

Research Article

Proposed Approach for Best Practices of Shari'ah Corporate Governance in the Malaysian Islamic Capital Market

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Abstract: With the rapid growth of Islamic finance industry, the countries offering Islamic products should be preparing standards and guidelines to cater for current market needs to ensure that the industry is operating in a conducive environment. Since Malaysia strives to position itself as a hub for Islamic finance, it must ensure that it proactively works towards moulding the industry. With the needs of the industry, the Central Bank of Malaysia has issued the Shari'ah Governance Framework for Islamic banks and Takaful. This was necessary in view of the lack of guidelines best practices in Shari'ah corporate governance in the Malaysian Islamic capital market. To this end, this study seeks to determine the approach best suited to establish a framework of Shari'ah corporate governance for listed companies in Malaysia. The interview results show that the hybrid approach is best suited to provide the general guidelines as a reference while accommodating the flexibility of Islamic law.

Keywords: Hybrid approach, Islamic capital market, Malaysia, Shari'ah governance

INTRODUCTION

Corporate governance is a natural need arising from the formation of corporations. Given the important role of corporations in contemporary economies and lifestyles, careful attention to corporate governance is needed from regulators, industry players and investors to avoid unnecessary financial crisis and strain on the economy (Othman and Rahman, 2010; Alnasser, 2012). Many developed and developing countries implement good corporate governance practices to the extent that it has become an expected global corporate and regulatory practice. The first Malaysian Code on Corporate Governance was introduced in 2000 and amended in 2007 and in 2012 respectively (Zulkafli *et al.*, 2014). For Malaysia, which is seeking to establish itself as a regional hub for Islamic financial markets, such a framework goes a long way in attract Muslim investors to invest in Malaysia.

The main reason for the emergence of the Islamic financial market is to avoid trading in those prohibited elements found in the conventional financial market. Thus, in the case of Malaysia, the Security Commission has come issued the Shari'ah screening procedure to assess the Shari'ah compliance of listed companies. A strong Islamic financial market can be established only if three sectors, i.e., Islamic banking, Takaful and the

Islamic Capital Market (ICM) support each other. In the Malaysian context, Islamic banking and Takaful are under the control of the Central Bank of Malaysia, i.e., Bank Negara Malaysia and ICM is under the supervision of the Security Commission. In the case of conventional corporate governance, Bank Negara Malaysia and the Security Commission have issued best practices for corporate governance. However, for Shari'ah corporate governance, only Bank Negara Malaysia has issued a Shari'ah Governance Framework designed for Islamic banks and Takaful operators. There is yet to be a suggested "Best Practices of Shari'ah Corporate Governance" for ICM. Thus, the aim of this research is to explore the opinions of Shari'ah advisors on the approach best suited to propose the specific framework for ICM.

LITERATURE REVIEW AND RESEARCH METHODOLOGY

Conventional corporate governance and its approaches: Malaysia has adopted the hybrid approach taken by the United Kingdom in developing the corporate governance framework. The first conventional corporate governance is the Cadbury Report (1992) from United Kingdom. Later, the Greenbury Report (1995) and Hampel Report in 1998

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were introduced. In 1999, the Combined Code was introduced and amended in 2000, 2003, 2006, 2008 and 2009, respectively. The UK Corporate Governance Code was introduced in 2010 and revised in 2012 (European Corporate Governance Institute, 2014). In the United Kingdom, the first corporate governance report, i.e., Cadbury Report (1992) used the prescriptive approach, while the Greenbury Report (1995) used the non-prescriptive approach. The Combined Code (1999) used the hybrid approach. Hence, it can be summed that, in so far as the experience of the United Kingdom is concerned, there are three main approaches in preparing conventional corporate governance guidelines.

In the prescriptive approach, the code provides compulsory guidelines with no room for flexibility except for companies to comply with the code. In the non-prescriptive approach, companies are required to disclose their corporate governance practices absent guidelines on disclosure and compliance. In this approach, the companies are free to implement their own preferred practices without need to follow any guidelines. In the hybrid approach, the general guidelines are given to the companies which are required to comply with room for flexibility. This means that in general, the companies are required to comply with the given guidelines and in cases of non-compliance, are required to provide the justification for their non-compliance (The Malaysian Code on Corporate Governance, 2012).

Shari'ah corporate governance and its approaches:

The Islamic Financial Services Board (2009) defines the Shari'ah governance system as, "a set of institutional and organizational arrangement through which an Islamic financial institution ensures that there is effective independent oversight of Shari'ah compliance over each of the following structures and process:

- Issuance of relevant Shari'ah pronouncement or resolution. This refers to a juristic opinion on any matter pertaining to Shari'ah issues in Islamic finance given by the appropriately mandated Shari'ah board.
- Dissemination of information on such Shari'ah pronouncement or resolutions to the operative personnel of the IFIs who monitor the day-to-day compliance with the Shari'ah resolutions vis-à-vis every level of operations and each transaction. However, this task would normally be done by the internal Shari'ah compliance department.
- An internal Shari'ah compliance review or audit reports that if there is any incident of non-compliance, it should be recorded and addressed and rectified. With regard to this, IFSB-3 sets out that Shari'ah resolution issued by the Shari'ah boards should be strictly adhered to.
- An annual Shari'ah compliance review or audit for verifying that internal Shari'ah compliance review

or audit has been appropriately carried out and its findings have been duly noted by the Shari'ah boards."

By referring to the definition above, it can be summed that Shari'ah governance is to ensure that all the business activities of Islamic financial institutions are operating in line with the Shari'ah. According to Elasrag (2014), there are five approaches to developing the Shari'ah Corporate Governance Framework. The first approach is the reactive approach. This approach is prevalent in non-Islamic legal frameworks wherein the Islamic financial institutions are operating. However, the regulations are silent on introducing the Shari'ah governance framework. The institutions have to operate within the existing conventional framework and at the same time comply with the Shari'ah. This is suitable in the United Kingdom and Turkey, whereby the regulators will get involved only if there are issues that may affect the industry. The second approach is the passive approach. This approach is implemented in Saudi Arabia. There is no Shari'ah advisory council at the central level or higher authority. The Shari'ah governance is practiced at an individual level and it is purely on the initiative and voluntary basis and is not regulated. The third approach is the minimalist approach. In this approach, although the regulatory bodies do not introduce their own Shari'ah governance framework, the Islamic financial institutions are nevertheless expected to have good Shari'ah governance practices. Hence, it can be said that in this approach, there is a concern and slight intervention from the regulatory bodies. This is practiced mostly in the GCC countries except for Oman and Saudi Arabia. Jurisdictions such as Bahrain, Dubai and Qatar prefer the adoption of AAOIFI standards on Shari'ah Governance. The fourth approach is the pro-active approach. This approach can be termed the regulatory-based approach. This is the favoured approach in Malaysia. The central bank or authority provides the guidelines and the Islamic financial institutions are required to adopt. The initiation is started from the regulatory body. This approach can be further divided into three sub approaches, namely the prescriptive approach, non-prescriptive approach and hybrid approach. The last approach is the intervention approach. In this approach, the third party makes the decisions on Shari'ah matters related to the Islamic financial institutions. In Pakistan, the Shari'ah Federal Court is the highest authority in dealing with the institutions regardless of having a Shari'ah board at the State Bank of Pakistan level.

Islamic capital market in Malaysia: The Islamic capital market is under the supervision of the Securities Commission Malaysia. The Shari'ah Advisory Council (SAC) of the Securities Commission has the solely authority to decide and to classify the listed companies as Shari'ah compliant or not. The list is updated bi-annually. The objectives of the list of Shari'ah

approved companies are to facilitate investors interested in investing in Shari'ah compliant stocks, to centralize the Shari'ah decisions domestically, to enhance the transparency and disclosure quality of the information, to promote the development of ICM and to encourage the development of Islamic instruments (Bursa Malaysia, 2014).

In the progress of Shari'ah screening, the first stage is examining the core activities of the companies. If the core activities are related to financial services based on *riba* (interest), gaming and gambling, manufacture or sale of non-halal products or related products, conventional insurance, entertainment activities that are non-permissible according to Shari'ah, manufacture or sale of tobacco-based products or related products, stock broking or share trading on Shari'ah non-compliant securities or other activities deemed non-permissible according to Shari'ah, the companies will not be categorized as Shari'ah approved companies. If the companies are not related to the above stated core activities, these companies will be assessed in the second stage. In the second stage, for companies that have incomes from both permissible and non-permissible activities, the SAC measures the level of mixed contributions from permissible and non-permissible activities towards turnover and profit before tax of the companies. The SAC uses benchmarks based on *Ijtihad* (Shari'ah based reasoning). In this stage, some financial ratios, for instance, the ratio of liquid assets to illiquid assets, are computed to compare with the benchmark. Where the contributions of non-permissible activities exceed the benchmark, the securities shall be classified as Shari'ah non-compliant. Moreover, public image and the contribution of the companies towards the society are additional criteria that SAC examines in assessing the companies. Currently, more than 80% of the listed companies are Shari'ah approved companies (Bursa Malaysia, 2014).

Research methodology: This qualitative research adopts the interview technique to explore the opinions of the Shari'ah advisors in selecting the available approaches to issue a framework for Shari'ah Corporate Governance for ICM. This study uses both primary and secondary data. Primary data is collected from the interviews and the secondary data is collected from the relevant books, articles and internet resources. The research sample includes nine Shari'ah advisors and scholars.

RESULTS

The interviewees are asked whether the ICM needs its own Shari'ah Corporate Governance Framework for which all interviewees collectively agreed. All the respondents believe that the Securities Commission should use the pro-active approach in preparing the

Shari'ah Corporate Governance Framework for the ICM. Among the sub-approaches of the pro-active approach, the hybrid approach is preferred. This approach is similar to the approach taken to prepare the conventional corporate governance code. There are three main reasons for supporting the hybrid approach by the interviewees. The first reason is that ICM is relatively new compared to conventional capital market. Hence, acquiring the confidence of the investors is essential, especially in Shari'ah compliance which is the unique nature of ICM. As the role of regulator, the Securities Commission needs to ensure that the unique nature of ICM is maintained by the companies and there is a continuous monitoring system by the Shari'ah board members. The second reason is that such a framework is necessary to be one of the leading ICMs and to render the ICM in Malaysia a point of reference by other countries offering ICM products.

The last reason is to allow the flexibility of *Fiqh* in implementing the rules and regulations. *Fiqh* is an Arabic term literally meaning "deep understanding" or "full comprehension". Its literal meaning is the true understanding of what is intended and its technical meaning is the science of deducing Islamic laws from evidence found in the sources of Islamic law (Bilal Philips, 2014). Hence, it can be said that Shari'ah scholars try to apply and interpret the ruling from the *Qur'an* and *Sunnah* to suite current market environments. Hence, flexibility is necessary to ensure that current market practices are in line with the Shari'ah. The importance of *Fiqh* flexibility is also highlighted by Shehada (2009).

CONCLUSION

The Islamic capital market is one of the main components of Islamic finance. Developing this market is essential to boost Islamic finance and render it globally competitive. In Malaysia, there is yet to be a Shari'ah corporate governance framework for the ICM. Hence, this study explores the opinions of Shari'ah advisors and scholars regarding the approach best suited to introduce this framework. All the interviewees collectively agree that the hybrid approach is the method best suited for Malaysia in developing the Shari'ah corporate governance for ICM. The findings will be useful especially for regulators. This result can serve as a stepping stone to develop a comprehensive Shari'ah corporate governance framework.

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