# The Islamic Governance and Accountability Framework for Corporate and *Sharī’ah* Board of Directors in achieving Sustainable Islamic Socio-Economic Performance

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**Abstract.** The responsibility and accountability of corporate and Sharī’ah board of directors are vital in ensuring the sustainability of the business operations of the Islamic financial institutions. Corporate scandals and failures have attracted considerable amount of public attention especially for Islamic institutions. They should be able to reflect the trust, moral and ethical values in running the business as Sharī’ah board has been part of their structure. This study intends to introduce the Islamic and Accountability Framework (IGAF) for Corporate and Sharī’ah board of directors in Islamic financial institutions. This IGAF will be in the form of a guide for person that has been appointed as director in the Islamic financial institution or even as a route map for them prior to be as reputable and credible board of directors (BODs). The framework has been developed based on prior analysis from the Islamic economic performance indicators also known as M Score. This Islamic Governance and Accountability Framework would contribute to the overall performance of the Islamic financial institutions specifically for achieving performance from Islamic indicators.

**Keywords:** Islamic Governance, Accountability Model, Board of Directors, Sharī’ah Board, M Score

**1 Introduction**

Corporate governance is becoming an essential mechanism in administering, monitoring and controlling institutions to ensure that they succeed in business. However, the growing number of failures demands that institutions portray a higher level of fairness, accountability and transparency. These failures are mostly due to the lack of good corporate governance, which can lead to the financial distress of the corporation or banks as highlighted by [24], [35], [25], [33], [21], [3] and [11].

In the United Kingdom, [10] has defined corporate governance as “…the system by which companies are directed and controlled. Board 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 structure is in place”. The [23] defined it as “the process and structure used to direct and manage the business and affairs of the institution towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholder value, whilst taking into account the interests of other stakeholders.” Therefore, directors are required to portray a higher level of responsibility and accountability for the use of shareholders’ funds. This is very pivotal to ensure the decisions or actions taken by the institutions are in their shareholder and stakeholder interests.

Effective beginning 1st January 2011, the Central Bank, i.e., Bank Negara Malaysia (BNM), has developed the *Sharī’ah* governance framework [6] for Islamic banks, with the ultimate objective being to enhance the role of the board, the *Sharī’ah* Committee and the management in relation to *Sharī’ah* matters. Indeed, the *Sharī’ah* Governance Framework was the first guideline on *Sharī’ah* governance matters to be issued and applied in Islamic financial institutions in Malaysia. In 2019, the *Sharī’ah* Governance Policy Document (SGPD) has been developed to further strengthen *Sharī’ah* governance practices in Malaysia.

The [19] defines the *Sharī’ah* governance system as per quoted similar in [6] as “a set of institutional and organizational arrangements through which Islamic banks ensure that there is effective independent oversight of *Sharī’ah* compliance over the issuance of relevant *Sharī’ah* pronouncements, dissemination of information and an internal *Sharī’ah* compliance review.” Meaning that, Islamic banks are also required to comply with the *Sharī’ah* governance requirements to ensure *Sharī’ah* compliance in addition to the corporate governance requirements.

The agency problems in Islamic financial institutions are unique to other financial institutions and corporation, and different ways of assessing and solving the issues are required. As highlighted by [8]; [13]; [34]; [14]; [5], the need to comply with *Sharī’ah* rules and regulations makes a huge difference between Islamic finance and other modes of financing.

There is a lack of appropriate theories in governance from an Islamic perspective to address the issue of accountability, and a governance structure to protect shareholders and other stakeholders as a whole. Stakeholders must be assured that their welfare will be taken care of properly by the authorized party, as suggested by [17], and [7]. This is due to the lack of a ‘shareholder model’ of corporate governance, particularly for Islamic banks. As suggested by [5], a proposed model for Islamic corporate governance is necessary to overcome the lack of a Western or conventional model of corporate governance to cater for Islamic banks, especially in protecting IAH rights; for instance, in the case of default and the investment strategy. Even though in the [19] the procedure for minimizing the risk has been outlined it is worth studying how the top key players in the Islamic banks are able to enhance performance, which, indirectly, contributes to the stakeholders’ protection.

The problem that arises as a result of this system of corporate ownership is that agents do not necessarily make decisions in the best interests of the principal, as both the principal and the agent have their own interests, which results in a conflict. This is also known as the agency problem. The assumption underlying this theory is that the goals of the principal and the agent are often in conflict. Whereby, the primary objective of the corporation is to maximize the shareholder’s wealth. In practice, this does not necessarily happen, as it is normal for managers to pursue their own personal objectives; for instance, to get a bonus every year, which constitutes individual wealth maximization. They may concentrate on projects and company investments that would provide high short-run profits as the short-term returns would benefit them via their pay. In addition, managers are also tempted to gain extra benefits, such as salaries with other supplements; for example, holiday packages through the company, and office equipment, etc. This leads to a reduction in shareholder value and is termed according to the agency theory as ‘residual loss’.

[12] highlight the concern among stakeholders, such as the depositors and investors in Islamic banks, concerning the management of their funds that are exposed to non-compliance risks. [22] contend that the rights of IAHs as the entity that bears the risk of the performance of the investment pool has not been properly addressed in the corporate governance practices of Islamic banks. IAHs appear to be part of the agency conflicts since they share the profit and loss similar to the nature of shareholders [12]; [30]. Although, occasionally, their deposits are generally higher than shareholders’ equity, they have no control rights or voice in shareholders’ meetings like other shareholders.

[4] point out that IAHs lack the governance rights, resulting in shareholders having no rights in getting the benefits of the Board of Directors (BOD) to monitor on their behalf, in receiving an annual report and in appointing external auditors to audit it, in taking part and voting in the Annual General Meeting or other general assemblies, and in appointing the *Sharī’ah* supervisory board of the bank. Basically, IAHs have no rights to interfere in the management of their funds.

**2 Literature Review**

Corporate meltdown in recent years has created much interest in the role of the board of directors in monitoring and controlling corporate performance. Since the introduction of codes, guidelines, rules, and regulations, it has been proven that the board is a unique and opaque element for ensuring corporate governance is effectively and efficiently implemented in the business institutions. This would absolutely guarantee that institutions are well administered, monitored and controlled by a credible, reputable and competent person.

At the international level, a *Sharī’ah* governance guideline was issued by the [19] to promote soundness and stability of the Islamic financial system. In the [19] – the ‘Guiding Principles on *Sharī’ah* Governance Systems for IIFS comprises five parts, which are, firstly, the guideline outlines the ‘general approach to the *Sharī’ah* Governance system’. Secondly, the term ‘competence’ in suggesting various measures to ensure reasonable expertise and skill-sets of *Sharī’ah* Committees (SB) and to assess their performance and professional development. Thirdly, the ‘independence’ of SBs in minimizing conflicts of interest should be ensured. Fourthly, the guideline highlights the importance of observing and preserving ‘confidentiality’ by all parties involved in *Sharī’ah* governance; and, fifthly, to enhance the ‘consistency’ of the professionalism of the SB members.

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In Malaysia, Bank Negara Malaysia developed the *Sharī’ah* governance framework [6] for Islamic banks, effective from 1st January 2011, with the ultimate objective being to enhance the role of the board, the *Sharī’ah* Committee and the management in relation to *Sharī’ah* matters. Indeed, the *Sharī’ah* governance framework is the first ever guideline on *Sharī’ah* governance produced by Malaysia and can be applied as a blueprint for all countries that have Islamic financial institutions. The definition of *Sharī’ah* governance in the *Sharī’ah* Governance Framework for Islamic Financial Institutions guideline has been adopted from the definition derived in the [19].

The *Sharī’ah* governance framework provides a comprehensive guideline for IFIs for administering the business according to *Sharī’ah*. By applying this framework in the IFIs, the public and financial market will be more convinced that IFIs are administered, monitored and controlled by qualified, credible and competent people. Hence, those people involved in IFIs are the key players for ensuring that the running of the business operations and activities are aligned with the expectations of the strategic objectives.

The board of directors are the top executives or key players of a corporation and assigned with the responsibility of formulating the policies and strategies, and supervising the operations of the Islamic banks. The BOD of every Islamic bank can be considered as the ultimate internal policymaker that is responsible for the establishment of the governance policy framework in their institution (Part 1: Para 13,[18]).

As per the general requirements, as stated in the *Sharī’ah* governance framework (SGF) issued by [6], the Board of Directors (BOD), *Sharī’ah* Committees and *Sharī’ah* Committee have important roles in implementing the strategic objectives of the Islamic banks to achieve better performance. The BOD has been recognized as having an ultimate accountability and responsibility by the authority, BNM, to ensure the effective functioning of the overall governance framework (corporate and *Sharī’ah* governance) in accordance with the size, complexity, and nature of the business.

The most crucial works are on the approval and the implementation of all the policies relating to *Sharī’ah* matters. The BOD is also expected to appoint a competent and qualified *Sharī’ah* Committee in the Islamic banks. Furthermore, the effective communications concerning the dissemination of *Sharī’ah* matters must be smooth and proper to ensure that all Islamic bank staff are fully aware of the *Sharī’ah* requirements at all times.

Non-executive directors (NED) are not employees of the company or affiliated with it in any other way, whilst executive directors are full-time employees of the company who manage the day-to-day operations of the business. Therefore, the existence of NED in the corporation may help corporations to prevent agency problems by monitoring and controlling the opportunistic behaviours of management in pursuing their interest.

At the international level and from the corporation perspective, the [10] recommends that there should be at least three non-executive directors on the board of quoted companies. Board independence is associated with the entry of outsiders onto the board and the [10] stated the rationale for having an outside presence on the board as *firstly, outside directors broaden the strategic view of boards and they widen a company’s vision. Secondly, outside board members ensure that boards always have their sights on the interests of the companies. They are well placed to resolve conflicts. Thirdly, the outside directors bring awareness of the external world and ever-changing nature of public expectations to board discussions. Finally, outside directors have a clear role in appointing and monitoring the executive team.*

As supported by other previous research works, their presence would enhance the quality of the director’s decision-making in the corporation and serve as a monitoring and control mechanism for improving performance [20]; [32]; [16]. In the banking industry, the majority of studies suggest that increases in the proportion of outside directors on the board increases the firm’s performance [3], and that they can be more effective in monitoring managers [1].

Moreover, [31] finds and highlights in his study for the banking sector in India that they, i.e., NEDs, would be able to offer *‘objectivity to board decisions’, provide ‘general interest of the bank’, and assure ‘compliance with sound corporate governance practices.’* Hence, the ideal number of independent non-executive directors would assist in enhancing performance, strengthening the monitoring mechanisms and helping in promoting good corporate governance. Moreover, the [18] outlines the importance of an independent non-executive director as the chairperson of the Governance Committee and members (Part 1: Para 16). They are particularly relevant to Islamic banks in cultivating a good corporate governance culture by providing different skills, such as legal expertise and business proficiency.

In line with the complexities and heavily regulated nature of the banking industry, banks need people who are knowledgeable and skillful. The BOD is also expected to have a reasonable understanding of the principles of *Sharī’ah* and its broad application in Islamic finance for Islamic banks (paragraph 4.1, [6]). Furthermore, the [19] provides a detailed discussion on the competency of the person in monitoring and controlling Islamic banks. Part II of the [19] mentions that the BOD and senior management of the IIFS need to comply with certain minimum criteria to maintain the public’s confidence.

By having proper ‘competency’ criteria, the public would feel secure in dealing with people who are competent, honest, financially sound and treat them fairly. The competency and credibility of key players in the Islamic banks provide the assurance that the Islamic bank’s operations are being monitored and controlled by qualified and trusted people. Competent directors may give a broader understanding in protecting the shareholders and other stakeholders due to the unique character of Islamic banks [22].

To ensure successful decision-making in meetings, one of the requirements concerns the frequency of the meetings as well as the quality of achieving a consensus in the meeting. Researchers in the banking industry, such as [3] and [1] conclude that by having more frequent board meetings, banks would enhance the quality of decision-making and improve performance as the complex nature of the banking industry requires more detailed analysis for every issue arising in the business.

**3 Methodology**

This framework has been derived from reviewing major literature from governance perspective: corporate and *Sharī’ah* governance, theories underlying governance, monitoring and control governance mechanisms and directors. The framework also consider the performance of Islamic banks as a proper matching to understand better the roles and responsibility of the board of directors and Shariah boards.

From accountability theory, the boards are to be more accountable to the Islamic banks and also to the ultimate owner, Allah (S.W.T), they are responsible for conducting regular meetings and making proper decisions for the betterment of the banks (the practise of *Shura*). However, based on the literature and considering the fact that by practicing the Islamic code of conduct according to the Islamic rules and principles, Islamic moral values and the complexity of the banking industry, banks with ideal board of directors attributes are expected to perform better.

Particularly, relevant to this study, other researches have investigated governance on Islamic bank performance such as [2], [15], [28] and [8]. [8] and [28] studies showed that independent of the board had a negative effect on IBs performance. They provide reasons on the lack of banking and *Sharī’ah* knowledge can reduced the monitoring efficiency and resulted in poor performance. Hence, a more positive attributes of board of directors toward enhancing corporate governance quality would lead to better results [2]. [15] findings show that board exerts a positive and significant impact on the financial performance. Moreover, Islamic banks with corporate governance quality can protect the shareholders’ interests, minimizes agency problems and achieve organizational performance [2]. [8] support that stakeholders’ interest is not only to achieve profits or shareholders’ wealth maximization but also covers ethics and Islamic Financial law.

In this research, the Islamic indicators have been used in understanding the roles and functions of board and Shariah directors in discharging theirs duties and responsibilities. This performance measure has been developed by [26] to represent Islamic economic performance of Islamic banks. Detail of the derivation of the formula of the performance measures can be observed in Appendix 1.

**4 Findings and Discussion**

In the Islamic banking industry, board of directors and Sharī’ah board have strong roles to play in corporate and Sharī’ah governance to minimize the potential and wider problems in agency conflict. Theoretically and ideally, good governance would lead to good performance. If the top key players in the Islamic banks are accountable for their actions it will lead to better decision making outcome and better governance. In fact, they are the key players in the Islamic banks to assure the achievement of objectives, missions and visions of the Islamic banks are well accomplished.

Performance in Islamic institutions shall be measured not just on the profits made by the institutions or corporations. They should be represented institutions that promoting Islamic indicators as performance measures. In this research, the framework shall be read and understand from the aspirations of the Islamic banks in fulfilling needs and equitable distribution, economic growth and economic stability.

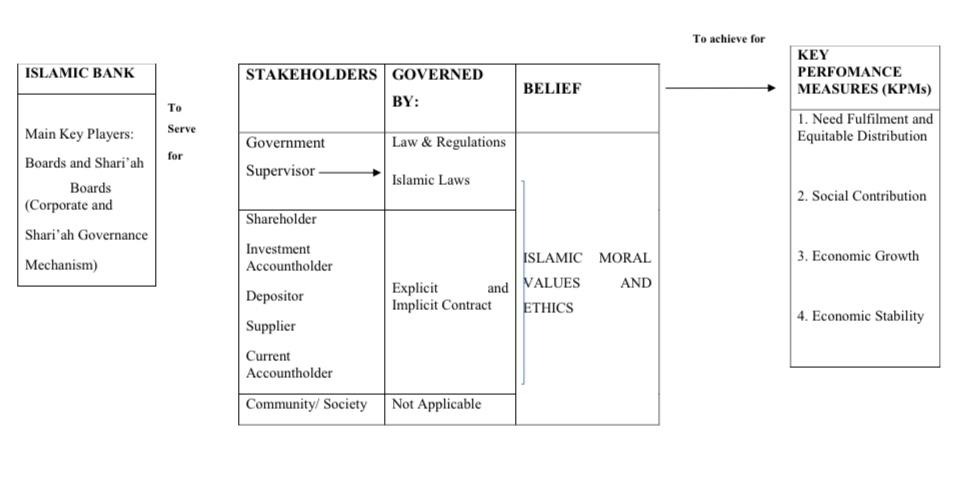
In this sense, it is strongly believed that Islamic banks need to have good key players and sound and accurate measures from the Islamic perspective, in this case corporate and Sharī’ah governance. The main key players as agent shall take place in ensuring the overall performance for Islamic banks in providing shareholder wealth maximization (act as principle) and the overall benefits to the mankind (Islamic moral values and ethics).

Islamic banks as Islamic institutions cannot use conventional theory to explain their business operations, processes and activities. Conventional theories are inadequate, insufficient and inaccurate in justifying the reasoning for Islamic banks. They need broader view in rationalizing their Islamic business nature. Hence, Islamic banks as an Islamic institution should apply theory based on Islamic philosophy in explaining their business nature to address any issues pertaining to them. It is therefore critical to outline the Islamic theoretical underpinning for Islamic banks that shall start from the foundation of Islamic belief that is everything in this universe including human beings was created by Allah S.W.T is His vicegerents and brothers unto each other.

Islam means ‘peace’ and ’submission’ to Allah S.W.T as clearly stated in the Al-Quran (51:56) “I have only created…men that they may serve me”. Therefore, in Islam human being are subjected to submit themselves to the ultimate guardian and they are expected to serve Allah S.W.T as khilafah in whatever they do in this word. This means we are accountable for whatever we do in this world. This means that whatever a man does in this world will affect later in the hereafter.

In the real human life, the worldview will absolutely affect by the way of people thinking and acting. Apparently, the worldview of Islam covers both the world and the religion matters. The Hereafter is the destination for which everyone will be accountable before Allah S.W.T. Therefore, their well-being in the Hereafter will depend on how they live in this world and carry out their responsibilities.

For this particular study, we propose this ‘An Islamic Accountability and Governance Framework’ is used to explain the overall view of the research discussion as illustrated in Figure 1 based on reasons that differentiate the role of monitoring and control mechanisms of Islamic banks that require different theory from conventional bank and corporation.



**Figure 1. Islamic Governance and Accountability Framework**

**5 Conclusion**

To sum, these attributes result in the characteristics of opaqueness and uniqueness of the Islamic banking. As Islamic banks, they need additional requirements i.e., Sharī’ah board and key Sharī’ah compliance functions in the monitoring and control mechanisms in the governance system to ensure corporate and Sharī’ah governance function smoothly in the institutions. Thus, an appropriate and adequate/ideal of monitoring and control mechanisms for Islamic banks is imperative so that shareholders and other stakeholders are ensured that their wealth has been taken care of properly by the management.

The above reasons and rationales, put forward to understand better the links and the emphasizes of top key players for them in discharging theirs duties and responsibilities that at the end of the process they have to be accountable for whatever actions and decision made for the Islamic banks. Hence, from this particular framework, the central challenge is for governance matter that has been typically approached as a matter of enhancing the accountability of the top corporate key players such as CEO, corporate directors and management.

To be specific, they are the people involved in making decisions for the corporations to ensure the smooth running of the business in achieving long term shareholder value and the interest of other stakeholders. To make decisions is not an easy task without compromising self-interest whilst making the best decisions for the corporations. Hence, the issue of accountability is an important theory from the Islamic perspective in governance to ensure that the process of decision making in fulfilling/accomplishing the corporation’s objectives and at the same time to comply with Islamic Sharī’ah rules and principles are done in a proper manner by the right person. The issues of trust, ethics, moral values and accountability are crucial in enhancing monitoring and control of the corporations.

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**Appendix 1**

The *M Score*is an Islamic performance indicator for measuring the ability of Islamic banks to achieve Islamic economic objectives. Islamic banks are expected to fulfil their functions in managing their business operations, process and activities. A high *M Score* means they are functioning well as Islamic corporations in fulfilling the needs of shareholders and stakeholders as a whole [26],[27].

*M Score* Equation

***M Score = ∑ WNFED [(WRIRES x RIRES) + (WRZPA x RZPA) + (WRTPA x RTPA)] + WEG [(WRTFA x RTFA) + (WRIGA x RIGA)] + WES [(WRIGE x RIGE) + (WRERA x RERA)]***

Note: **Islamic Economic Performance Measures (IEP / *M Score*):**

*∑* = Total Sum

*x =*  Multiplied with

**WNFED = Weighted Need Fufilment and Equitable Distribution:**

WRIRES = Weighted Ratio of Investment in Real Economic Sector over Assets;

RIRES = Ratio of Investment in Real Economic Sector over Assets;

WRZPA = Weighted Ratio of Zakat Paid over Assets;

RZPA = Ratio of Zakat Paid over Assets;

WRTPA = Weighted Ratio of Tax Paid over Assets;

RTPA = Ratio of Tax Paid over Assets;

**WEG = Weighted of Economic Growth:**

WRTFA = Weighted Ratio of Total Financing over Assets;

RTFA = Ratio of Total Financing over Assets;

WRIGA = Weighted Ratio of Income Generation over Assets;

RIGA = Ratio of Income Generation over Assets;

**WES = Weighted of Economic Stability:**

WRIGE = Weighted Ratio of Income Generation over Equity;

RIGE = Ratio of Income Generation over Equity;

WRERA = Weighted Ratio of Employee Remuneration over Assets;

RERA = Ratio of Employee Remuneration over Assets.



Hence,

***M Score =*** ***∑ 0.36 [(4.3 x RIRES) + (4.39 x RZPA) + (3.57 x RTPA)] + 0.33 [(3.96 x RTFA) + (3.89 x RIGA)] + 0.31 [(3.99 x RIGE) + (3.74 x RERA)]***

\*the value of 0.36, 0.33 and 0.3 (out of 100%) together with 4.3, 4.39, 3.57, 3.96, 3.89, 3.99 and 3.74 were derived from the respondent’s answers on the weightage importance score (likert scale - out of 5).

|  |  |  |
| --- | --- | --- |
| **The Need Fulfilment and Equitable Distribution (NFED)** | **Economic Growth (EG)** | **Economic Stability (ES)** |
| The achievements of the Islamic banks must fulfil the needs of individuals and society. Needs refers to necessities, comforts, and refinements. The purpose of this measurement was to indicate that the Islamic banks endeavour to eliminate misery and poverty for those who are extremely poor and unable to utilize their full potential. | Economic growth was used to measure the capability of the Islamic banks in achieving the balance between the competing claims of the present and future consumptions. Two ratios used to represent economic growth. | Economic stability was a measurement for the long-term survival of the Islamic banks in the business. There were also two ratios in measuring economic stability. |
| The first ratio is *‘IRES’*, *investment made in real economic sector,* i.e., investment in real economic sector is divided by total assets. The investment made in real economic sector can be used as a yardstick in helping society to gain equal benefits. To achieve a fair and equal distribution of income and wealth, the second ratio was *‘ZPA’*, zakat paid. The amount of zakat paid was divided by the total assets. A higher amount of zakat paid indicated the equal distribution of income and wealth by the Islamic bank. The third ratio was *‘TPA’*, tax paid. The amount of tax paid was divided by the total assets. The tax payment ratio indicated the responsibility of Islamic banks in prospering the economic growth of the country as a whole. | The first ratio was ‘*TFA’*, the amount of total financing was divided by total assets. The higher the *‘TFA*’ ratio means that Islamic banks put their best effort in assisting people to have a comfortable life (reducing hardship) as highlighted by [29]. The second ratio was ‘*IGA’*, income generation over assets. The amount of net income was divided by total assets. The income generation from the total assets indicates faster growth in the Islamic banks. The higher the *‘IGA’* ratio, the better the performance of the Islamic banks. | The first ratio was *‘IGE’*, Income generation over equity measures the stability of the long-term performance of Islamic banks as they could provide a guarantee of a return to the owners of the business. The second ratio was ‘*ERA’,* total employee remuneration,which was the formula forthe amount of total remuneration divided by the total assets. The higher the ‘*ERA’* ratio, the better the Islamic banks were in paying higher remuneration to employees and were able to take care of their stakeholders, and, ultimately, contribute to the betterment of the Islamic banks. |

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