper specifically identifies and reviews corporate governance practices that are base on Islamic critical theory view essential to the performance as well as financial viability of IFIs. The findings of the study indicate that Islamic corporate governance practices are linked to Islamic critical theory based on Quran and Sunnah. Having competencies in the practices will allow IFIs to not only improve their organizational performance but also sustain their financial viability as well as competitive advantage.

**KEYWORDS:** Corporate Governance, IFIs, Performance.

### **I. INTRODUCTION**

Islamic Financial institutions (IFIs) were established to content the financial services to the society. These financial institutions operate in line with *Shari'ah*. Islamic financial institutions providing various types of Islamic finance products and financial services that are expected from the society. Interestingly, in developing and developed nations, IFIs have turn out to be not only vital players in the financial industry but also the key source of financing individual with minimal income as well as those that do not patronize the services provided by other conventional financial institutions. More importantly, in developing countries, the facilities and other financial services provided by IFIs are significantly being recognized as one of the recent tools for increased financial inclusion.

Significantly, as financial institutions to the society, their success lays heavily on their corporate governance practices and how effective they are being managed. The success of IFIs depends on their performance and ability to sustain financial viability because of the ability to adopt quality corporate governance practices. Corporate governance practices are measured not only important to IFIs but also major tools for their organizational performance. As the Islamic financial industry grows, corporate governance is being endorsed as an ideal tool to facilitate its expansion and reach.

Despite the recognition of corporate governance practices to organizations such as financial institutions, these practices have not attracted much research and interest. It is apparent that corporate governance from the Islamic point view has been neglected. The review of the past studies confirms that previous research primarily concentrated on investigating corporate governance practices from the conventional perspectives [1; 2; 3; 4; 5; 6; 7; 8; 9; 10]. Based on these findings and research gaps, the paper is presented in three sections. The following Section Two is literature review. Finally, Section three presents discussion and conclusion of the paper.

### **II. THE LITERATURE REVIEW**

Organizational performance can be measured in terms of financial and non-financial. Over time, performance of financial institutions is evaluated through the financial measures. Financial performance is understood to be performing financial activities. Broadly, it is the level at which organizations achieve the set financial goals. In addition, it could be a way of assessing the organization's policies and operations in financial terms. It discloses the whole organization's wellbeing over time that can serve as yardstick to compare with other organizations within the same industry. Financial performance is an essential component for organizations that are profit-oriented. It is typically measured through profitability, leverage, liquidity and growth. Profitability is defined as the financial measure of firm's success achieved in relation to the capital invested and obtained from the volume of net accounting profit. Profitability is critical to firm's performance and its prolonged absence could be reason for corporate failures.

Leverage (gearing) is another significant measure of firm's performance which is identified by a mix of debt in the capital structure [11]. Though, this has been disputed, but financial leverage constantly affects the financial performance which has been empirically tested positively [12]. Liquidity is the firm's financial ability to liquid assets in form of short-term debt, that is, one year period, [13]. It therefore reflected the ability to pay wages and salaries, bills and adequate working capital to run the business. A firm has a corporate objective of keeping adequate liquidity for its survival. Size is the yardstick that usually measure growth upon which most firms depends on as indicator of performance [14].

Islamic critical theory encompasses every aspect of human life and offers solutions according to teachings of Quran and Sunnah resulting in emancipation, transformation and a better life [15]. Past studies [16; 17] conclude that this theory is not new as it has been described in studies. It involves infusion of morality and ethics on legal, cultural, political, social and economic aspects. This study needs to look at corporate governance from the religious aspect so that financial experts will appreciate that having known the existence of God will bring fear of God and ultimately uphold trust as a requirement to achieve optimum performance.

It is apparent that stakeholders and other interested parties are continuously in the quest to know the financial position of the organization and its financial performance over time. Therefore, study on performance of organizations remains relevance in the global trend.

According to [18], performance of IFIs is seen from organization of work an organization is able to accomplish and the ethical conduct of employees according to Islamic principles. This is in addition to providing the best path way to achieve objectives. Islam stimulated participation in economic activities and earning income which comes from allowed (halal) resources. With regard to Islamic critical theory, the aim of engaging in financial dealings is not just to gain profit in this world (dunya) for well-being but it is a component of faith that could lead to success in the hereafter (akhirah). Several studies [19] offer yardstick to measure performance of organization and or its employees in accordance to the teachings of Islam. [20] proposed that avoidance of business with usury, sincere intention, avoidance of fraudulent element in financial contracts, justice and trust as the essential regulations and business ethics in line with Quranic provisions. Similarly, [21] believes Muslim ethical code of conduct cannot be delineated from the rules and regulations required in financial dealings, and stated some performance measurements as sincerity (ikhlas), trust (amanah), justice (adl), truthfulness (sidq), benevolence (ihsan), weighs and measures, forward transaction, swearing in trade, monopoly, price control, corporate social responsibility, rights and obligation of employees and fulfillment of promises. They emphasized forward transaction, swearing in trade, price control and monopoly as violating Islamic teaching and should be avoided while complying with the rest. These are all enshrined in the beliefs of the Islamic theory. Moreover, every economic activity must take measures that are ethically acceptable to principles of Islam. The Islamic perspectives of the variables in this study that is Islamic corporate governance and performance of Islamic financial institutions linked them up as one because their focus is the teachings of Quran and Sunnah which is a core concern to Islamic critical theory [15].

## **2.1. Corporate governance from conventional view**

Corporate governance is a research area that continue to appeal interest due to its complex nature in tackling corporate issues that existed since the time of Adam Smith [22]. According to [23], the meeting of the G7 leaders after the Asian financial crisis and the Russian debt of 1998, triggered corporate governance and incentives becoming a top priority to organization of economic cooperation development. Furthermore, the pronounced financial scandals and corporate failures such as Enron and WorldCom, Swissair, Global Crossing Ltd., Health South, Tyco international companies, Pamalat, and Jinro Ltd increased the need to understand the role of corporate governance in different corporate settings [24].

Corporation was defined by the [25] to mean "group of people authorized to act as one and to be considered in law as a single entity". Furthermore, from the legal perspective, it is regarded as "an artificial legal individual created by law and under the authority of law of a nation" [26]. Both definitions gave the understanding that corporation is a representation of group of people coming under one sole entity to achieve some established objectives.

On the other hand, governance as defined by the [25], means "any act or matter of governing". This can be extended to mean the style or manner by which corporation, organization or institution is guided, directed and controlled. Corporate governance can be understood to mean the relationship network that exists in an organizational set up involving employees, management, shareholders, community and environment for a purpose.

To sum up, corporate governance is defined as "that governance that deals with the mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are

protected” [27]. Likewise, Organization for Economic Co-operation and Development (OECD) defined corporate governance as “procedures and processes of directing and controlling in an organization, being the most popular concept of corporate governance in Western countries [28]. This definition is viewed from the financial institutions’ perspective having a distinct characteristics and class of stakeholders compared to other form of organizations.

Corporate governance is described from the banking perspective by the Basel Committee for Banking Supervision (BCBS) to mean “the manner in which the business and affairs of every institution is governed by its board of directors and the senior management relating to the manner in which banks set its corporate objective, routine business activities, interest of stakeholders such that corporate activities are carried out in a secured and complete style protecting the interest of depositors and complying with legal and regulatory requirements ” (BCBS, 1999:3). This comprehensive definition proves their distinct nature and thus, are more regulated than other entities. Subsequently, [29] view corporate governance to mean “the process of managing the overall organization to improve principal-agent relationship, serving in the interest of shareholders and the organization in accordance with laws and ethics of the nation”. The next section will discuss the concept of corporate governance from the Islamic view, definition of Islamic corporate governance and a presentation of its components.

**2.2. The concept of Islamic corporate governance of IFIs**

At first, corporate governance was discussed in [30], where he outlined the main component of framework for corporate governance as Shariah supervisory board (SSB) with its internal controls. Subsequently, the Accounting and Auditing Organization for Islamic financial institutions [31] and Islamic Financial Services Board [32] issued Shariah governance guidelines for compliance by the IFIs in addition to conventional corporate governance guidelines. [33], established the foundation of Islamic corporate governance and he classified it into three phases as follows;

1st phase (pre-1980s): At this period, there is no literature on corporate governance in Islamic economies [34].

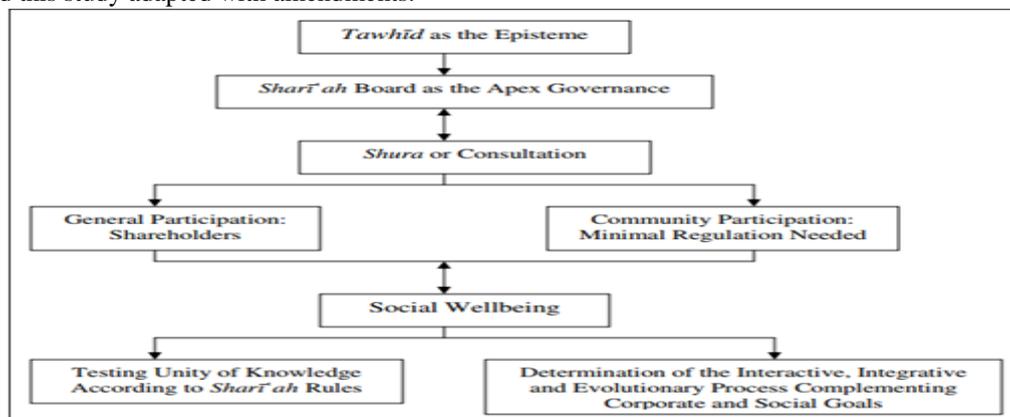
2nd phase (1980s-1990s): This period began few studies on corporate governance of IFIs issues especially Shariah review and audit [35].

The advent of corporate failures of IFIs during the 1990s through 2000s such as Ihlas House in Turkey, Islamic bank of South Africa and Islamic investment companies of Egypt kindled the writing of more studies on corporate governance from organizations, institutions and even individuals.

3rd phase (post 2000): the advent of studies like [36] on role and function of Shariah board, auditing and accounting, also, framework of corporate governance, [37] on corporate governance disclosure; [38] on corporate governance of Islamic banks, characteristics, effects on stakeholders and role of Islamic bank supervisors. Furthermore, [39] publish a survey on Shariah boards of IFIs. As well as study by [40] on issues of governance, transparency and standardization n of Islamic banks were made.

Despite the positive development in bringing corporate governance into limelight, the quest for studies to establish a theoretical foundation of corporate governance from an Islamic paradigm remained vague [41]. Consequently, [42] presents the theory of corporate governance founded on epistemology of Tawhid (oneness of God) presented as follows;

The most prevalent write ups on the concept of Tawhid which is a core principle that develop the ethic of trust in a person, are [42; 43; 44], and tried to present the Tawhid and shura based approach as sourced from [42; 43; 41; 45] and this study adapted with amendments.



Source: (Choudhury & Hoque, 2006; Hasan, 2008, 2011, and Thajudeen, 2013).

**Figure 1.**

It has been shown that, corporations are seen from similar understanding of the western perspective as being legal entities with limited liabilities, as affirmed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Shariah standards No.12 and accept that it has been incorporated by law. Governance deals with directing, monitoring and controlling something or someone. However, Islamic financial institutions are required to design a corporate governance structure that is in accordance with the Islamic principles of Shariah. This involves referring to the Quran and teachings from the Sunnah.

**2.3. Shariah supervisory board**

AAOIFI Governance standards defined Shariah supervisory board as “an independent body entrusted with the duty of directing, reviewing and supervising the activities of IFIs with the aim of Shariah compliance and by means of legal rulings affecting Islamic banking and finance”. Moreover, the AAOIFI standards issued significantly to enhance the practice of Shariah supervisory board, mostly referred to as (SSB) in Islamic banks. They are responsible for Shariah supervision of the institutions which is a function of corporate governance.

Equally important, Islamic critical theory confirm the role of SSB in ensuring activities carried out IFIs comply with the teachings of Shariah and ensure disclosure to attract public confidence. The appointment of Shariah supervisory board (SSB) is made by approval from board of directors at the annual general meeting. This encourage social justice as held by the theory [15]. Furthermore, AAOIFI standard require the board to state opinion on whether the IFIs contracts observe Shariah compliance. However, divergence of opinions of SSBs of different IFIs are possible due to the science of interpretation of the law [46]. Thus, the need for proper recording and auditing which is very important in Islam and can be evident in the following Qur’anic verse;

“Then who is given his record in his right hand, soon will he shall be reckon with by an easy reckoning, and he shall go back to his people joyful. And as to him who is given his book behind his back, He shall call for perdition, and enter into burning fire”. (Al-Inshiqaq, 84:7-12)

Evidently, the practice of recording financial transactions and obligations was always present in Islam and this is confirmed from the above Qur’anic verse [47].

Nevertheless, the Shariah supervisory boards at Central bank’s level differ in scope, governance, and accountability in different jurisdictions. Shariah boards of directors have the role to ensure Shariah compliance by assigning responsibility for routine Shariah compliance to senior management. This role is justified where senior management work under the supervision of the Shariah board, implying the Shariah board’s advisory role to the central bank.

Then again, Shariah board has responsibility for Shariah compliance [48]. In the same way, it becomes relevant for them to play active role in supervising the financial institutions on shariah compliance to achieve the objective of regulating the financial system. In line with this, the result of a true Shariah governance practice is compliance with Islamic financial institutions in line with principles of Shariah as well as producing a report to the institutions and stakeholders [49]. This information disclosure function indicates the extent of Shariah compliance by the Islamic financial institutions [50].

To elaborate, corporate governance has been defined from the Islamic perspective by regulatory bodies such as IFSB, AAOIFI and scholars like [42] who define and re-define the concept. The Islamic critical theory further highlights corporate governance from the provision of Quranic verses and Hadith.

**2.4. Definition of Islamic corporate governance**

The provision of the guiding principles on corporate governance for Institutions offering only Islamic financial services (excluding Islamic insurance (takaful) institution and mutual trust fund) (IFSB-3) defined corporate governance from the Islamic framework as “a set of relationships between a company’s management, its board of directors, its shareholders and other stakeholders which establish the structure through which the goals of the company are set, and the means of attaining those goals and monitoring performance are determined” [39]. Additionally, IFSB is vested with the role of enhancing the level of corporate governance in Islamic financial institutions [51]. Likewise, AAOIFI standard No.1 and IFSB-10 provides for SSB appointment, composition and report. It was emphasized that it is ideal for Shariah board, to install Shariah governance and abide by Islamic principles fundamental for Islamic financial institutions [52]. Currently, AAOIFI and IFSB are the most recognized international regulatory bodies leading issuance of Shariah governance guidelines [52; 53].

Equally important is the definition of corporate governance of IFIs given by [42] as “a set of organizational arrangements as to how a corporation is directed, managed, governed and controlled, providing the governance structure to protect all stakeholders’ interests, achieving objectives, supportive social responsibility and complying with principles of Shariah”. Thus, compliance with Shariah principles is what makes Islamic finance distinct from conventional financial system [54].

There is no doubt that Islamic critical theory becomes a reference to corporate governance support to the principles of fairness, accountability, transparency and justice. As such, to distinguish its values and features from its western counterpart, there is a need to further strengthen the understanding of these values and features. This is to ensure emancipation and transformation from interest-based financial dealings to interest-free dealing as supported by the theory.

The divine values of Islam originate from the holy Qur’an and Hadith which has notably affected the Muslims way of life [15]. Furthermore, the economic and business activities of the Muslims make it appropriate to adapt to Islamic finance practice [55]. Fundamental to this is the provision of Qur’an 2:282 states: “O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing Let a scribe write down faithfully as between the parties: let not the scribe refuse to write: as Allah Has taught him, so let him write. Let him who incurs the liability dictate, but let him fear His Lord Allah, and not diminish aught of what he owes..... let the trustee [faithfully] discharge his trust and let him Fear his Lord conceal not evidence; for whoever conceals it, - his heart is tainted with sin. And Allah knoweth all that ye do”. (Al-Qur’an 2:282).

The above divine Qur’anic verse is fundamental to the corporate governance framework. It is apparent directly from the verse the significance of compliance with Shariah principles, mode of making transactions and the ethical conduct in any form of transaction. It emphasizes on the principle of corporate governance and other components of regulatory framework such as risk management, liquidity management and capital adequacy. The verse deals principally on the law of contracts and principles of evidence. This is a key corporate governance function. Again, it stipulates the importance of written documents and the principle of fairness and justice. Islamic critical theory referred to Quranic injunctions on issue of expertise and trustworthy witnesses and accountability. For that reason, documentation and witnessing reduce risk in a contract under taking. The was mentioned in the verse as: “if you conceal the truth of a matter knowingly, your Lord who is all-knowing and all-aware, will make you account for it” (interpretation by Ibn Abbas). The noble Quran has incited a unique spirit on the human hearts to be on guard in form of fear of Allah and reality of hereafter.

This stated the fair and justice nature of Islamic dealings and among the essential principles of corporate governance. The theory intensely indicates the duty of care and responsibility required on anything entrust to people for safe-keeping. As such, the basis of corporate governance originates from Islamic teachings.

[42] proposes a corporate governance theoretical framework based on faith referring to it as a theory on decision-making processes involving Islamic socio-scientific epistemology of Tawhid. Their study concluded that Islamic corporate governance is extensively important on areas of transaction-cost minimization in decision making. Based on the ideas of achieving organizational objectives and complying with Shariah principles, they find the need to re-define the conceptual definition of Islamic corporate governance.

They re-define Islamic corporate governance to mean “a set of corporate arrangements as to how a corporation is directed, managed, governed and controlled, and providing governance structure where interests of all stakeholders are protected, objectives achieved, social responsibility upheld and the principles of Shariah complied with”.

Notwithstanding the re-definition by [42], IFSB and AAOIFI some fundamental requirements on Islamic corporate governance found in the Qur’an were omitted. Based on the ideas of Islamic critical theory, Quran and the Sunnah are fundamental to resolve corporate governance issues. Significantly, the Quranic verse, 2:282 explains:

The word “faithfully” means honesty that is vital in every financial dealing. The power of faithfulness is strong that the verse mentioned it 3 times.

“and not diminish aught of what he owes.”

“The witnesses should not refuse when they are called on [For evidence].” And

“and let him Fear his Lord conceal not evidence;”

These parts of the verse disclose the importance of full disclosure in any financial contract in Islam.

“More suitable as evidence, and more convenient to prevent doubts among yourselves”

“and get two witnesses, out of your own men,”

The above verse describes being transparent is to prevent doubts among transacting members and the presence of witness affirms to a transparent contract.

“and let neither scribe nor witness suffer harm.”

This explains the protection of stakeholders rights by considering the stewardship role as a trust and thus being a trustee to their property.

“And Allah is well acquainted with all things.”

“And Allah knoweth all that ye do”.

These parts of the verse explain the day when one will be accountable to all his deeds, as such accountability allows reflection.

To sum up, the three main essentials of a good corporate governance practice are disclosure, transparency and accountability [41; 56].

From the foregoing Quranic verse and corporate governance of IFIs view of [42; 43; 41; 45], IFSB and AAOIFI, this study suggested a refined definition of Islamic corporate governance as a theoretical contribution to corporate governance literature.

“An arranged Shariah-compliant system of managing an organization structured in a way to provide full disclosure, transparency and accountability such that stakeholder’s interest is protected and accentuating social responsibility using trustworthiness as a tool to achieve the desired goals/objectives”.

The appearance of trustworthiness in the definition came as mentioned in the verse and a core element in the stability and reliability of any contract. More importantly, the unique point of reference regarding trustworthiness and good character is Prophet Muhammad (Peace be upon him) and it is said to be heaviest conduct to be placed on the scale (al-mizan) on the Day of Judgment [57]. As such, regulatory, supervisory and other financial experts of Islamic financial institutions should consider it as a duty Amanah (trust) from Allah SWT [58].

Another essential point is to affirm by the believe in Islam that every human being is accountable for their actions no matter how small as they are clearly recorded in the books. Thus, to be accountable which is an element of transparency in all dealings, can be explained from the Quran, 2: 282.

In Islam, accepting faith means abiding by the teachings of the religion and this interprets the concept of accountability in the Islamic accounting theory [59]. Accountability is one of the major essential components of corporate governance practice [56].

It has been shown that Shariah principles are the backbone to the operations of Islamic financial institutions conforming to the religious requirements [60]. Likewise, Shariah corporate governance has similar objectives as conventional corporate governance but the idea and approach varied because in addition to protecting the interest of the stakeholders, it considered Shariah principles [61; 41; 62; 63].

## **2.5. Components of Islamic corporate governance**

The components of Islamic corporate governance are described by the studies of [36; 64; 65; 66; 67] as follows:

1. **Board of Directors:** The board of directors is a vital internal governance mechanism of IFIs. Organizations require strong board containing skilled directors to work towards achieving high performance. Numerous studies found positive relationship between BOD and performance of organizations [ 36; 64; 68; 69; 70; 66]. Board of directors played the role of setting and approval of organization’s policies and strategies to monitor any development that will lead to achieving corporate goals [65].
2. **Disclosure and Transparency requirements:** [67] found components of corporate governance to include disclosure and transparency requirements, accountability of board members, their expectations and responsibilities, internal and external mechanisms for compliance. Moreover, previous study by [68; 65] found a significant positive relationship between disclosure and transparency in corporate governance practice.
3. **Shariah Supervisory Board:** They are mostly referred to as (SSB) in IFIs responsible for Shariah supervision of the institutions, a vital function of corporate governance. Studies [71; 65; 67] view accountability as a role to Shariah supervisory board. They also issue Shariah-related rules and policies and check Shariah compliance of all products to ensure compliance [64].
4. **Audit:** this unit is responsible for both internal and external review systems of the financial institutions. It safeguards policies set by the board are properly abide by management and ensure sound information disclosure to review of financial report [64]. Audit is considered one of the core components of corporate governance [65].
5. **Investment Account Holders (IAH):** Both the accounting and auditing organization for IFIs (AAOIFI) and the Islamic finance supervisory board require IFIs to be transparent in disclosing the appropriate returns on IAH,

shareholder's fund and the bases and percentages due on expenses and profits to give them a view of the performance of their investments [64]. It was found that positive relationship exists between IAH and performance of organization [65]. The next section will present discussion and conclusion of the study.

This essay discusses Islamic critical theory in that mankind is enjoined to do good deeds everywhere to be fair and just according to God's commandants including in corporate governance practice (board of directors, shariah supervisory board, audit, investment account holders and information disclosure). In the same way, the IFIs would stand a better chance of success by implementing these corporate governance practices as reviewed and presented. Equip with the corporate governance practices, IFIs will be able to not only put extra efforts and adopt to global trends occurring in their business environment but they will strive to achieve more competitive advantage.

### **3. Discussion and conclusion**

It has been shown that corporate governance practices are considered important to the performance of IFIs as well as their financial viability. The review of the corporate governance practices suggests that these practices are linked to the performance of IFIs. Findings of previous studies have provided theoretical evidence that suggests IFIs that adopt the corporate governance practices were able to not only improve on their operations but also enhance their institutional performance. Emphasized are the results of several prior studies showing positive effect of corporate governance on organizational performance [72; 73; 74; 75; 6; 76; 1; 9; 77].

In summary, the review of the literature suggested board of directors, disclosure and transparency requirements, Shariah supervisory board, audit practices, and investment account holders to be the key determinants for performance of IFIs. For that reason, IFIs will need to identify and develop their competencies on these practices. It is apparent that having competencies in the practices will allow IFIs to not only improve their organizational performance but also sustain their financial viability as well as competitive advantage. Therefore, based on Islamic critical theory, and referring to the paper in view, regulators and supervisory authorities must have the belief that situations can affect one's actions, as such suggest finding solutions to overcome problems arising from wrong actions (corporate governance issues) by complying with Quranic injunctions.

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