Shari'ah Compliant Corporate Governance

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Abstract

Corporate governance is a combination of rules for the supervision and administration of companies in order to achieve transparency, accountability, disclosure responsibilities and fairness. These philosophies of corporate governance protect the interests of shareholders and increase their confidence in the financial market. The Shari'ah scholars assert that Shari'ah offers a broad mechanism to administer religious rites but along with other aspects of life including politics, history, geography, anthropology, international law and international relations, business and contractual law. Islamic law is also based on the principles of ethics, honesty and integrity in order to achieve transparency, accountability (by creating a system of check and balance), disclosure and fairness as these are the strengths of corporate governance as well. This paper investigates the shari'ah compliant rules of corporate governance to assess the impact of these principles in Islamic financial market. The methodology employed to conduct this study is doctrinal along with the principles of qualitative research; relying upon inductive approach and exploratory philosophy. This paper will contribute meaningfully in the existing literature.

Keywords: corporate governance, Islamic principles of corporate governance, transparency, accountability

Introduction

Islamic financing is somewhat different from conventional financing due to the interest-free transactions as well as employing the conduct of ethics, morality, integrity and honesty. The notion of corporate governance is not new; its principles have been followed by the corporations since long. However, the word 'corporate governance' got recognition and importance a few decades before when the world experienced huge financial scandals such as; WorldCom, Enron, Adelphia, Nugan Hand Bank, CMS Energy, Freddie Mac and many more. These scandals evidence the illicit practices, bad governance, mismanagement and illegal actions that derail the equity and company value at one hand and; damage the capital of masses who invest their

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shares in these companies. In fact, it affects the all stakeholders attached to such companies.

Unfortunately, the Islamic financial institutions are also the victim of these corporate scams; though Islamic principles are based on honesty, integrity, truth and fairness. The failure of Turkish Ihlas Finance House in 2001 is an evidence of such scandal which evidences that weak corporate governance generates harmful ramification for the strength and sustainability of Islamic financial institutions.

Although Islam promotes corporate governance best principles which include morals, honesty and integrity, however practically it is an uphill task to incorporate these standards into Shari'ah compliant corporate governance as well as implementing it in letter and spirit. Therefore, the contemporary CG principles of institutional investors following Islamic principles of corporate governance apply the conventional corporate governance benchmark, such as the OECD and the Basil Committee for Banking Supervision standard, with adjustment to the shari'ah. OECD defines CG in the following:

> *"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of obtaining those objectives and monitoring performance are determined".*

There are five key objectives of corporate governance fundamentally highlighted by its definitions such as: the theoretical objective; the kinds of business include; the structure of governance; the way of achieving the objectives; and mechanism to observe the outcome for effective and efficient CG.

The theoretical aim of the contemporary corporate governance and Shari'ah rules of corporate governance are quite dissimilar. For instance, according to the conventional model, the objective of a company could be to enhance the benefit of shareholders as well as the wealth of all stakeholders. However, in Shari'ah law, there is only one objective and that is to serve Allah. The purpose behind this could be to unite the whole Islamic society and avoid the conflict of interest. Such united practices lead the society towards mutual harmony and cooperation with each other instead to compete; as the success in life according to Shari'ah is to gain peace and happiness (*falah*). The conventional literature does not have such philosophical connotations.

Shari'ah Acquiescent Corporate Governance Principles

The Shari'ah compliant CG is grounded on the four directives of Allah which are khilfah (vicegerency), amanah, masulıyah, and shafafıyah(transparency). The notion of khilafah means that;

> *"human beings are vicegerents of Allah in this world, and they are required to obey Allah's commands only no matter they act in any capacity such as doctor, engineer, director or CEO of an Islamic corporation".*

It shows that the humans will follow and comply with the values of Shari'ah throughout their lives in all matters. Likewise, shafafıyah (transparency) denotes that:

> *"actions of all human beings should be visible to all. This shafafiyah in the actions of human beings is the main factor in holding them accountable for their actions".*

This principle of transparency has been derived from the following Sunnah of the Prophet Muhammad (PBUH):

> *"When we appoint someone to an administrative post and provide him with an allowance, anything he takes beyond that is unfaithful dealing".*
>
> *"Whosoever from you is appointed by us to a position of authority and he conceals from us a needle or something smaller than that, it would be misappropriation of public funds and will have to produce it on the Day of Judgment".*

The word amanah is derived from an Arabic term amn and its meaning is peace, security and protection. Islamic jurisprudence denotes this word in the perspective of "thing"; as well as in the perspective of an element or characteristic. For instance, the contract of mudarabah as well as public power comes under the ambit of amanah. The principle of amanah denotes that if a person performs his duty with honesty and diligence, he will not be liable for any damage sustained, however if the loss is occurred as a result of his negligence or misconduct, he will be held responsible. In such cases, the conditions settled by all parties involved, relieving the obligation of the amin, will be void.

Abu Dhar narrated following the hadith of the Prophet Mohammad (PBUH) that: the power is amanah; and it must be delegated to a competent person. In the light of this, any office-holder is responsible (amin) in the capability of his official position. Therefore, s/he is liable for the negligence and misconduct of his/her actions. Similarly, in corporate governance regime, the directors and chief executive officer are stewards of shareholders and trustee of their authority. Likewise, the person making the appointments is also responsible for exploitation of his powers and accountable for nepotism and favoritism.

The Principle of Masuliyah (accountability) is additionally a significant principle of Islamic concept of CG, as it is the;

> *"the process through which a person or group can be held to account for their conducts".*

In other words accountability creates a system of check and balance by making answerable to each individual for his/her actions. The Prophet (PBUH) says:

> *"Each one of you is a guardian and each guardian is accountable to everything under his care."*

The aforementioned hadith authenticate the notion of accountability more forcefully. In Islam accountability lies in two-ways: one, each individual the liable for is actions in this life to the extent of this official capacity; second, he/she is liable in the life after death. Islamic legal system advocates the notion of accountability life in three ways namely, hudud, qisas, and tazir.

Tazir sentences are applicable in the absence of hudud and qisas. For instance, a waqf guardian is responsible for the property of waqf, the zakat collector is accountable to the ruler and the administrator is responsible for his trust. If the rights of society are at stake, citizens have the right to ask the holders of authority responsible for their actions. The act and infliction of responsibility in the initial days of Islam may additionally be observed in the time of the Abu Bakr al-Siddiq (RA) accentuated the importance of responsibility in his initial speech in the following terms:

> *"I have been given authority over you but I am not the best of you. If I do well, help me and if I do ill, then put me right.... The weak among you shall be strong in my eyes until I secure his right if God wills; and the strong among you shall be weak in my eyes until Iwrest the right from him...Obey me as long as I obey God and His apostle, and if I disobey them, you owe me no obedience".*

Similarly, the next Caliph, Umar ibn al-Khattab (RA) emphasized in his first speech the need to be responsible in his administration and the safeguard of rights of all citizens, including minorities. Formerly a man requested the caliph Umar (RA) to take additional cloth than the normal portion of each partner, he denied and explained correctly regarding his accountability to Allah in life hereafter. Therefore, each office holder is responsible for their actions. Following this rule, corporate governance actors including directors of Islamic banks, are likewise responsible for whatever they do in their official capacity. If someone does not play his role correctly, suitable measures must be adopted. It follows that before commending the duty of director, administrator, auditor and board member of Shari'ah, it is necessary to ensure that people are competent to fill their respective positions. Once charged, they must exercise due diligence and not commit delinquency or negligence in the performance of their obligations. If a person commits defilement, it is essential that suitable measures be taken against them.

Implementation of Islamic Philosophies of Corporate Governance

The key players to enforce CG whether conventional or Islamic are corporate boards. Directors are chosen by the shareholders and act as stewards to of shareholders. Board of directors enjoy unlimited powers to run a company including monitoring the decision-making process and its implementation. Being the brain and central point of a company, board of directors is answerable for the defiance with the philosophies of CG. Likewise corporate boards of Islamic banks are eventually answerable for guaranteeing Shari'ah amenability.

As holders of key positions, the directors are responsible and answerable regarding all of their authority according to the Islamic rules of amanah. According to this principle, the trust power is delegated to the competent persons to properly execute the trusts. To guarantee the competence of the directors, the SECP requires the minimum experience of five to seven years in order to qualify for the position of Director, along with the minimum condition required to obtain a directorship. The minimum qualification required for graduating with five years of executive experience or seven years of legal experience is sufficient to guarantee the capability of an individual to delegate the activities of banks as a manager.

In order to strengthen further the reliability as well as repute of directors, the SBP launched the Fit and Proper Test (FPT) in 2011. The FPT verifies the honesty of people based on their participation or persuasion for deception, counterfeit or any other crime. Any person involved in the said crime, or who has been sentenced, demonstrates their evil character as well as fraudulence, which cannot be trusted, because the amanah rule wants to be trusted by honest and upright people.

In the same way, Section 1 (iii) of the FPT Act assesses the uprightness of an individual based on the fact that they have breached a benchmark of the State Bank or any other regulatory body. If an individual has committed such a violation, he or she is deemed not entitled for the corporate governance position. The benchmarks of regulators and professional bodies are essential to certify the proper functioning and maintenance of the level of operation of organizations such as banks. People involved in defilements of the rules should not have confidence in the matters of delicate and complex institutions such as banks, particularly Islamic banks. In addition, the FPT contemplates that a person is not eligible for the position of director if he is insolvent or have no reliability, which is verified due to his association to an unlawful movement related to banking and late payments to an institutional investor or taxes payable to a government agency.

The prohibition of a person based on late payment also imitates the Islamic principle of amanah. Those who do not pay their debts are not trustworthy and, therefore, cannot be commended with any authority of amanah. A person can be appointed as director only if he has a proven track record of service in an institution. In addition, it has not been degraded or dismissed by its institution, government or regulatory body.
This shows that the person under consideration for the delegation of an authority must prove his integrity and standing. Returning power to honest individuals evidence that it is according to the principle of amanah. In addition, the board of directors of an Islamic bank is eventually answerable for establishing an environment compatible with Shari'ah within Islamic banks. For this purpose, they must have additional skills to guarantee such an atmosphere.

To this end, Section 2(iv) necessitates the administration to provide appropriate training and guidance for board members to inform them about Islamic principles of corporate governance and financial transactions. Although, through these trainings, board members can become familiar with Islamic banking and financial thoughts, they cannot be predictable to be capable enough to be aware of the risks of default from the beginning of Shari'ah.

Accountability Challenge of Corporate Governance thespians for Sharī 'Ahnon-Applicability

The objective of upright corporate governance is unable to be attained in the absence of accountability and fixing the responsibility of the corporate governance actors. Appeared as a substitute to conventional banks, Islamic banks must work in accordance with the ethics of Islam. The SBP has published the Shari'ah governance structure for banks; though the delinquency is that it does not fix the responsibility for breach of the provisions of corporate governance principles. The SBP merely declares that corporate boards will ultimately be responsible for the breach of Shari'ah; however, unable to clarify who they are responsible for and to what extent, if he is withdrawn or punished for any action other than Shari'ah or not? A fine may be levied on a company in case of administrative breach, for example by not conducting two joint meetings of corporate boards with that of Shari'ah board, however the administration is not answerable for the breach of transactions from Shari'ah non-compliance.

Likewise, members of the State Bank are responsible to some extent and are dismissed; however the motivation behind their dismissal is not Shari'ah breach or the formulation of wrong opinions. Instead, they are removed in connection to the Section 3(ix) of the SGF for breach of the necessities of paragraphs 3 to 6 of the FPT, as annexed to Annex A of the SGF. Similarly, each IBI group leader must take the necessary measures against leaders who are unable to follow Shari'ah in their corresponding field.

> *"Instances of Shari'ah non-compliance shall also have a strong bearing on their performance appraisals, promotions, increments, bonuses, etc."*

But this verification is not effective because of the reasons that the group leader does not usually have adequate familiarity with Shari'ah to be able to analyze whether the behavior of a worker working under his authority is opposite to Islamic principle; and even if the group leader learns that the worker's specific actions are against Shari'ah. It is ambiguous that which measures can be taken against such worker. Therefore, the authors submit that the question of answerability for the non-compliance of Shari'ah should be taken more seriously and strict rules should be established for Shari'ah defiance by guaranteeing sanctions appropriate for those who cause nonconformities.

The aforementioned discussion highlights that the principles of Islamic business ethics are not the consequence of external problems. These are the teachings of the Holy Qur'an and evident from the practice of the Prophet Muhammad (PBUH) and are a natural part of Muslim thought and understanding. Sharia-based Islamic business rationality is committed to preserving and promoting the public interest and is an established wisdom within the Sharia-supervised market paradigm. The scholars from other religions also comprehend that unbridled capitalism also disrupts their religious principles of business ethics, diluting the values that are central to the harmony and stability of societies. These apprehensions are mutual to all present civilizations and it is urgent that interested citizens of these civilizations cooperate with each other for establishing better governance standards across corporations. Else, the rising commercialism will result into the quick deterioration of our society, business market and environment by causing an irreparable damage to future generations. Nowadays, in modern economic and commercial life, the economic model that complies with sharia is used primarily by the Islamic financial institution, although it is still comparatively restricted to the transaction, and not to the economic model in its own right. It is highly necessary to go further in other aspects of business, such as human resources management, marketing management, operational management and other aspects of business management from the standpoint of the teachings of Islam. Any company with an Islamic name must follow Shari'ah philosophies and standards in the dealings of its business.

Conclusion

This paper explored whether the corporate governance system of Pakistan guarantees the capability of stakeholders entrusted with the amanah (trusteeship) of their concerned authorities and investigated the mechanism of accountability of non-performance particularly regarding Shari'ah compliance. The findings of this paper acknowledged the significance of Shari'ah principles of vicergency and amanah in promoting the principles of good corporate governance.

In addition, it is found that the supervision of corporate board is very significant for its effectiveness. The monitoring and evaluation of the board committees by creating a strong mechanism of accountability provides valuable feedback to improve its effectiveness and maximize its strengths and focus on the areas in need of improvement. Nevertheless, the evaluation mechanisms must be unprejudiced and rigorous. A Shari'ah Board on the basis of principles of amanah can also be established for achieving these goals as the Shari'ah Board is required to be independent and authoritative in order to implement Shari'ah confirming attributes required for the better growth of corporate governance including transparency, accountability, fairness and disclosure requirements.

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