

CHAPTER I : INTRODUCTION

1.1 Background of Study

In recent years, the concept of Shariah governance for Islamic financial institutions (IFI) has attracted the interest of many scholars in the field of governance and supervision. The emergence and fast growth of Islamic finance and banking have led to extensive discussion among scholars in this field of study. The interest pertains to Shariah governance in regard to Islamic financial institutions that have the responsibility for ensuring adherence to the Shariah principles across the whole spectrum of their business. Therefore, in conducting their business activities, their claim to be an Islamic financial institution must be a faithful claim that abides by all the Shariah principles.

However, in the case of Islamic Credit Co-operatives, despite this sector being subject to the same issues pertaining to accountability, governance and the responsibility to safeguard its stakeholders, it has received little academic attention in terms of Shariah governance. Notwithstanding the fact that Islamic banking should have an adequate and sound system for upholding Shariah principles and protecting stakeholders' interests, the weight of concern should be similar in respect of Islamic credit co-operatives.

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their members. Hence, any failure in the governance of these financial institutions, either real or perceived, would attract adverse public reaction and could severely affect their reputation and public confidence. Consequently, it might lead to investors rethinking their investment decisions concerning whether to invest or divest.

1.2 Problem Statement

In the history of the development of national economics, co-operative unions have been considered to be a key mechanism and instrumental for governments to improve the economy of rural communities (Fredericks, 1986; Asan Ali, 1998; Hayati Md Salleh et al., 2008).

Recently, there has been renewed interest and concern in the co-operative sector with a growing number of studies exploring the issues pertaining to governance and accountability for co-operatives (Cheuk, 2012; Maslinawati & Intan, 2013; Maslinawati et al., 2013; Azmah et al., 2013; Intan et al., 2013). Despite their long history of establishment, since 1922, co-operatives still face a number of problems resulting from a lack of transparency, poor governance and under-performance (Cheuk, 2012), which might be due to the absence of good corporate governance and the lack of integrity of the boards and management (Intan et al., 2013).

The co-operative movement in Malaysia started off as a rural, small-sized business movement that provided many basic services, such as agricultural and consumer credit for the rural community during the British colonial era (Fredericks, 1986). It has also been highlighted that, initially, the British intended to replace the dependence of rural communities on money-lenders and free people from debt-bondage resulting from the high-interest charged by giving them access to a more viable credit

system; namely, the co-operative credit system. Since then, the co-operative movement has expanded day-by-day, especially when supported by various initiatives by the local government transformation plan (Maslinawati et al., 2013). The co-operative sector has now turned into an efficient business and has become a major driver in respect of the country's social and economic goals.

Table 1.1- Status of Co-operative by Function as at 30 June 2016

No	Functions	Number of Co-operatives	Number of Members	Number of Capital Share/Fee	Number of Assets	Acquisitions
(RM MILLION)						
1.	Banking	2	967,25	3,326.58	98,345.78	13,319.84
2.	Credit	598	1,299,725	6,172.47	12,491.83	3,274.47
3.	Agriculture	2,858	750,714	613	2,688	579
4.	Housing	276	154,188	198.39	639.63	157.20
5.	Industry	323	19,683	11.03	76.31	21.88
6.	Consumer	5,208	2,664,615	414	1,832	852
7.	Development	232	37,600	20.65	90.74	28.31
8.	Transportation	479	143,893	67.37	297.37	410.79
9.	Services	3,271	987,453	3,121	9,025	1,428
	Total	13,247	7,025,127	7,025,127	7,025,127	20,071.41

Source: SKM's website

According to Maslinawati et al. (2013), and as shown in table 1, as at 30 June 2016, co-operatives offering financial services were a significant contributor to the total revenue of the co-operative movement as a whole. The contribution is mainly provided by two co-operative functions – banking-based co-operative and credit-based co-operative – with 66.36% and 16.31%, respectively. Interestingly, the table also reflects that co-operatives received a huge amount of public trust and confidence, and that they contribute significantly towards the national economic development. Hence, the issues of accountability, good governance and proper management are a concern, not only to

safeguard all the members but also to ensure the sustainability of the national economic growth.

The most detrimental occasion occurs when an important financial institution or credit co-operative is exposed to an accountability issue, as the subsequent systematic domino effect would, eventually, affect the economy of the whole country. For instance, a reoccurrence of the severe scandal faced by Bank Rakyat in 1975, 20 years after their establishment, which led to the chairman, the managing director and the bank secretary being charged and convicted of a breach of trust (Hayati Md Salleh et al., 2003; Radziah, 2012). According to Hayati Md Salleh et al. (2008), this situation led to insolvency, with Bank Rakyat suffering a cumulative loss of RM65.233 million, and debts and liabilities exceeding the asset wealth of RM47.966 million. Notably, Tun Hussien Onn, the Prime Minister at that time, sought through parliament the urgent intervention of the government to help Bank Rakyat, or, in other words, to help its 27,314 members and 1,000 co-operative members who would be affected by this betrayal, most of whom were poor farmers, ranchers, fishermen, low government officials, small traders or others with low incomes.

Nevertheless, the domino effect could be the worst effect, particularly to the credit co-operative, especially as the co-operative business model uses an external capital source, normally a financial institution, for financing or credit activities. Therefore, these financial institutions must be subjected to a higher standard of accountability, integrity, transparency and professionalism when conducting their business operations.

Although the governance functioning appears to be a vital function to improve performance, it involves a comprehensive governing model. This is because the governance of an organisation is interrelated to the individual skills, experience and

motivation (Maslinawati et al., 2013). The relationship between the board and the management is supported by the effectiveness of the governance policies, procedures and process (Tricker, 2012).

To date, the much published research on the co-operative sector only dealt with the concept and performance of the co-operatives, and, hence, its generalisability is limited (Mohd Khairuddin & Dzulhilmi, 2015). In addition, a few writers have drawn on systematic research into accountability issues and challenges (Nur Eyliawati et al., 2015; Maslinawati & Intan, 2013; Maslinawati et al., 2013; Azmah et al., 2013; Intan et al., 2013). However, little attention has been conducted on the Shariah governance issues and practices. Thus, with the emergence of Islamic co-operatives, there is an urgent need to explore and address this concept with the implementation of Islamic transaction principles in place for use as guidelines in governance.

The Malaysia Co-operative Societies Commission, as the regulator for this sector, has issued guideline – GP28-Shariah Governance for Co-operatives (hereinafter to be referred to as GP28) – as an external arrangement to safeguard the Shariah principles in Islamic credit co-operatives. This guideline highlights and names the four main organs that should effectively function as an internal arrangement for the Shariah governance framework. The four main organs are:

- i. Board of Directors
- ii. Shariah Committee
- iii. Management
- iv. Internal Auditor Committee

Therefore, this study attempts to explore and investigate the current Shariah governance arrangements and practices in the case of the Co-operative sector.

Specifically, co-operatives offer the Islamic credit scheme to their members, and, thus, this study would help fill the gap in the literature by providing evidence in this area.

1.3 Research Questions

The formulation of the problem can be decomposed according to the following questions:

1. What are the internal arrangements of Shariah governance in the Islamic Credit Co-operative sector?
2. What are the attributes of the Shariah Committee in the Credit Co-operative sector?
3. What are the external arrangements of Shariah governance in the Islamic Credit Co-operative sector?

1.4 Research Objectives

1. To examine the internal arrangements of Shariah governance practices in the Islamic credit co-operative sector.
2. To examine the attributes of the Shariah Committee in the Credit Co-operative sector.
3. To examine the external arrangements of Shariah governance practices in the Islamic credit co-operative sector.

1.5 Scope of the Research

In general, the co-operatives in this sector are differentiated by function. The Malaysia Co-operative Societies Commission (hereinafter to be referred to as SKM) lists nine different functions in this sector:

- i. Banking
- ii. Credit
- iii. Agriculture
- iv. Housing
- v. Industry
- vi. Consumer
- vii. Development
- viii. Transportation; and
- ix. Services

Hence, this study focuses on the Shariah Governance arrangements in the four different credit co-operatives – also known as Islamic credit co-operatives – that were selected for this study that offer Islamic financing schemes. The internal and external arrangements for Shariah governance in these four Islamic Credit Co-operatives were identified. The selection was based on various criteria, as follows:

- i. Co-operatives that are listed on the Index 100 Co-operatives Best Performance by SKM.
- ii. A credit co-operative that offers an Islamic credit facility to their members.
- iii. Co-operatives that have instituted a Shariah Committee function for their respective co-operative.

Moreover, the study also obtains an insight and perspective from the regulator and the Apex body in this sector. Interviews were conducted with the Shariah Compliance Unit, SKM as regulator, and also the Shariah Unit, Malaysian National Co-operative Movement (hereinafter to be referred to as ANGKASA) as the Apex body in this sector.

The study was conducted by referring to the SKM's regulatory framework, which focuses on GP28 – Shariah Governance for Co-operatives ((hereinafter to be referred to as GP28) and identifies the gaps between the current practice in Islamic Credit Co-operatives in Malaysia. In addition, this study adopts qualitative methodology using in-depth interviews as primary data. Meanwhile, the content analysis technique is based on obtainable documents, such as the annual reports, related guidelines and previous studies regarding Shariah governance.

1.6 Structure of the Study

This study is structured into five chapters. Chapter one is the introduction chapter, which highlights the background of the study and provides an overview of the similarities in governance features between Islamic financial institutions and Islamic credit co-operatives, and the increased need for adequate Shariah governance for the co-operative sector. It continues with the problem statement, research questions and research objectives derived from the problem statement. Then, continues with the scope of the study, the structure of the study, and, lastly, the conclusion.

Chapter two discusses the literature review and the past empirical studies related to this study. It also discusses the concept and fundamental model of corporate governance from a Western and Islamic perspective, and continues the concept of

Shariah governance in Islamic financial institutions in general. Next, a brief explanation regarding corporate governance and Shariah governance in Islamic credit co-operatives is provided. In addition, the relevant guidelines issued by the co-operative regulator are also elaborated upon. Furthermore, past empirical studies are discussed, including the issues and challenges in terms of governance practices in Islamic financial institutions and Islamic credit co-operatives.

Chapter 3 outlines the research methodology used in this research. As the research applied the qualitative method, case studies and interviews were selected. Further, the research design and method of sampling are explained. Then, the discussion continues with data collection and analysis, and concludes by reporting the findings.

Chapter 4 provides the analysis of the findings and discussion. This chapter highlights the similarities and differences in the current internal and external arrangements of Shariah governance practices in four Islamic credit co-operatives in Malaysia that implement GP28.

Chapter 5 summarises the content of this thesis, briefly explains the findings, and discusses the research objectives and answers to the research questions. It also provides a conclusion and recommendations in respect of Shariah governance practices for Islamic credit co-operatives in Malaysia. In addition, the study highlights the limitations and potential for future research in the areas of Shariah governance in Islamic credit co-operatives in Malaysia.

1.7 Conclusion

Nowadays, Shariah governance has become a significant basis for preserving the Shariah principles in Islamic financial institutions, including in credit co-operatives.

By having an adequate Shariah governance framework, Islamic institutions would gain confidence and trust from their stakeholders, including investors, as well as the Muslim society at large.

Thus, hopefully, this study explains the current Shariah governance practices in Islamic credit co-operatives in Malaysia by identifying the internal and external arrangements of the Shariah governance framework in four different Islamic Credit Co-operatives. Subsequently, the analysis and discussion pertaining to the issues and challenges highlighted in this study explain the contribution of the study, as well as its suggestions, limitations and guidance for future research.

