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Legal Obstacles in Shari'ah Corporate Governance of Islamic Financial Institutions in Malaysia

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Overview

This paper was sent to be published in the Journal of King Abdulaziz University for Islamic Economics. Also, it was presented in different title[1] in the Asia-Pacific Business Research Conference in Malysia, February 2011. The researchers highlighted the significant role of the Shari'ah corporate governance in the effectiveness and stability of Islamic financial Institutions in Malaysia. They outline the roles of corporate governance (in both conventional and Islamic corporations) through which it can be directed, administered and controlled. However, they argue that Shari'ah corporate governance has different perspective and methodology. The Shari'ah corporate governance primary is based on the tenets of Islam as the primary law and then on other positive laws, such as laws regulating the interest of the directors and the stakeholders. They described the structure of shari'ah corporate governance in Malaysia in order to emphasize and underscore some legal obstacles in the Shari'ah corporate governance and suggest some practical solutions to reform absence in the law.

Comments

1. The researchers consider that the difference between shari'ah corporate governance and the conventional corporate governance depends on their objectives. They state that "Shari'ah corporate governance considers God in the core of their structure, stipulating that the corporation can only carry out their activities in accordance with the commandments of God and the interest of stakeholders of the corporation would come next". This statement has broad meaning as firstly, that considering God "Allah" must be in all of our transactions, whether there is commandments from Him or not. So, there is no need to have direct order or command from Allah. For example, marketing of

(1) It is tilted as: "The Legal Conflicts in Shari'ah Corporate Governance of Islamic Financial Institutions in Malaysia"<http://www.wbiconpro.com/>.

Islamic products should include an intention to obey Allah, even if the products are fully compliant with His order. Secondly, the majority of the rules issued for Islamic financial institutions and their products are enacted according to *Ijtihad* and some totally transformed from Western rules, such as Corporate Governance principles, which were taken from OECD and BIS principles. Therefore, using the expression " commandments of God" indicate that Allah (SWT) has commanded us the details of our governance, while the truth that Allah has clarified what is right and what is wrong and has left wide-range of life transactions to be organized by us according to our benefit. The prophet (peace upon him) himself has said "you know what is good for your life"[(2)]. Thirdly, there is distinction between Allah's commands -such as the prohibition of Riba and the lawfulness of trade- and the Ulama's Ihtihad -such as prohibition of organized Tawarruq and the permission of Istisna' contract. It is more accurate in this regard for the researchers to use the expression " Shari’ah Law" instead of " The Commandments of God". Finally, if Islamic financial Institutions comply with Islamic law "Shari’ah", then maintaining the interest of stakeholders of a corporation should be part of Islamic law and there should be no conflict, even if the interest of the stakeholders or the shareholders aim to acquire legal profit. This is because we talk about Islamic financial institutions, and in such institutions, if shareholders seek illegal profit or illegal interest, then our problem is not with the corporate governance, but with structure of the institution itself. This means that the main consideration is on the structure of Islamic institution not on the corporate governance, which is merely, a method of organization that can be transformed according to the principles of the institution. Moreover, the differences of Fatwa between Muslim scholars confirm that although their Fatwas are part of Islamic law, they cannot be considered as the Commandment of God.

2. Corporate Governance is defined as "Procedures and processes according to which an organisation is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making"[(3)]. It is known from the definition that corporate governance is a method of administration and organization of rights and can be structured according to the principles of Islamic Financial Institutions. Thus, a corporate governance regulation can be tailored and its compliance to Islamic law depends on the level of compliance of the Institution itself.

(2) It is narrated by Muslim in his Sahih.
(3) OECD glossary, http://stats.oecd.org/glossary/detail.asp?ID=6778.

3. The researchers aimed to discuss the legal problems facing the implementation of true shari'ah corporate governance to Islamic Financial Institutions in Malaysia. They indicate that a proper shari'ah governance structure should be in line with Islamic law. Indeed, shari'ah corporate governance is an important part of the law of Islamic banks. This means that Islamic banking is not just to prohibit *Riba*, but also to comply with other Islamic laws and principles.

4. The researchers have linked[4] the nature of the corporate governance to the Islamic faith, which is a must. However, Islamic law is also based on ethics more than any other laws, as ethics in Islamic law is practical. The researchers should have mentioned the role of Islamic ethics in promoting good shari'ah corporate governance and how would this norm advance the shari'ah corporate governance more than conventional corporate governance. Indeed, corporate governance can be linked to institutional environment and business ethics and social interests of the communities in which an Islamic financial institution operates and the impact on its reputation and its long-term achievement. Ethics in Islamic law is vital and cannot be ignored from any subject or field, so it is better in the analysis when discussing shari'ah corporate governance to consider ethics and ethical standards.

5. The Researchers have quoted the corporate governance definition of Malekian & Daryaei as "the way in which the boards oversee the running of a company by its managers, and how board members are, in turn, accountable to shareholders, stakeholders and the company". They state that definition covers the accountability of the Board of Directors to shareholders, stakeholders and the company and missed the accountability of the Board of Directors to God and the society. In my view, corporate governance is a frame and structure that works according to the by-laws and other regulations of the institution and the "Islamicity" of the corporate governance totally depends on the "Islamicity" of the by-laws and regulations of the institution. Thus, the accountability to God comes within the accountability of the institution, which should Islamize its laws.

6. Moreover, the researchers consider that corporate governance should cover an accountability of the Board of Directors to God and the society, which are crucial factors in shari'ah corporate governance. This statement is not accurate as the accountability of the Board of Directors to God is an intention to apply the shari'ah rules established by the local laws as well as the by-laws and other regulations. They will be rewarded for their intention and they will be

(4) Part 4.0

exposed to legal action for their failure. However, the intention cannot be stated in a law, while a failure can be included in a law. Of course such rule cannot be stated as "if the Board of Directors failed to obey God", instead it could be in a form of "a failure to comply with the shari'ah law leads to …..". Hence, it is subjective to use the word "God", alternatively, in law, the word "Shari'ah Law" is more objective and can be measured.

7. Similarly, the accountability to the society is so general. In Islam, Muslims have a particular duty only towards poor individuals or society, which is the payment of Zakah, otherwise all other social supports are non-obligatory. Therefore, the accountability of the Board of Directors to a society cannot be generalized. They might be accountable, if there is "a social responsibility law" enforced by a government, then they have to comply with this law and corporate governance will organize the implementation of such law.

8. The researchers have mentioned a shortage in the guideline which is a lack of specific detailed shari'ah rules such as shari'ah audit rules and / or shari'ah risk management rules. Of course, as mentioned above, Shari'ah corporate governance is a method to ensure the implementation of laws and regulation, and to guarantee that all activities and divisions of an institution shall be legally established. Indeed, shari'ah corporate governance is not a solution itself, but it is a method of implementing solutions.

9. The researchers have explained excellent roles of Shari'ah Committee in an Islamic financial institution. Islamic financial institutions may not need to have separate shari'ah corporate governance different from general corporate governance, but it is a must for a corporate governance in an Islamic financial institution to include specific rules for the Shari'ah Committee expanding its roles and responsibilities.

10. Of course, as the researchers suggested, a law for Islamic financial institutions should indicate that the members of Shari'ah Committee should not be immune from legal action. Indeed, they should be exposed to civil and criminal liabilities similar to the Board of Directors. They should be selected according to certain standards based on knowledge and capacity. For example, a scholar may not be capable if he has a certain number of membership in other Shari'ah Committees. Moreover, Shari'ah Committees in Islamic financial institutions should be accountable before high shar'iah committees in central banks.