

CHAPTER II : LITERATURE REVIEW

2.1 Introduction

This chapter reviews the concepts of corporate governance and Shariah governance, especially within Islamic Financial Institutions and Islamic Credit Co-operatives. It includes the definitions of corporate and Shariah governance, the developments and the models that have been studied in this research. Besides that, this research also examines the emerging issues previously mentioned by earlier researchers in their studies. This chapter also discusses the internal arrangement for Shariah governance, namely, the board of directors, Shariah Committee, and management, as well as the external arrangement by the respective regulator and Apex body in this sector. Subsequently, this chapter highlights the current area of research that has been neglected for a long time by researchers, which is the Shariah governance practice for Islamic Credit Co-operatives.

2.2 The Principles and Concept of Corporate Governance

At the end of the last century, the establishment of corporate entities led to increased concern about the main vital function that corporate entities should have, namely, a governance function. This function is to ensure the sustainability and continuity of the entity itself resulting from the effectiveness of a governing body (Tickers, 2012; Adams, 2012; Garcia-Torea et al., 2015).

Over the past decade, this function has become a concern that encompasses all entities including joint ventures; co-operatives; partnerships; profit oriented companies;

and non-profit organizations, such as voluntary and community organizations, charities, and academic institutions; as well as government-linked companies. Notably, some of these entities may use a different name for their governing body, some may call their governance body a board or committee, a governor or body of council, but whatever it is called, the essential governance principles and practices are still the same as far as protecting the interests of all the related parties.

According to Tricker (2012), essentially, the concept of corporate governance is about the way power is exercised over corporate entities. It describes the governance activities by the board and their relationship with the shareholder or members, and with those in management, as well as with other stakeholders, such as external auditors, regulators, and other legitimate stakeholders. This statement is in line with Abdul Rahim (1998) who explained the concept of corporate accountability, which was initially formulated based on the agency theory to represent the shareholder value system by ensuring the effectiveness of certain elements – supervising and monitoring management performance, and ensuring the accountability towards other stakeholders.

Corporate governance is different from management. Corporate governance describes the functionality of the governing body over the executive management. The governing body is responsible for ensuring that the executives who form the management and who run the corporation follow the right path and run it well (Adams, 2012). Thus, this governing body should be setting the company's direction, formulating strategy, supervising management, and also take responsibility for the organization's decisions and performance (Tickers, 2012). Thus, Garcia-Torea et al. (2015) argued that the governing body would appear to be an effective governing body if it at least exercised all these responsibilities.

2.2.1 Definition of Corporate Governance

Over the past 20 years, with the development of the corporate governance discipline, there has been a large number of published studies defining corporate governance. However, the best definition is the definition given and adopted by the responsible authorities that have made a significant contribution to the development of corporate governance. Notably, the definition derived from the Cadbury Report 1992 as the first code for corporate governance, and the definition from the Organization for Economic Cooperation and Development (OECD), as the organization directly involved with and assisting the development of global guidelines on corporate governance, are sufficient for obtaining a fundamental understanding of the definition of corporate governance.

In 1992, the need for a good corporate governance code was answered by the issuance of the Cadbury Report. This code defines corporate governance as:

“Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board’s actions are subject to laws, regulations and the shareholders in general meeting.”

While the Organisation for Economic Co-operation and Development (OECD) gave the following definition of corporate governance:

“A set of relationships between a company’s management, its board, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance. It helps define the way authority and responsibility are allocated and how corporate decisions are made.”

In considering these definitions of corporate governance by the responsible authorities, Tricker (2012) considered that they encompass all the perspectives needed to understand corporate governance, namely, the operational perspective, relationship perspective, stakeholders’ perspective, financial economics perspective, and societal perspective. Thus, indicating the sufficiency of these definitions for adoption and modification by regulators around the world.

2.2.2 The Fundamental Models of Corporate Governance

According to Sulaiman Abdullah & Jorah (2012), several main corporate governance models are used internationally, each with its own distinct features.

First, the Anglo-Saxon American Model was introduced by the Securities and Exchange Commission (SEC), United States, in the 1970s. This Model is also known as the unitary board since the mandatory requirement from the SEC is to establish a board, as well as audit, nomination, and remuneration committees. In addition, these committees, which consist of both executive and outside directors, are responsible for monitoring and supervising how the business is being carried out, i.e. in the right or wrong direction (Ungureanu, 2012). In other words, the unitary board has effectively two main responsibilities, the formulation and implementation of strategic decisions and supervising management performance (Tricker, 2012).

Second, the UK/Commonwealth principles-based model, which is perceived as being similar to the previous model mentioned. However, in the context of the board of directors, the code of governance in the UK requires independent non-executive or outside directors; sub-committees, such as audit, remuneration, and nomination; and also requires the separation of CEO duality (Tricker, 2012). In addition, the legal practice is different from the US, which uses a prescriptive rule-based legal approach to governance, in that the UK regulator uses a non-prescriptive, principle-based, and self-regulatory approach, in which, although the compliance is voluntary, the corporate should comply with the requirements or provide an explanatory statement for non-conformance (Tricker, 2012).

Third, the Japanese business network system or *Keiretsu*. *Keiretsu* is a network of companies in Japan with a cross-holding and interlocking directorship (Tricker, 2012), in which there is a close relationship with shareholders, as well as with loyal suppliers and customers, including the financial institutions (Ungureanu, 2012). Thus, the banks have an influence on the decision-making in Japan. The Japanese model has an internal based control, which comprises a board of directors, an office of representative directors, and an office of the auditor (Sulaiman Abdullah & Jorih, 2012).

Fourth, the emergence of the family-based model or family-centric with close family control, which is now actively practised by corporations in south-east Asia (Tricker, 2012), for instance, in Singapore, Taiwan, Malaysia, Thailand and Indonesia. In the context of the board of directors, the board is perceived as playing a supportive role, as the real power is with the family who exercise control through an equity stake held by the family (Tricker, 2012).

Notwithstanding all these models, initially, the issue of corporate governance immediately arises when there is a separation between the ownership and control. This separation gave birth to the agency theory, which highlights the agency dilemma of ensuring that all the agent's activities objectively fulfil the principal's interest. Nevertheless, this is becoming more challenging in modern corporations due to the increasing diversity of shareholders in public companies. In recognition of the agency dilemma, another theory surfaced to explore the concepts of governance from a different perspective, known as the stewardship theory (Tricker, 2012). With regard to the stewardship theory, the shareholders have to trust the directors to act as stewards of their wealth. Indeed, the shareholders should rely on and trust the decisions of the directors, since the directors are the party with access to the company's information and know far more about the current situation of the company compared to the shareholders.

2.3 Theories of Corporate Governance

The phase of 'Corporate Governance' emerged after the exploration of the theoretical relationship between the principal and the agent. The basic principle that reflects corporate governance is that whenever a principal has to place their trust in an agent to run and handle their business, then the issue of governance and supervision arises (Tricker, 2012). Consequently, the model and theory pertaining to corporate governance have emerged and expanded day-by-day.

2.3.1.1 Agency, Stewardship, Stakeholder Theories and Islamic Credit Co-operatives

This subsection summarises the related theories – agency, stewardship and stakeholder – concerning corporate governance and their relevance to the Islamic Credit Co-operatives. Then, it explains which theory is the most appropriate in terms of the Shariah governance practices of the Islamic Credit Co-operatives. Furthermore, in line with the suggestion of Sulaiman Abdullah Nasser & Mohamad Jorah Muhamed (2017), that it is important to reassess the theoretical background that is commonly used as the underlying theory in the discussions of corporate governance, this study considers that such a reassessment would contribute to the knowledge in the area of governance, particularly among co-operatives.

Although credit co-operatives are considered to be financial intermediaries that have similarities to other modern financial intermediaries, such as banks, it is not possible to simply adopt the theories that are discussed in respect of modern financial institutions without relooking and re-examining the nature of the relationship between the principal and the agent in co-operatives. Only then can we affirm which theory is the most appropriate for the governance of credit co-operatives and the Shariah governance of Islamic Credit Co-operatives, or decide whether a single theory could be applied to the co-operatives setting.

Basically, credit co-operatives are a form of organization that were established with a common interest and shared purpose of its members, which led to their involvement in profit-oriented activities, such as business, retail and banking. Credit co-operatives are institutions that are owned and run by and for their members. This gives their members an equal say and share of the profit, and each member is eligible to be elected to the respective Board of the Co-operative. Hence, co-operatives are owned

and democratically controlled¹ by their members since everyone has an equal say and the power to elect the Board of the Co-operative during the annual general meeting irrespective of how many shares he or she possess. The Board of the Co-operative is elected based on the trust to run the co-operative on behalf of its members and is responsible to set up a management team to support the business activities of the co-operative.

Consequently, it gives birth to the agency dilemma as per the concern underlying the agency theory. The agency dilemma is to ensure that all the activities of the agent objectively fulfil the interests of the principal (Tricker, 2012). In the case of credit co-operatives, the board is perceived as potentially abusing the interests of their members by using the resources for their self-interest. This separation gives preliminary backing for the agency theory to be the underlying theory in the governance of credit co-operatives. This is because all the members of a co-operative have an equal right regardless of how many shares they have. Thus, the biggest criticism of the agency theory being irrelevant in modern corporate governance is countered in that the complexity of aligning the interests of minority shareholders, majority shareholders and institutional shareholders in modern corporate governance does not arise due to the nature of co-operatives.

However, it is too early to conclude that the agency theory should be the underlying foundation for the corporate governance in co-operatives. This is because the Boards of Co-operatives are legally bound by the by-laws of their respective co-operative. Each co-operative has its own rules and regulations, and legal documentation that describe the direction of the co-operative, as well as its activities and businesses

¹ <http://ica.coop/en/what-co-operative> (date assessed: 8 February 2017)

that the co-operative operates within. Thus, the Board of each Co-operative has a fiduciary duty to direct and manage the co-operative in accordance with the respective by-laws. As a result, the Board of the Co-operative has a fiduciary duty to act as a steward for the interests of its members, thus indicating that the stewardship theory should be the underlying foundation for the governance of co-operatives in contrast to the suggestion in the previous paragraph.

However, the role of co-operatives towards society at large cannot be considered in isolation. From the outset, co-operatives have been considered to be an economic activity with a strong social responsibility towards the members, in particular, and society, in general. Hayati Md Salleh et al. (2008) stated that a co-operative is a business entity or organisation that promotes cooperation among a group of people to work together to solve the problems they encounter. Such a venture that is in keeping with the identity of a co-operative would help in poverty reduction, as well as facilitate job creation, economic growth and social development. The identity that is universally accepted² comprises:

- i. Voluntary and open membership;
- ii. Democratic member control;
- iii. Members economic participation;
- iv. Autonomy and independence;
- v. Education training and information;
- vi. Cooperation among co-operatives, and;
- vii. Concern for the community.

² <http://ica.coop/en/what-co-operative> (date assessed: 8 February 2017)

Hence, the stakeholder theory should be considered as having the most appropriate fit for the underlying theory in respect of governance in co-operatives. The stakeholder theory diverts the corporate governance concept from shareholder-centric to that of stakeholder-centric (Sulaiman et al., 2017) which considers, recognises and concerns the values and beliefs of the appropriate relationships they encounter (Tricker, 2012). Thus, in line with the identity and the role of co-operatives at the societal level, the stakeholder theory should be the underlying foundation for co-operative governance since its sustainability affects the society at large.

Consequently, the stakeholder theory provides a comprehensive view regarding the importance of fulfilling the interests of stakeholders and the responsibilities of co-operatives. In considering the stakeholder theory and aligning with the Islamic perspective, the stakeholder theory is a natural fit as the underlying foundation for Islamic Credit co-operatives since it does not consider profit maximization to be the ultimate objective. Hence, this theory embraces the unique requirements of Shariah governance in that the aim of co-operatives is not simply profit maximization, but to conduct the activities in accordance with the Shariah principles and to promote the overall welfare of society (Abdul Rahim, 1998).

Therefore, enhancing the stakeholder value in line with the Shariah principles is a central purpose for all Islamic Credit Co-operatives. Their sustainability and financial performance will depend on the confidence of the stakeholders. Thus, there is a need for comprehensive Islamic governance and supervision that considers both the regulatory and moral aspects, as suggested by Abdul Rahman (1998). Hence, the idea of a religious audit as a control mechanism in the Islamic banking industry is to ensure that the shareholders' confidence is protected (Sulaiman et al., 2012). The control mechanism pertaining to the Shariah principle is undertaken by the Shariah Supervisory

Board or Shariah Committee. Therefore, having a functioning Shariah Committee would help Islamic Credit Co-operatives enhance the stakeholders' value. Stakeholders will be more confident if the Shariah Committee is an independent body that provides just and fair decisions to ensure that all the resources are utilised in accordance with the Islamic tenets.

2.4 Corporate Governance and Shariah Governance in Islamic Financial Institutions

This section briefly discusses the fundamentals of corporate governance and Shariah governance of Islamic financial institutions to provide an understanding and appreciation of the subject.

2.4.1 Corporate Governance in Islamic Financial Institutions

The recent studies conducted by Grais & Pellegrini (2006); Sulaiman Abdullah & Jorah (2012); and Maliah Sulaiman et al. (2015) note that good corporate governance in IFIs should be in accordance with Shariah principles to safeguard the interests of all stakeholders and ensure that they strictly adhere to the Islamic principles. Conducting all activities in accordance with Shariah entails that the institution pledges:

- i. not to engage in interest-based debt transactions;
- ii. not to conduct pure financial transactions disconnected from real activity;
- iii. not to participate in transactions where there is exploitation of any party; and,
- iv. not to participate in activities regarded as harmful to society.

In addition to the information related to the financial indicators, Stakeholders of IFIs are concerned whether all their stakes comply with the Shariah principles and regulations (Mustafa, 2012). Thus, the directors appointed in IFIs should be qualified and have the necessary values, including transparency, integrity and accountability, to ensure that they strictly adhere to the Shariah principles. Mustafa (2012) also noted that in addition to being responsible to the company's shareholders and stakeholders, ultimately, Muslim directors are responsible and accountable to Allah (SWT). This is because, as a Muslim, they believe that all their deeds and actions will be answerable to Allah in the hereafter. Thus, if the practices of Muslim directors are in accordance with the true teachings of Islam, they will exercise their roles and responsibilities in line with the interests of the shareholders.

Mustafa (2012) also opined that only a pious or an individual with a strong religious background could make the system effective and trustworthy. Such a pious person holds five significant values, namely, *siddiq* (truthfulness), *ikhlas* (sincerity), *'adalah* (justice), *ukhuwah* (brotherhood) and *mujahadah* (determination).

Since corporate governance is important for enhancing efficiency, mitigating risk, increasing stability and promoting economic development, Sulaiman Abdullah & Jorah (2012), contended that IFIs should also practice good corporate governance, especially to address any issue that arises due to the unique characteristics of IFIs (Karim & Azhar, 2015).

Notably, in line with the global focus on corporate governance, various regulatory bodies for IFIs have moved considerably towards improving the regulatory and supervisory framework for the purpose of developing corporate governance standards that are customised to the nature of IFIs (Karim & Azhar, 2015; Maliah Sulaiman et al. (2015). The corporate governance guidelines and standards issued by

the Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), and Bank Negara Malaysia (BNM) are some examples of the corporate governance frameworks that have been introduced for the purpose of addressing the governance of IFIs. In Malaysia, in terms of monitoring corporate governance practices, Bursa Malaysia and the Securities Commission act as regulators for the corporate governance practices of all public corporations, while Bank Negara Malaysia acts in respect of financial institutions.

Specifically, in 2016, BNM issued the *“Policy Document on Corporate Governance”*, which applies to all licensed banks, licensed investment banks, licensed Islamic banks, licensed insurers, licensed takaful operators, and financial holding companies. In 2006, the IFSB issued the *“Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)”* (IFSB-3), and, in late 2005, the AAOIFI formulated six *“Governance Standards for Islamic Financial Institutions”*.

BNM’s policy document on corporate governance, issued 3 August 2016, prescribed the sound and prudent manner of corporate governance for all licenced financial institutions with due regard to the interests of depositors, policy owners and participants. The policy represents a fundamental component of the BNM’s supervisory assessment and is a key factor in determining the level of supervisory intensity applied to a financial institution. Accordingly, this policy document sets out the strengthened expectations concerning the oversight responsibilities of directors and the composition of the board. BNM expects to see evidence of an effective challenge by the board, particularly in relation to key strategic decisions. In turn, senior management are responsible and accountable for the sound and prudent day-to-day management of the financial institution in accordance with the direction of the board.

Meanwhile, under the IFSB's guideline on Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services, (IIFS) (excluding (a) Islamic Insurance (*Takaful*) Institutions and (b) Islamic Mutual Funds), the IFSB highlighted seven guiding principles of prudential requirements in the area of corporate governance. The Guiding Principles are divided into four parts:

- i. general governance approach of IIFS,
- ii. rights of investment account holders (IAH),
- iii. compliance with Islamic Shariah rules and principles; and,
- iv. transparency of financial reporting in respect of investment accounts.

These guiding principles were designed to facilitate Islamic financial institution services identify areas where appropriate governance structures and processes are required, and to recommend best practices in addressing these issues, especially pertaining to the roles and functions of the main organs of governance in Islamic financial institution services, namely, the board of directors and the Shariah supervisory board (IFSB, 2006).

In addition, AAOIFI adopted Governance Standard No. 6 '*Statement on Governance Principles*' for IFIs. This standard formulates the basic concepts and foundation, which might be enhanced or modified in the future in relation to the governance of IFIs. The standard highlighted seven principles, which constitute the basis for the governance of IFIs, namely, enhancing confidence, Shariah compliance, business model, stakeholders' interests, social responsibility, business ethics and culture.

2.5 Shariah Governance in Islamic Financial Institutions

The emergence of Islamic finance in the world has given birth to a new governance concept and perspective, namely, Shariah governance. Previously, if the objective of common corporate governance was to protect and safeguard the shareholders' value of their investment or any stake they put in, Shariah governance provides an additional protection and safeguard – conformity with all the principles of Shariah. Shariah conformity is perceived as being a new stakeholders' perspective and interest when they are dealing with an IFI. Once an institution claims to be an Islamic financial institution, it should avoid the basic Shariah prohibitions in respect of commerce and the execution of its business transactions (Muhammad Ayub, 2009). The basic and fundamental Shariah prohibitions in business are the prohibition of usury (*riba*), the prohibition of uncertainty (*gharar*), and the prohibition of games of chance (*Maisir/Qimar*).

According to Karim & Azhar (2015), Shariah governance can be defined as the overall system that manages the conformity of the activities of Islamic Banks and financial institutions to the precepts of Shariah pertaining to a transaction. Interestingly, it proposes an internal and external structural arrangement for Shariah governance. The internal arrangement encompasses all the related parties involved in the internal governing and monitoring, namely, internal audit function, board of directors, related board committees, senior management, legal, and compliance. Furthermore, the external structural arrangement consists of the Shariah supervisory board, internal audit firm, Shariah audit and advisory firm, standard-setting organization related to IFI, for instance, AAOIFI, or non-related to IFI, such as OECD, banking and industry associations, rating agencies and indices.

Moreover, Karim & Azhar (2015) also highlighted the importance of Shariah governance for gaining the trust and confidence of stakeholders of IFIs. In addition, this trust and confidence would have a direct impact on the stability of an institution and contributes to its well-functioning as a financial intermediary. For instance, ultimately, the events of non-Shariah compliance will lead to a decrease in stakeholders' confidence, thereby resulting in fund withdrawals, which will severely affect the institutions as financial intermediaries. Thus, they asserted that having a good Shariah governance system is essential for IFIs.

In the case of Malaysia, it practises Shariah governance based on a centralized model, which is dissimilar to some Islamic countries, such as those in the Gulf Cooperation Council, which practice a decentralised model (Hamza, 2013). In Malaysia's model, the respective regulator, which is BNM, has full responsibility to ensure that the objectives of Shariah governance are achieved by strengthening the laws and regulations.

In 2013, BNM took the initiative to enact the Islamic Financial Services Act 2013 (IFSA 2013) to strengthen the regulatory platform for Islamic banking. This was proposed back in 2001 in the Financial Sector Master Plan (FSMP) with the intention of creating a separate and viable effective platform for Islamic banking in parallel with conventional banking. Notably, IFSA combined several separate laws into a single legislative framework and repealed the Islamic Banking Act 1983 and the Takaful Act 1984. It also comprises the Payment Systems Act 2003 and Exchange Control Act 2013.

Not too long before, in 2010, BNM issued a vital framework pertaining to the Shariah governance practice in IFIs, namely, the Shariah Governance Framework (SGF). The primary objective of the issuance of the SGF was to enhance the role of the SC and the management in respect of Shariah matters, enhance the relevant bodies that

have the responsibility to execute Shariah compliance, and attain a Shariah-based operating environment.

The objectives of the SGF, which was fully enforced on 1 July 2011, are as follows: firstly, to set out guidelines on Shariah governance structures, processes and arrangements of the IFIs in order to ensure that all the operations and business activities are in compliance with the Shariah. Secondly, to provide comprehensive guidance to the board, SC and management of the Islamic financial institutions to enable them to discharge their duties in matters relating to Shariah. Lastly, to outline the functions in relation to Shariah review, Shariah audit, Shariah risk management and Shariah research.

2.6 Corporate Governance and Shariah Governance in Islamic Credit Co-operatives

This section briefly discusses the fundamentals of corporate governance and Shariah governance in the co-operative sector in order to facilitate, and gain an understanding and appreciation of the subject.

2.6.1 Corporate Governance in Islamic Credit Co-operatives

The Malaysia Co-operative Societies Act 1993 (Act 502), defined a co-operative as an organization formed and owned by a group of individuals for the purpose of improving the participation in the economic and social activities of its members based on the co-operative principles. All co-operatives in Malaysia are managed based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. This Act also gives authority to SKM to function as a responsible regulator for monitoring,

supervising and regulating the co-operatives and the co-operative sector including in respect of the corporate governance practices of co-operatives.

On 8 April 2015, SKM issued a special guideline of good governance for co-operatives, namely '*GP 27 – Co-operative Governance Guidelines (GP27)*'. This guideline defined 'governance' as a process and structure for directing and managing the business and affairs of co-operatives so as to increase the prosperity of the business and corporate accountability with the ultimate objective of safeguarding the shareholders' interests. In respect of co-operatives, corporate governance is the relationship between the members as business owners, who run the business as a management and Board to manage on behalf of the owner with a view to achieving the objectives of the co-operative.

This guideline is designed based on the concept of responsibility, accountability and transparency of Board members, which focuses on the roles and responsibilities of the Board of the Co-operatives and the management. It consists of three main principles:

- i. fair board of directors;
- ii. management oversight; and
- iii. transparency and integrity.

In addition, this guideline lists 15 common principles that should be used as a reference concerning the practices of co-operatives to achieve good corporate governance.

2.6.2 GP28- Shariah Governance in Islamic Credit Co-operatives

The Shariah principles are of prime importance to businesses or financial services that claim to be a Shariah-compliant institution. The degree of compliance with the Shariah principles will strengthen the public confidence and credibility of the

Islamic financing institutions as an alternative to conventional loans, particularly in the co-operative sector.

The Co-operative Commission of Malaysia (SKM), as the regulatory agency for the co-operative sector, always gives priority to supervising and monitoring to ensure that the overall business activity of Shariah-based co-operatives operates in accordance with Islamic principles. Towards this goal, a Shariah Committee must be established by the co-operatives that conduct their business or activities based on Shariah.

The SKM recently issued the “*GP28-Shariah Governance Guideline*” (GP28), which became effective in July 2015. GP28 was issued under section 86B of the Societies Act 1993 to regulate co-operatives doing business or activities related to Shariah-compliant activities. This guideline emphasised the establishment of a Shariah Committee and best practices for Shariah governance co-operatives to ensure the effective oversight, responsibility, and accountability of the boards of co-operatives, Shariah Committees, management and also the internal audit committees.

GP28 serves as a general guide towards ensuring that all the activities and transactions of the Islamic co-operative strictly adhere to Shariah principles. The Shariah principles in business transactions are to avoid any Shariah prohibitions as previously mentioned, such as the prohibition of usury, the prohibition of uncertainty, and the prohibition of games of chance. Consequently, the degree of compliance with the Shariah principles would be a good indicator of the confidence for current and prospective members concerning the integrity of an Islamic credit co-operative.

GP28 essentially aims to strengthen the Shariah governance process in terms of decision making, accountability and independence, and is divided into two sections as follows:

- i. Establishment of Shariah Committee

ii. Shariah Governance

The introduction of GP28 describes the objectives and types of co-operative that are subject to this guideline. There are four types of co-operative mentioned in GP28 that should adopt this guideline:

- i. co-operative with banking function;
- ii. co-operative credit;
- iii. co-operative financing; and,
- iv. co-operative engaged with activities *Ar-rahnu* (Islamic pawn).

The next section is the requirement to establish a Shariah Committee function.

According to GP28, co-operatives have three options for establishing this Committee:

- i. establish a Shariah Committee internally; or
- ii. establish a Shariah Committee for a group of Co-operatives; or
- iii. appoint an external institution that is recognized by the Islamic Banking and Finance Institute Malaysia (IBFIM), and International Shariah Research Academy for Islamic Finance (ISRA) as a Shariah Committee.

Co-operatives should also determine whether a person is fit and suitable to appoint as a member of the Shariah Committee; hence, attention should be given to their honesty, good personal reputation and integrity in respect of their financial capability. Not only that, GP28 also highlighted the requirement and expected competencies the boards should have. This requirement is to ensure the key function of Shariah governance, namely, that the Board of the Co-operative is capable of discharging its role and responsibility effectively. In addition, GP28 also highlights the requirement for the independence of the Shariah Committee. This requirement is to ensure that the Shariah Committee does not have any relationship to non-independent board members or management that could lead to biased decisions pertaining to issues that arise.

GP28 also provides a guideline concerning the implementation of Shariah governance for Islamic co-operative, which outlines the level of oversight, accountability, and responsibility of the main organs, which consist of the Board of the Co-operative, the Shariah Committee, the management and the internal audit of the co-operative. Whereas, the confidentiality guidelines provide a minimum set of requirements that emphasise the importance of preserving the confidentiality of any information that would result in a disaster to the co-operative

2.7 Past Empirical Studies on Shariah Governance for Islamic Financial Institutions

There is a growing body of literature that recognises the importance of Shariah supervisory and governance for IFIs. Of key importance to Shariah governance for IFIs is to ensure that all the activities and transactions performed by IFIs adhere to the related Shariah principle, which would help to uphold the integrity of the IFI and sustain the confidence of the stakeholders. For the purpose of this study, some relevant studies will be discussed in detail. As this study focuses on Shariah governance practices, the discussion will focus on past studies (Grassa, 2013; Zulkifli, 2010, 2011, 2014; Abdul Rahim, 1998, 2008, 2011) because they discussed issues that are directly related to this study.

The academic literature on the Shariah supervisory or governance system in IFIs has revealed the emergence of several different practices of Shariah governance worldwide due to different jurisdictions, with different approaches – some opting for greater involvement by the regulatory authorities and vice versa (Zulkifli, 2010). One of the significant studies was conducted by Grassa (2013), who focussed and compared

the development of the Shariah governance system and discussed the different practices of Shariah governance in IFIs. This was a comparative analysis of Southeast Asia models and Gulf Cooperation Council (GCC) models since both are leading regions in Islamic Finance. To achieve this objective, the researcher focussed on the contributions of relevant literature and the existing laws and regulations for Islamic financial institutions, which provided a reflective synthesis on the practical work of Shariah governance systems across different jurisdictions.

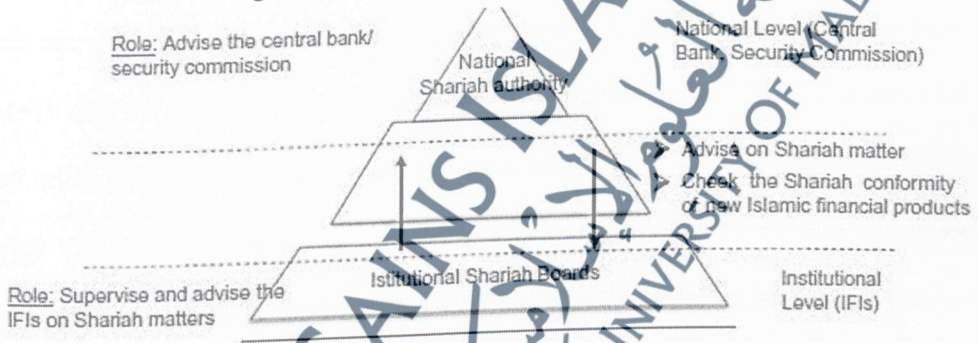
In an analysis of the Shariah supervisory system in Southeast Asia, Grassa (2012) and Hamza (2013) found that Southeast Asian countries have developed a unique Shariah supervisory model through the provision of dual Shariah control bodies: a higher Shariah authority at the national level and internal Shariah Boards (SB) at the institutional level. In addition, normally, a higher Shariah authority is established by the Central banks or securities commissions as the supreme regulatory authority (Grassa, 2013). Even though the roles and duties of the national Shariah authority might be different, in general, and in practice, the national Shariah authority guides and advises the central bank or the securities commission on Shariah matters related to Islamic financial operations and services, and also analyses the Shariah compliance of new products/schemes submitted by IFIs (Grassa, 2013).

According to Grassa (2013), the Shariah Supervisory Board model depicted in Figure 2.1, is the model currently being practised and implemented in Malaysia and Indonesia; it is also known as a centralized model (Hamza, 2013). In the case of Malaysia, the regulator has undertaken a serious initiative to regulate the Shariah governance practices through the enactment of the Islamic Financial Services Act 2013 and issuance of the Guidelines or Shariah Governance Framework (Grassa, 2013). Meanwhile, in his observation of the Shariah supervisory model in GCC, Grassa (2013)

identified several different practices compared to the previous observations for South-east Asian countries.

He also pointed out that there are three categories of Shariah governance practices in GCC, as depicted in Figure 2.2. First, the establishment of the national SB setting in the Central Bank is used as adopted by the Kingdom of Bahrain. Second, the delegation of power of the higher Shariah authority to another government body, such as the Ministry of Awaqaf and Religious Affairs or the Ministry of Justice and Islamic

Figure 2.1: Centralised Shariah Supervisory model.



affairs, such as in Qatar, UAE and Kuwait. Third, no specific regulation for Shariah supervisory practices, which are left to the voluntary initiative of the IFIs and the influence from the market; this is also known as the self-regulated approach (Hassan, 2010).

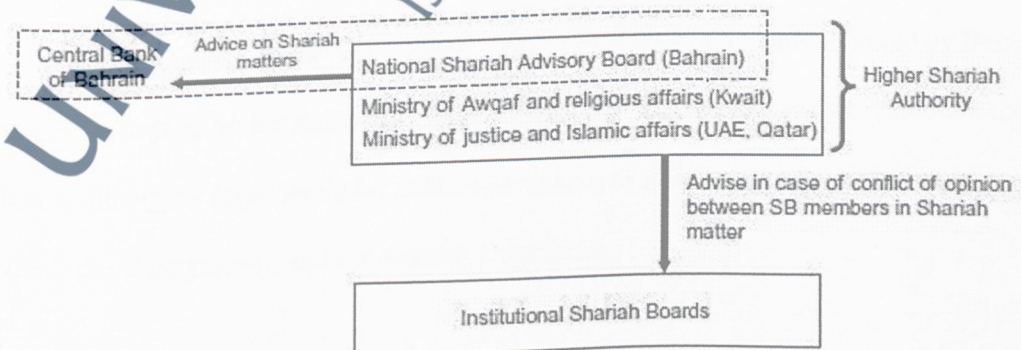


Figure 2.2: Decentralised Shariah Supervisory model.

Following the above discussion, some writers have argued that the different practices of Shariah governance in different countries would give birth to another issue at the national level as well as at the institutional level (Grassa, 2013; Hamza, 2013). At the national level, Grassa (2013) highlighted two main issues. The first is related to the absence and weak supervision of the higher Shariah authority, while the second, is related to the Supervisory/advisory role of the higher Shariah authority. At the institutional level, several issues have been identified, which include the absence of a comprehensive regulatory framework governing the SB attributes and Shariah practices, the repetition of the names of certain Shariah scholars on many Shariah Boards, and the absence of an external Shariah review (Grassa, 2013). Grassa (2013) concluded in a similar vein to the studies conducted by Zulkifli (2011, 2014), and Hamza (2013), who noted that an effective Shariah supervisory system has become crucial for IFIs. They contended that national Shariah authorities need to play an even more important role in the monitoring and implementation of governance practices in IFIs. Meanwhile, the existing Shariah governance framework needs further improvement in order to reinforce the development and growth of the Islamic finance industry. To achieve this, the international and national Islamic financial organizations need to work together to establish an effective Shariah governance system.

In an analysis of the Shariah Governance Framework document issued by Bank Negara Malaysia, Abdul Rahim (2011) found that this document clearly highlighted the three main organs responsible for matters pertaining to Shariah governance, namely, the board, the management, and the Shariah Committee.

Meanwhile, these three organs should be supported by three main functions to provide a sound and balanced system, namely, Shariah risk management and control, a Shariah review function, and a Shariah audit function. Interestingly, the Shariah audit function should be undertaken by an independent internal audit unit, or an external qualified competent third party. An independent requirement would help the auditor undertake an independent assurance process and report pertaining to Shariah conformity. Hence, the need for an effective Shariah audit function confirms the need for a proper and comprehensive guideline for IFIs undertaking the Shariah audit function.

In considering the need for a Shariah audit framework, Abdul Rahim (2011) pointed out the urgency to strengthen the current practices of the internal Shariah audit function. In his study, he suggested four essential aspects to assist the Shariah audit function unit to function effectively. First, the board should establish an objective or Shariah audit charter that encompasses the Shariah audit position to address the Shariah related issues. This charter should also highlight that the scope of the Shariah audit should cover all the IFI's business activities and operations. Second, the Shariah audit unit should be independent of the management. The Shariah audit report should be directly presented, reviewed and endorsed by the Board Audit Committee, and escalated to the Shariah Committee. Third, the internal Shariah auditing process should be undertaken with relevant, accepted and established Shariah reference and other audit evidence or documents, for instance, the written opinion of the SAC or BNM. Finally, the requirement for the competency of the Shariah auditor encompasses their knowledge, skill, and other competencies that would facilitate them carrying out their duties. Together, this study indicates that the Shariah audit should be performed by a third party and an independent auditor. Considering that the current function of the

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Shariah Committee is only to advise the IFI, the Shariah audit would help IFIs have an adequate Shariah control and assurance system.

In recent years, Abdul Rahim (2011) highlighted an important area that would make the Shariah governance system more effective, reliable and controlled with integrity. He explained that the Shariah audit requirement constitutes an important control mechanism to enhance the integrity of the IFI. Moreover, he also asserted that this audit requirement would help the Shariah Committee as well as the respective regulator to play an effective role in monitoring, controlling and responding to an IFI if any Shariah related issue arises. The Shariah audit is a process of accumulating and evaluating the relevant evidence and reporting the current degree of Shariah governance practice. Thus, the purpose of this study is to provide an overview of the recent research and developments initiated by the International Shariah Research Academy in Islamic Finance (ISRA) and Bank Negara Malaysia (BNM) to produce a Shariah Audit Framework as a complement to the Shariah Governance Framework (SGF) recently issued by BNM. In addition, this paper also discusses the need for a Shariah Audit Framework and elaborates on the institutional arrangements and requirements to be able to effectively exercise the Shariah Audit Function.

2.8 Past Empirical Studies on Islamic Credit Co-operatives

The Malaysian co-operative movement has had a significant history since the establishment of the first co-operative in 1922 during the British colonial era. Over the years, their numbers have rapidly increased and become an important intermediary for national economic development. The existing literature on co-operatives is extensive and particularly focuses on the role of co-operatives as a mechanism to alleviate poverty (Asan Ali, 1998; Hayati Md Salleh et al., 2008; Cheuk, 2012) and on their performance

(Hafizah Hammad et al., 2016; Maslinawati & Intan, 2013). To date, only a few studies have been conducted that assess and investigate the current practice of corporate governance and accountability of co-operatives, and none have explored the Shariah governance in regard of Islamic Credit Co-operatives. Hence, for the sake of this study, some relevant literature is discussed in detail. This section focuses on the studies conducted by Nur Eyliawati et al. (2015), Maslinawati & Intan, (2013), and Maslinawati et al. (2013).

In the recent study conducted by Nur Eyliawati et al. (2015), they examined the degree of accountability that has been practised by co-operatives in Malaysia. In doing so, they used a new accountability conceptual framework for co-operatives based on the earlier study conducted by Bovens (2007) concerning the types of accountability. Nur Eyliawati et al. (2015) proposed a framework comprising four new classifications of accountability for co-operatives, namely, vertical accountability, diagonal accountability, horizontal accountability and managerial accountability. The first, vertical accountability, indicates that the principal-agent relationship consists of hierarchical and bureaucratic accountability. The second, diagonal accountability, is the accountability in the shadow of the hierarchy, such as internal, external audit unit and also comprises legal and administrative accountability. The third, horizontal accountability, is the direct accountability to society and the public at large, and is not limited to their members only. The fourth, the managerial accountability, indicates the accountability for all the activities and transactions of the co-operative, and encompasses the financial, procedures and product accountability.

Subsequently, Nur Eyliawati et al. (2015) conducted a focus group interview using semi-structured interview questions. This method was used to help the researchers obtain a deeper insight into two main themes: the nature of co-operatives that relate to

their function and the accountability practices in co-operatives. Subsequently, five co-operatives were selected as a sample for the focus group interview based on their performance, as provided by SKM. In order to analyse the information, they developed a few codes using the key themes related to the research objectives based on the proposed classification of accountability for co-operatives. Finally, they analysed the transcription data using the codes that had been developed.

In developing the Proposed Accountability Conceptual Framework, Nur Eyliawati and his team (2015) asked the respondents to indicate whether all their respective co-operatives currently had and practised all four classifications of accountability. Interestingly, this study found that all the respondents agreed that their respective co-operatives were practising all three classifications of accountability except the horizontal accountability (Nur Eyliawati et al., 2015). They also asserted that this finding is in line with past studies performed by other researchers, which showed no evidence that horizontal accountability was related to co-operatives.

In another analysis on the accountability of co-operatives, the study conducted by Maslinawati & Intan, (2013) argued that transparency and compliance are a core component of accountability for co-operatives, as they would increase the public confidence and help the co-operative sustain a good reputation in the eyes of their stakeholders. Hence, this study attempts to investigate the current transparency practices of co-operatives and the extent of their effect on their reputation.

To understand the transparency and compliance, Maslinawati & Intan (2013) summarized and defined transparency as the availability of relevant, reliable information about performance, financial position, investment portfolio, governance practices, and risk exposure. They also added that the objective of transparency is to gain and enhance public trust, but that this objectivity could only be achieved if the

information is accessible once reporting was done. For another core component of accountability, namely, compliance, they asserted that the internal audit committee is a vital determinant of good co-operative compliance. Thus, the internal audit committee should effectively discharge its responsibilities, some of which are reviewing, examining, validating all the accounting records, and reporting and communicating to the board and management if any discrepancies are found.

In respect of co-operatives in Malaysia, even though the co-operative movement has no obligation to disclose its financial position to the public at large, the obligation still exists for co-operatives to disclose information to the members of the co-operative movement (Maslinawati & Intan, 2013). Therefore, significant analysis and discussion were undertaken in this study to present the current level of transparency for co-operatives. Notably, the transparency of the financial reporting requirement of co-operative movement is governed by the Co-operative Societies Act 1993 (Amended) (Act 502), which stated that co-operatives should prepare, keep and ensure the availability for inspection by the Registrar General, its trading, and profit and loss accounts, and balance sheet together with any other document required not less than two months after the completion of each financial year for the purpose of audit. The Act, under section 60 (1), states that all these documents must be audited by somebody approved by the Registrar General to ensure a true and fair view of the information reported. Subsequently, as required by Section 59 (1) and (2), the co-operative should submit these audited documents to its members and Registrar General not less than fifteen days and thirty days, respectively. In addition, these documents should be presented at its annual general meeting at least once in a calendar year.

In respect of the preparation format for the financial statement, Maslinawati & Intan (2013) indicated that the Malaysia Co-operative Movement Commission (SKM),

as the regulator in this industry, decided upon the minimum requirement of the financial statement, which needs to be followed by the co-operative in accordance with the standardized format laid out in GP: 23.

Another interesting finding of Maslinawati & Intan (2013) is the relationship among transparency, compliance and reputation. This study explained the increasing trend of social demand for transparent reporting concerning the degree of co-operative compliance due to the fraudulent behaviour of some co-operative managers. In that the ultimate objective of a co-operative is to maximise the value of its stakeholders, this study highlighted the importance of co-operatives responding to this trend by communicating information concerning their achievement, profitability and commitment to improving their social performance. Therefore, co-operatives should embrace the emergence of social media phenomena as an opportunity and strategic tool for the dissemination of the aforementioned information due to the availability, low cost and accessibility. Moreover, if a co-operative reports positive news or achievements, its reputation is immediately enhanced (Maslinawati & Intan, 2013). In addition, any obstructive issue or failure on the part of the co-operative to communicate immediately with sufficient information could lead to negative perceptions regarding the co-operative's effectiveness in discharging its roles, and, consequently, lead to the withdrawal of support by its members and other stakeholders.

However, they also opined that the eagerness of the stakeholders is not limited to that of a transparent report or accessibility to information, but also concerns information about the reliability of those with whom they deal. Hence, performance rankings are important for portraying and creating a good reputation. In the case of co-operatives, SKM took the initiative to establish the 100 Top Best Co-operatives in Malaysia, which, indirectly, displays the top 100 co-operatives in Malaysia with the

highest reputation. These 100 Top Best Co-operatives in Malaysia are displayed and can be accessed on the SKM website.

Above all, they concluded that the level of transparency of co-operatives is governed and legislated by law, and encompasses all the key important aspects of transparency, namely, the requirement for the preparation of a financial statement, the requirement to appoint an auditor, the requirement to disseminate an audited financial statement to the members and Registrar General, and that all these requirements should be exercised in a specific time frame. Thus, this is in line with the essence of transparency, which is the availability of timely and specific information to those it concerns. They also found that there is a relationship between the transparency, compliance and reputation, and suggested that future studies fill the gap by proposing a best practices framework for Malaysian co-operatives.

In the same year, Maslinawati et al. (2013) conducted another research to investigate the issues and challenges in the Malaysian co-operative movement. Subsequently, they provided empirical evidence of a government initiative to improve the co-operative movement. In their review of the issues and challenges, Mohamad and Othman identified four significant issues and challenges that have long been faced by Malaysian co-operatives. In addition, all these issues contribute to the inefficient performance of co-operatives in Malaysia (Maslinawati et al., 2013).

They further explained these issues by highlighting the lack of capital. Due to the size of co-operatives, many heavily depend on the internal resources of capital, which is the share capital from members' subscriptions, fees, and accumulated profits. As a result, the co-operatives face difficulty in getting adequate capital to implement their profit-generating activities. Without making a profit, co-operatives are unable to fulfil their member's expectations to provide a reasonable return for their share

subscription. Consequently, this issue can hinder co-operatives from maintaining a good level of accountability, especially if they neglect the compliance requirement which involves cost. The second issue and challenge is the absence of good corporate governance and a weak structure. Simply put, this issue arises when the internal audit committee and board fail to exercise their duties, functions and responsibilities. They also pointed out that members normally have a tendency to appoint famous or influential members to hold board positions rather than appointments based on a member's experience or trustworthiness. Hence, it makes the governance structure weak due to the lack of accountability in the boardroom. Third, the issue of the lack of management talent due to the limited capital makes it difficult to get an experienced and professional manager. Finally, is the issue of the lack of integrity among the management. Until now, the events of corruption, fraud and mismanagement in the co-operative sector still resonate.

Interestingly, they linked all the aforementioned issues and challenges with the efforts of the Malaysian Government to improve the co-operative movement. Subsequently, they identified four significant efforts from the Malaysian government. First, the initiative programme of 1 community 1 co-operative (1K1K), which was introduced to restore the public confidence in the co-operative model. Second, the effort to improve the knowledge of the management to enhance the organizational competency and its operation. Hence, the Malaysian government established the one and only co-operative education institution in Malaysia, namely, the Co-operative College of Malaysia (MKM), as a continuous training and education platform. Next, for many years, the Malaysia government has shown its commitment and exerted effort to improve this sector by providing technical and financial assistance through grants and subsidies.

In conclusion, much of the literature since the mid-1990s emphasises and agrees about the roles of co-operatives as a mechanism to enhance the social economy, and especially as an institution to provide micro-credit financial assistance. However, only a small body of literature concerns governance in co-operatives and their accountability, as discussed above. In addition to the issue of co-operative governance, which has not been resolved, recently, the shifting phenomena of credit co-operatives towards becoming an Islamic financial assistance provider by offering Shariah-compliant products, has led to another issue of governance, namely, Shariah governance. For many years, this phenomenon was surprisingly neglected by researchers. Hence, this study attempts to fill this gap and discuss and compare the Shariah governance practices based on Shariah-governance practices in other Islamic financial institutions.

2.9 Conclusion

Over the past decade, the world has witnessed a significant transformation in the role of corporations and Islamic financial institutions in terms of economic development and sustainability. Both create jobs, generate tax income, produce a wide variety of goods and services, and, increasingly, manage our savings, secure our retirement income, and increase Zakat collection. Thus, good corporate governance and Shariah Governance are essential to serve the interests of all the stakeholders, including the regulator.

Although several studies have been conducted on Shariah governance, previous researchers tended to study Islamic banking, and none of them specifically studied the current practice of Shariah governance in Islamic credit co-operatives. Due to the lack of literature and empirical evidence, this study has taken the initiative to conduct an

exploratory study to highlight the importance of prudent Shariah governance in the co-operative sector.

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