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Shariah Governance Practices of Malaysian Islamic Banks in the Light of Shariah Compliance

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ABSTRACT

Islamic banks in Malaysia must conform to Shariah rules in their operations. Islam's prohibition of usury is the main justification for the necessity of Islamic banks (IBs). Indeed, the implementation of Shariah governance through the Shariah Supervisory Board (SSB) is essential to monitor and govern the operations of IBs for ensuring the integrity, credibility and transparency of IBs. Failure to conform to good Shariah governance practices will result in the IBs' failure to uphold Shariah in their operations. The objective of this paper is to examine the Shariah governance practices of IBs in Malaysia. This study employs content analysis to identify the extent to which the Shariah governance is being practised by IBs. A disclosure checklist was developed based on a review of previous studies and regulations, namely the Guidelines of Financial Reporting for Islamic Financial Institutions (GP8-i) 2005, Islamic Financial Services Act (IFSA) 2013 and Shariah Governance Framework (SGF) 2010 and Exposure Draft of SGF 2017. It consists of five dimensions: i) Shariah Committee; three control functions under Shariah governance, ii) Shariah Risk Management, iii) Shariah Review, iv) Shariah Audit and v) Transparency and Disclosure. The findings suggest that IBs were more likely to disclose Shariah committee attributes, whereas Shariah control function items (Shariah risk management, Shariah review, Shariah audit) and transparency and disclosure were less likely to be disclosed, indicating that IBs seem to be heavily dependent on the competency of SSB members rather than the Shariah compliance mechanisms. This study contributes to the interest of IBs and the Shariah Committee themselves to consider various mechanisms of Shariah governance practices to garner trust and confidence of a wide range of stakeholders. Future studies can be carried out to suggest best practices of Shariah compliance mechanisms in relation to the SGF issued by the Central Bank of Malaysia.

Keywords: Islamic banks; Shariah Supervisory Board (SSB); Shariah Committee; Shariah Governance; Disclosure

Introduction

Islamic banks are established not only to have socio-economic purposes but also to promote Islamic values while protecting the needs of the Muslim society at large. Because of that, Islamic banks in their operations must conform to Shariah guidelines. Such compliance is necessary if they were to attract Muslims to become their clients. Besides adherence to Shariah, Muslims also prefer Islamic banks that are transparent in their disclosure practices (Sulaiman and Willett, 2003). In the context of this study, this includes governance practices; specifically, to what extent do Islamic banks (IBs) in Malaysia comply with the Shariah in their managements and operations of the bank services? Such compliance falls under the responsibility of the Shariah Supervisory Board (SSB) of IBs, whose functions are similar to the Board of Directors (BOD). The SSB is mainly responsible in monitoring and governing the operations of IBs and functions as a control mechanism to ensure the Shariah compliance of the banks in their services and management.

According to Grais and Pellegrini (2006), an effective SSB must portray competence, accountability and disclosure in monitoring managers. However, a legal framework with guidelines and enforcement is crucial to assure the implementation (Masruki et al. 2018a). The tremendous growth of IBs today has provided the government of Malaysia with the initiative to produce the legal framework for IBs specifically and Islamic Financial Institutions (IFIs) generally. Such an initiative is critical in enhancing the credibility of IFIs, which carry the Shariah compliance image in their operations. As Muneeza and Hassan (2014) suggest, IFIs in their development must be supported with a comprehensive legal framework and good corporate governance. Such provisions include Guidelines of Reporting for IFIs, namely GP8-i 2005, Shariah Governance Framework (SGF) 2010 and its Exposure Draft, 2017 as well as Islamic Finance Service Act (IFSA) 2013.

The Central Bank of Malaysia (Bank Negara Malaysia or BNM) has issued a set of guidelines for the disclosure of financial information and reports in licensed IBs called Guidelines on Financial Reporting for Licenced Islamic Banks 2005 (BNM/GP8-i). The purpose of this document is to ensure that the disclosure report of every IB is comparable and consistent and that they comply with the stipulations of Company Act 1965 and current Shariah requirements and accounting standards. The guidelines are also essential to facilitate various stakeholders for evaluating financial position and performance of the banks

(Bank Negara Malaysia 2005), both financial and non-financial (Md Zain & Shafii 2018). In addition to that, Shariah disclosure must be reported to the BOD for monitoring purposes and it has to be independent.

Therefore, such guidelines were used in this study to develop the Shariah governance index for transparency and disclosure as indicators of Shariah governance practices. In order to promote more robust and rigorous Shariah governance, BNM requires all IBs to adopt the Shariah Governance Framework (SGF) 2010. This is in relation to the responsibility of each institution's Shariah Board to ensure its transactions align with Shariah (Grassa 2015). Members of the Shariah Board have the obligation to direct, review and monitor the activities of Islamic institutions and ensure their conformance with Shariah principles. As Figure 1 below depicts, SGF 2010 has outlined the roles, functions and reporting relationships of the key organs of IFIs.

However, based on the Exposure Draft - ED of SGF (2017), there is no Shariah Research function, and the Shariah compliance section has been changed to control functions that consist of Shariah review, Shariah audit and Shariah risk management. This guideline is the requirement of Shariah compliance to assure that IFIs' services comply with Shariah and to promote good governance within IFIs. The framework shown in Figure 1 explains that the Shariah committee, Shariah review, Shariah audit and Shariah risk management are pertinent for IBs.

The Islamic Financial Service Act (IFSA) 2013 is another legal framework which came into the governance picture of IBs. It is a new statute that repeals the Islamic Banking Act 1983 and was enforced on 30 June 2013. IFSA has specified the requirements for Shariah committee, such as the criteria of a Shariah committee (Miskam & Nasrul 2013) and positioning the Shariah committee as equal partners of the BOD and Senior Management (Sori et al. 2015). IFSA also emphasises the transparency, accountability and governance of IBs in their management and operations. In this study, IFSA was referred to in identifying the disclosure items of Shariah governance.

The underlying principle of Shariah practice is to benefit the individual and the community, allowing the improvement of human life in this world. Its aims of preserving faith, life, progeny, intellect and wealth ultimately lead Muslims to the sole religious purpose of the afterlife. This thus explains their need for IBs, which practise full Shariah compliance in their operations and management of the banks. Thus, this paper attempts to examine the Shariah governance practices of local and foreign IBs operating in Malaysia using the legal framework of BNM's SGF.

The organisation of this paper is as follows: The next section briefly reviews recent literature on Shariah governance as practised by IBs. The third section describes the method used in this study, while the fourth section discusses the findings. The last section concludes and highlights its implications and limitations and provides suggestions for future research.

Literature Review

As the main purpose of IBs is to satisfy the religious needs and requirements of Muslims, their activities must adhere entirely to Shariah principles. For this reason, Bank Negara Malaysia (BNM) has developed certain guidelines for IFIs, such as the Shariah Governance Framework (SGF), in order to enhance the consistency and credibility of IFIs towards Shariah accountability. All IFIs, including IBs, have to conduct their business activities in line with Shariah guidelines and to avoid Shariah risks such as *riba* (usury), *maisir* (gambling) and *gharar* (uncertainty) in their transactions. Any unethical conducts in the operations of

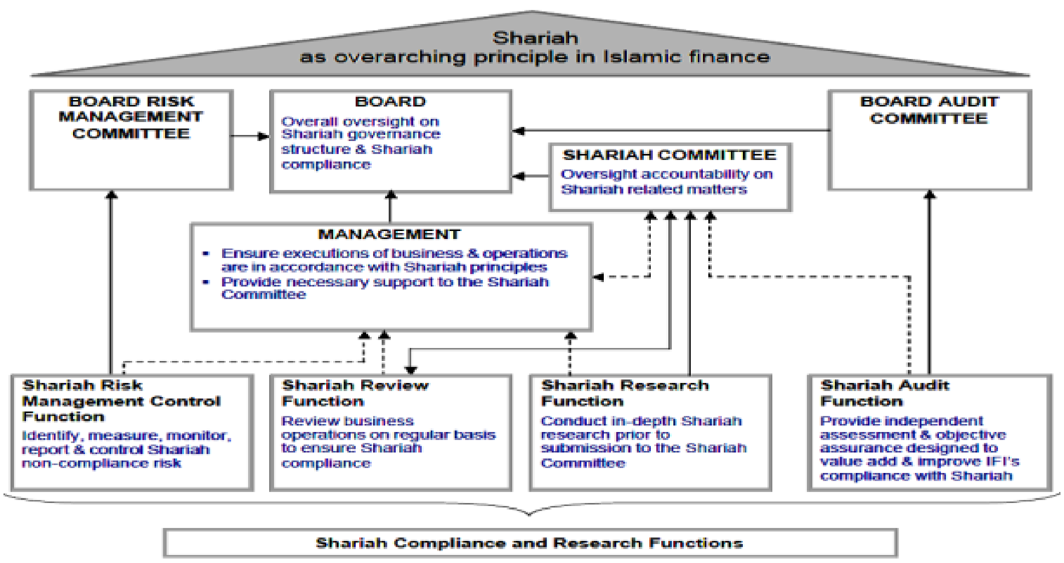

FIGURE 1. Shariah Governance Framework (SGF) 2010
Source: Shariah Governance Framework (2010), Central Bank of Malaysia

the banks are strictly prohibited (Satkunasingam & Shanmugam 2006).

Because IBs are heavily concerned with Shariah compliance, IBs must enact a Shariah Supervisory Board (SSB) as required by SGF. As per the BNM, Shariah governance and conventional governance are dissimilar: *"Shariah governance is integral to Islamic financial system stability. The institutionalisation of a sound Shariah governance framework strengthens public confidence in the aims, management and business operations of the Islamic financial institutions"* (Bank Negara Malaysia 2017).

In this study, based on the Exposure Draft of Shariah Governance (2017), five dimensions of Shariah disclosure were identified to explicate the Shariah governance practice for IBs, namely: i) Shariah Committee (Part B), three control functions – ii) Shariah Risk Management, iii) Shariah Review and iv) Shariah Audit (Part E), as well as v) Transparency and Disclosure (Part G). Details of each of the dimension are explained below:

SHARIAH COMMITTEE

The Shariah Committee (SC) or sometimes known as Supervisory Board (SSB) is an independent committee that acts as an oversight body to monitor the operations and business affairs of the IBs. SSB provides assurance to the stakeholders that the activities of IBs are consistent with Shariah rulings. In fact, a standard policy of SSB refers to the Islamic principles (Almutairi & Quttainah 2017; Ismail et al. 2016), directing them to carry out audit and investigating all products and activities of IBs. For that reason, SSB members are appointed from among the Shariah scholars in order to lead the IBs with Islamic values and compliance with Shariah. According to Grassa (2013), SSB is one of the components of Shariah governance to ensure Shariah compliance in the banks' day-to-day operations and activities.

SHARIAH RISK MANAGEMENT

According to Ginena (2014), Shariah risk is a part of operational risks, considering that IBs might risk financial loss as a consequence of non-compliant activities. The Shariah risk function includes identifying the possible risk, measuring the level of risk, monitoring and facilitating the effective risk management and controlling the recurrence of non-compliance risk (Ismail et al. 2016). Although risks are impossible to be avoided, the function of Shariah risk is to mitigate the risk and, importantly, the risk management must be consistent with the Shariah guidelines. As the risk exposure is more on Shariah non-compliance risks, Section 28(5) of IFSA (2013) cautions that any elements of Shariah non-compliance activities of IBs are against the law. According to the Act, an imprisonment of a maximum of eight years or a fine up to MYR25,000 or both could be sentenced upon conviction (Hassan 2014). This highlights the importance of Shariah risk in Shariah governance practice.

SHARIAH REVIEW

Shariah review is a periodical review of the IBs' operations to ensure their compliance with Shariah rules. It plays a significant role to ensure all activities of IBs are in line with the Shariah rules, fatwa, guidelines and rulings issued by the SSB (Bahari & Baharudin 2016). Based on the SGF (2010), the Shariah review function is recommended as a proper governance practice mechanism in monitoring the IBs' activities. As the Islamic banking industry nowadays is getting increasingly complex and dynamic, the possibility of Shariah non-compliance contracts or transactions is heightened (Besar et al. 2009). Indeed, the Shariah review function is pertinent to explicate Shariah Governance practice.

SHARIAH AUDIT

It refers to an auditing process and attestation of the Shariah complaint practice by examining financial statements and other related documents in all aspects of an organisation, including operational activities (Abdul Rahman 2008). Shariah audit is an "independent assessment conducted periodically to improve the compliance and to ensure the effectiveness of the Shariah control system" (Shafii et al. 2013). The Shariah audit function is implemented at three levels: i) audit of the financial statement, ii) compliance audit on organisational structure, people and process and iii) review on the adequacy of the Shariah governance process. As a result, Alam et al. (2019) suggest an efficient conduct of Shariah audit will minimise Shariah non-compliance risks, promoting good Shariah practice in the Islamic banking sector.

TRANSPARENCY AND DISCLOSURE

Full disclosure in Islamic corporate reports and demonstrating accountability to various stakeholders in such reports (Baydoun & Willett 2000; Masruki et al. 2016). The entirety of the bank's operations, transactions and activities should be comprehensively reported to garner trust and confidence of clients. Additionally, transparency could also prevent fraud cases or any possibility of dispute in transactions. Both disclosure and transparency are mentioned in SGF 2010 as part of the Shariah governance mechanisms, and as evinced by Bijalwan and Madan (2013), disclosure and transparency are important for better Shariah governance.

Based on the reviewed literature (e.g. Md. Zain et al. 2020; Aziz et al. 2019; Masruki et al. 2019a; Masruki et al. 2019b; Ismail et al. 2016) and legal regulations discussed above, a Shariah Governance index was developed based on five dimensions, these include: i) Shariah Committee; Shariah control functions of ii) Shariah

TABLE 1. Shariah Governance Disclosure Index (SGDI)

No.	Shariah Governance		Required by law (mandatory) of GP8-i, IFSA and SGF*
1	Shariah Committee (SC) (8 items)	1.1	Members of the SC are individuals with relevant experience and qualification in Shariah
		1.2	No fewer than five qualified individuals are to be appointed as SC
		1.3	Majority of the SC must be qualified and possess in-depth knowledge in Shariah
		1.4	At least one (1) member of the SC is appointed as a member of the board
		1.5	Disclose adequate information on the IFI's state of compliance in its annual report
		1.6	Duties of SC
		1.7	Meetings are scheduled to be held at least six (6) times annually
		1.8	At least 75% minimum attendance requirement of the meetings"
2.	Shariah Review (4 items)	2.1	Planning and implementing the Shariah review programme, which encompasses its objectives, scope, reporting, rectification and follow-up actions
		2.2	Documenting all processes carried out during the Shariah review
		2.3	Reporting the Shariah review outcome and highlighting any non-compliances to the Shariah Committee and the management
		2.4	Rectifying any instances of non-compliance to prevent their recurrence
3.	Shariah Audit (4 items)	3.1	Performing Shariah audit on financial statement items
		3.2	Performing Shariah audit by internal auditors that have adequate knowledge and training in Shariah
		3.3	Performing compliance audit on organisational structure, people, process and information technology application systems
		3.4	Reviewing of adequacy of the Shariah governance process
4.	Shariah Risk Management (4 items)	4.1	Carrying out by risk officers with relevant qualifications and/or experience
		4.2	Facilitating the process of identifying, measuring, controlling and monitoring Shariah non-compliance risks inherent in the IFI's operations and activities
		4.3	Formulating and recommending appropriate Shariah non-compliance risk management policies and guidelines
		4.4	Developing and implementing processes for Shariah non-compliance risk awareness in the IFI
5.	Transparency & Disclosure items)	5.1	Disclose the audited financial statement
		5.2	Disclose the audit report
		5.3	Involvement in non-permissible activities and less the percentage of profit, reason for involvement in non-permissible activities and handling of non-permissible activities
		5.4	Basis of Shariah concept in approving new product
		5.5	Amount paid for zakat
		5.6	Uses/beneficiaries of zakat
		5.7	Attestation that zakah has been computed according to Shariah
		5.8	Sources of charity (sadaqah) and its uses

*Guidelines of Financial Reporting for Islamic Financial Institutions (GP8-i) 2005, Islamic Financial Services Act (IFSA) 2013 and Shariah Governance Framework (SGF) 2010 and Exposure Draft of SGF 2017.
Sources: adapted from Md. Zain et al. (2020); Aziz et al. (2019); Masruki et al. (2019a), Masruki et al. (2019b); Ismail et al. (2016).

Risk Management, iii) Shariah Review and iv) Shariah Audit; as well as v) Transparency and Disclosure. Table 1 shows the details.

Methodology

This study involved all Islamic banks (IBs) in Malaysia for a five-year period, from 2012 to 2016, consisting of 10 local IBs and six foreign IBs. The IBs' annual reports were obtained from their respective websites. Following previous studies, Shariah governance practice in this study was measured using content analysis to generate Shariah disclosure scores. Past studies too have used content analysis as the methodology to study reporting and disclosure practices and argued that content analysis is the most appropriate method for this kind of study (Hossain et al. 1994; Hossainey et al. 2003; Scaltrito 2015). A disclosure checklist (28 items) was developed with reference from relevant regulations such as Guideline on Financial Reporting for Licenced Islamic Banks (GP8-i) 2005, Islamic Financial Services Act (IFSA) 2013 and Shariah Governance Framework (SGF) (2010/2017). The total items were divided into five dimensions: Shariah Committee (8), Shariah Review (4), Shariah Risk (4), Shariah Audit (4) and Transparency and Disclosure (8) (Table 1). The checklist outlines the characteristics to codify Shariah governance practice information presented in the annual reports of IBs (El-Halaby et al., 2015). Table 2 shows a list of disclosure items for the index (with a maximum score of 28).

TABLE 2. Summary of Shariah Governance Disclosure Index (SGDI)

Shariah Governance Disclosure Index (SGDI)	Number of items (max. = 28)
Shariah Committee	8
Shariah Review	4
Shariah Audit	4
Shariah Risk Management	4
Transparency & Disclosure	8

A score of one (1) is given if an item is disclosed and two (2) otherwise. Two coders with Accounting background analysed the annual reports to ensure reliability of the index used in this study by checking the consistency of the disclosure score. The second coder ensured that all coding done by the first coder was accurate. It was found that there was no significant difference between the first and second coder, which indicated that the developed index of SGDI is reliable for application. A descriptive analysis was initially carried out to look at the Shariah governance practices. Next, the differentials between local and foreign IBs and a gap analysis were carried out to look at the extent of such practices.

Data Analysis And Results

Table 3 shows the descriptive statistics of the dimensions of the SSB. These include the Shariah Committee, Shariah Review, Shariah Audit, Shariah Risk Management and Transparency Disclosure scores for all of the sampled IBs during the study period.

Based on Table 3, information regarding Shariah Committee was the most disclosed item in the annual reports of Malaysian IBs (M = 1.70). Other items, by rank, were: Shariah Risk, Shariah Audit, Transparency and Disclosure and Shariah Review, with means ranging from 1.50 to 1.52. This study implies that IBs rely heavily on the expertise of their Shariah committee members in relation to Shariah governance matters, consistent with the findings of Grasa (2013). However, Shariah control functions, namely Shariah Risk, Shariah Audit, Transparency and Disclosure and Shariah Review seemed to be reported less, which may contribute to Shariah accountability issues (Besar et al. 2009). For that reason, this study highlights the importance of implementing quality disclosure and reporting to better discharge accountability of the reporting entity (Masruki et al. 2018b).

TABLE 3. Descriptive Statistics

SSB Dimensions	N	Minimum	Maximum	Mean
Shariah Committee	80	1.00	2.00	1.6975
Shariah Review	80	1.00	2.00	1.4969
Shariah Audit	80	1.00	2.00	1.5031
Shariah Risk Management	80	1.00	2.00	1.5156
Transparency & Disclosure	80	1.00	1.71	1.4994

N = Number of observations
Note: This table presents the full sample of the descriptive statistics for the Shariah disclosure items.

This analysis was further extended to differentiate the Shariah governance practices between local and foreign IBs in Malaysia. Table 4 presents the results in percentage, showing 10 local and six foreign IBs during 2012-2016, together with their gap analysis.

Based on the above table, local IBs were more likely to disclose Shariah governance items compared to foreign IBs in Malaysia. Looking at the gap ranking, the highest differences (35.3%-38.6%) were reported for Shariah Risk, Shariah Review, Shariah Committee and Shariah Audit, while the lowest difference (25.3%) was found for Transparency and Disclosure. These results suggest that

TABLE 4. Percentage of Shariah governance practice of Islamic banks

SSB Dimensions	N	Percentage of Shariah governance practice		Differences	*Gap Ranking	**P-value
		Local	Foreign			
Shariah Committee	80	98.18	62.75	35.43	3	0.000
Shariah Review	80	87.75	50.00	37.75	2	0.000
Shariah Audit	80	88.25	52.92	35.33	4	0.000
Shariah Risk	80	90.25	51.67	38.58	1	0.000
Transparency and Disclosure	80	84.48	59.17	25.31	5	0.000
Overall		89.78	55.30	34.48		

* The gap is measured between local and foreign IB based on the percentage of differences
**P-value is based on T-test

all IBs in Malaysia are less likely to disclose Shariah governance items in their annual reports. Overall, the gap for Shariah governance disclosure items for both local and foreign banks was 34.5%. This may be due to the lack of competency of SSB in Shariah governance functions (Shariah audit, Shariah review and Shariah audit tasks), supporting the findings of Aziz et al. (2019).

Furthermore, the t-test was run to determine whether there were any significant differences between the Shariah governance practices of local and foreign IBs in Malaysia. Table 4 shows that there was a significant difference in Shariah governance disclosure between local and foreign IBs. The requirements and guidelines of Shariah governance such as IFSA, SGF and GP8-i would encourage better quality and more disclosure among local IBs (Masruki et al. 2018a; Ahmed & Mohamad 2019). As for foreign banks, they may have different views depending on their origin countries. This study suggests that the Shariah governance practices of Malaysian IBs need to be enhanced to garner trust from a wide range of stakeholders, especially depositors, investors, Muslims and the public.

Conclusion

This paper has analysed the Shariah governance disclosure of local and foreign IBs in Malaysia using the five SSB dimensions, namely: Shariah Committee, Shariah Review, Shariah Risk, Shariah Audit and Transparency and Disclosure. These functions were derived from the Malaysian Shariah Governance Framework (SGF) 2010 and 2017 issued by the Central Bank of Malaysia. The study covered the entire population of sixteen Malaysian IBs through a five-year period, from 2012-2016. The Shariah governance disclosure in the annual reports of these banks were evaluated based on the presence of the disclosure items using a self-developed disclosure index, the Shariah Governance Disclosure Index (SGDI). This study found that the Shariah Committee attributes were the most disclosed Shariah governance items compared to those of the three Shariah control functions (Shariah review, Shariah risk management and Shariah audit) and Transparency and Disclosure. This implies that IBs are heavily dependent on the expertise of their Shariah committee in Shariah governance matters. They seemed to exhibit a lack of disclosure on Shariah control functions and transparency, inhibiting the effectiveness of the SSB of Malaysian IBs. Bank Negara Malaysia as the regulator of IBs in Malaysia should instruct them to report and disclose more Shariah transparency items. More disclosure would attract more Muslim investors. Based on the findings, policy makers could also draft and issue new guidelines for IBs to improve their Shariah governance practices.

However, the findings of this study should be taken with caution, since the Shariah disclosure index was developed without taking into account international regulations, such as those developed by Accounting and Auditing for Islamic Financial Institutions (AAOIFI), which may explain the low disclosure scores of foreign IBs in Malaysia. The study period also ended in 2016, while this study began in 2017, the same year of the issuance of the SGF-Exposure Draft (ED). Therefore, future studies could evaluate best Shariah governance practices, considering global best practices, in particular on Shariah control functions and transparency, pre- and post-2017. In addition, a comprehensive annual report should include such disclosures on Shariah governance.

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