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Corporate governance of Islamic financial institutions in Malaysia

Maliah Sulaiman[1], Norakma Abd Majid[2], Noraini Mohd Ariffin[3]

[1]Professor of Accounting, International Islamic University, Malaysia, maliah@iium.edu.my
[2]Academic Fellow, Universiti Malaysia Terengganu, norakma.amajid@gmail.com
[3]Assistant Professor, International Islamic University, Malaysia, norainima@iium.edu.my

Abstract - Given the phenomenal increase in Islamic banking activities globally, it is important that there exists good governance practice around Islamic financial institutions (IFIs). This is primarily to ensure its sustainability in the long run. More importantly, in order for Islamic banks to play an optimum role in the development of Islamic countries, it is pertinent to develop regulatory structures to control fraud, exploitation, and un-Islamic behavior. Additionally, the development of strong governance practices will win public confidence and thereby promote trust amongst equity holders, investors and other parties dealing with these IFIs. However, promulgating and developing standards and guidelines on corporate governance (CG) may not be adequate. What is needed is to examine the extent IFIs are actually following such guidelines. This is precisely what we have attempted to do. There are two stages to the study. A disclosure index is first developed using the guidelines issued by the Central Bank of Malaysia (BNM), the standard on CG promulgated by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the framework introduced by the Islamic Financial Services Board (IFSB). The index developed in the first stage is then used to assess the annual reports of all 16 IFIs operating in Malaysia. This paper reports on the second stage of the study. The results do not appear too promising. On a scale of 0 to 100, the CG disclosure index ranges from a low of 42.28 to a high of 68.29, with the average score hovering around 51.42. The implications of the results, the limitations of the study and suggestions for future research are also discussed.

Keywords: Islamic financial institutions (IFIs), corporate governance, general governance guidelines, specific governance guidelines, Malaysia

1. Introduction

A series of corporate failures of "giant" corporations worldwide (e.g., Enron, Tyco, Worldcom, Pharmalat, etc.) has shaken the confidence and trust of stakeholders. Consequently, this has brought increasing attention to corporate governance (CG) issues. Increasing CG disclosures in annual reports may be interpreted as a way by which companies try to secure the level of confidence and trust of its stakeholders. More importantly, the issue of transparency has now become pertinent. Bhat, Hope and Kang (2006) opine that the knowledge of a firm's governance practices is useful in assessing the credibility of financial information presented in its annual report. This is because governance-related disclosure aids users in assessing the quality of information and guides stakeholders in more accurately setting expectations about the future of an organization's performance. Specific to Islamic banking, one observes a proactive stance on the part of regulators to improve the regulatory and supervisory framework in supporting higher CG standards for Islamic financial institutions (IFIs). Given the uniqueness of IFIs, an international guideline developed by OECD or the Cadbury Report may not address CG issues of IFIs, as governance structures are industry specific (Adam and Mehran, 2005).

In line with the global focus on CG, various regulatory bodies for IFIs have moved a considerable distance toward improving the regulatory and supervisory framework in developing higher CG standards. The CG Guidelines and standards issued by the Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB) and the Central Bank of Malaysia (BNM) are some examples. These guidelines may well assist IFIs to establish their

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governing structures. Consequently, such guidelines may improve the governance practices of IFIs and thus enhance its transparency. However, promulgating and developing standards and guidelines on CG are insufficient. What is needed is to examine the extent IFIs are actually complying with such guidelines. This is precisely what the study attempts to do. Specifically, this research will examine CG disclosure practices of IFIs in Malaysia using a two-stage process. The first stage is the development of a comprehensive CG index. Consistent with prior studies, the index acts as a proxy for disclosure quality. The comprehensive corporate governance disclosure (CGD) Index used in this study is based on three governance guidelines and codes promulgated by AAOIFI, IFSB and the Central Bank of Malaysia (later on collectively referred as "Guidelines"). The CG index developed is then used to assess the quality of CG of IFIs in Malaysia. This constitutes the second stage of the study, which is the focus of this paper.

The study contributes to the literature in several important respects. The use of a comprehensive index to examine CG practices of IFIs in Malaysia will greatly enhance the literature on CG in IFIs. Second, the CG index developed from three recently released governance guidelines available to IFIs (2006, 2007 and 2008) speaks of the currency of the research. Finally, the division in terms of general and specific governance related information, to the authors' knowledge, is a first in studies concerning CG and IFIs. Understanding the quality of CG disclosure by examining its extent and focus is a fundamental starting point in gaining insights into the preference of IFIs on CG disclosure information. The remainder of the paper is structured as follows: The following section discusses the literature review while section 3 focuses on the theoretical framework of the study. Section 4 describes the data collection and the findings, while section 5 concludes.

2. Literature review

Corporate governance (CG), broadly defined, is a set of processes, policies and laws affecting the way an organization is directed, administered and controlled. Bansuch, Pate and Thies (2008) defined CG as a set of formalised values and procedures implemented by the owners, directors and the management of the business in its various operations as well as its interactions with stakeholders. Holder-Webb, Cohen, Nath and Wood, (2008) defined CG as the provision of effective boards, strong shareholder rights, and broad disclosures in managing a business. From the perspective of IFIs, governance specifically addresses issues pertaining to the role and conduct of the *Shariah* Supervisory Boards (SSB). More specifically, CG of IFIs should include the following:

i. Safeguarding interests of investment account holders
ii. Compliance with *Shariah*
iii. Governance and risk management of Mudaraba and Musharaka contracts
iv. Establishment of a comprehensive CG framework articulating the fiduciary responsibilities of the board and senior management

A focus on all the above will lead to an improvement in the level of trust and confidence in the Islamic finance industry (Iqbal and Greuning, 2008). More importantly, AAOIFI claims that strong governance practices will win public confidence and thereby promote trust amongst their equity holders, investors and other parties dealing with them. Subsequently, this would enhance *Shariah* compliance.

In order to examine if indeed there exists differences between CG of IFIs and other organizations, it is important to understand what are the unique characteristics of IFIs in the first place. The uniqueness of IFIs emanates from its fundamental principle to conduct its operations in accordance with Islamic *Shariah,* the primary issue being the prohibition of the receipt and payment of *riba* (interest). A pre-determined fixed rate of return on capital – where one party bears the risk while the other party receives a reward irrespective of the outcome of the use of the borrowed amount—would mean an uneven distribution of risk and reward in the transaction. More importantly, *riba* also leads to the concentration of wealth by transferring wealth from the poor to the rich. This is primarily why *riba* is prohibited. The alternative to avoid dealing with interest is the various forms of profit-sharing contracts that are peculiar to Islamic banking. These contracts are said to enhance justice and equitable distribution of profits and risks in investment (Bashir, 1984).

Archer and Karim (2007) identified two main types of accounts offered by IFIs to mobilize funds from its customers. The first is the profit–sharing and loss bearing *mudharabah* contract. This type of limited duration investment account is distinct from equity shares. The relationship between the investment account holders (IAH) and the bank is that of a provider of funds and a fund manager. More importantly, there is a transfer of control over investment decisions from the IAHs to the bank as a *mudharib.* Thus, the IAHs have no right to intervene in the *mudharib's* decisions over the funds. Further, IAHs do not possess any right of governance or oversight, making this a unique feature of IFIs and IAHs. This then gives rise to the importance of proper governance procedures in order to ensure that the rights of IAHs are not compromised. In the absence of a right to manage, the only choice possible to IAHs is the right to withdraw their funds when there is dissatisfaction in the bank's performance. Udovitch (1970) argued that in a *mudharabah* contract, the bank as a *mudharib* acts as a steward with respect to the capital entrusted to him. As such, the bank is not liable for any losses occurring in the normal course of business *and* if there is no negligence (Archer and Karim, 2007: 315).

Another major issue pertinent to IFIs is the need for IFIs to balance financial performance with ethical behavior. The latter provides an incentive to disclose specific-governance information, which may not necessarily attribute to financial outcomes, but could moreso serve the purpose of attaining fairness and equity for a wider group of stakeholders. In several important respects, the specificities of IFIs impact how CG should be structured. According to Ericco and Farahbaksh (1998), depositors of Islamic banks have more incentive to assess the performance of banks because their capital value and returns on investment deposits are not fixed and guaranteed. The outcomes of their investment depend on the bank's performance in investing depositors' funds. Indeed the incentive for depositors to scrutinize the performance of banks is to ensure protection of the capital value of their funds as well as to ensure that the rates of return paid to them reflect a fair application of the Profit and Loss Sharing (PLS) principles (Erricco and Farahbaksh, 1998:14).

Lewis (2005) contends that there are two aspects that give shape to the nature of Islamic corporate governance (ICG). The first aspect is the *Shariah*. *Shariah* claims sovereignty over all aspects of human life, including ethical and social matters. Thus, every act of believers must conform to *Shariah* and ethical standards derived from Islamic principles. The ethical principles defined what is true, fair and just, the nature of corporate responsibilities, and the priorities to society, along with some specific governance standards. Ethical production and distribution are regulated by the halal-haram code and adhered to the notion of *"adl"* (justice). The second aspect is the specifics of Islamic economics and financial principles. For example, issues such as *zakah* (the alms tax), the ban on *riba* (usury) and the prohibition on speculation have a direct impact upon corporate practices and policies.

Specific to the appointment of the board of directors, Chapra (2007) identified three matters of importance. The first pertains to the need for board members to possess a high degree of moral integrity and professional competence in the banking business. These qualities may help them to effectively perform their expected duties toward the institutions. Second is to ensure that the board member is well-versed in *Shariah* matters concerning Islamic banking. Finally, board members must make sure that there is adequate transparency in the disclosure of activities of IFIs. More specifically, IFIs must adhere to guidelines/standards laid down by the supervisory authority of the country. In Malaysia, for example, the guidelines issued by the Central Bank of Malaysia would rank supreme.

Hameed and Sigit (2005) conducted a comparative study of CG disclosures in annual reports of Malaysian and Indonesian IFIs between the period of 2000 and 2003. A CG disclosure index developed important issues related to IFIs, such as the internal *Shariah* review; social responsibilities for stakeholders; bases for profit allocation between owner equity and IAHs; the PER (profit equalization reserve); IRR (investment risk reserve), and the SSB. The score obtained for each bank was rated using the rule of classification suggested by Irwanto (2002). Irwanto (2002) grouped the scores into four (4) categories: 81–100 (very informative); between 66 and 81 (sufficiently informative); between 51 and 66 (less informative) and between 0 and 51 (not informative). Overall, there was an increasing trend of CG disclosures for both Malaysian and Indonesian IFIs from 2000 to 2003. Additionally, the scores for Malaysian IFIs were higher, ranging from "not informative" to "sufficiently informative" (a score between 0 and 81). On the other hand, scores for IFIs in Indonesia range from 0 to 51 (not informative). What comes as a surprise is the fact that none of IFIs disclosed specific items that are unique to them, such as internal *Shariah* review and bases for profit allocation between owner equity and IAHs.

Hassan and Christopher (2005) examined corporate governance disclosure of one IFI in Malaysia. The study was unable to offer an extensive list of governance requirements due to the limited number of governance guidelines for IFIs at the time the study was undertaken. They argued that IFIs operate on a different set of rules to comply with the requirements of the *Shariah*. Specifically, IFIs, to meet the expectations of the Muslim community, must provide financing that accords with *Shariah*. As indicated earlier, because of the prohibition of *riba*, the PLS contracts are prevalent in IFIs. This suggests a different relationship from those offered by conventional banking. In line with this argument, the authors inferred that IFIs should be selective with regards to the appointment of board members and managers in terms of specific qualification requirements. Emanating from the notions of unity in Islam, universal brotherhood, trust and accountability in *Shariah*, IFIs are expected to provide greater transparency in disclosure (Hassan and Christopher, 2005).

3. Theoretical framework

The theoretical framework of this study merely concentrates on the quality of CG information disclosure practices by IFIs in Malaysia. It focuses on examining the extent that CG information is disclosed by IFIs and the difference of CG disclosure quality between local and foreign owned IFIs in terms of their preference to prioritize either specific or general kinds of governance information in their annual reports in 2009. More specifically, the primary objective of this study is thus to examine the quality of CG disclosure provided by IFIs in Malaysia in their annual report. Figure 1 below presents the research framework.

The stewardship theory was chosen as a framework for this study on account of the contextual characteristics of IFIs. Contextually, the multifaceted objectives, which focus on more than just economic factors, include having an ideal composition of board structure supported by strategic board committees – nominating, remuneration, risk management, and audit. The good structure of these elements supports proper accounting for risk, handling effective internal control systems, related parties transactions, an adherence to issued guidelines, and the production of various management reports for achieving operational efficiency among IFIs. However, the integration of the PLS mechanism in the basic operation and the ethical conduct of business attached to the "ultimate goal of Maqasid *Shariah*" (Bhatti and Bhatti, 2009:72) of the Islamic financial industry has been perceived as being in the best interests of the group, as opposed to individual financial rewards. This context means accountability to a broader group of the community (*ummah*). The essence of Maqasid *Shariah* substantially curbs any endeavour to acquire wealth by unlawful means, which leads to social inequality and social waste (Bhatti and Bhatti, 2009). As such, the governance structure in IFIs should include the establishment of a *Shariah* and governance committee, the performance of an internal *Shariah* review as an assurance of continuous *Shariah* compliance and the provision of relevant information intended to govern the relationship with IAHs.

The first type of governance information targeted operational efficiency, which is common in all kinds of commercial entities. However, the second type of governance information is to pursue and exclusively secure the attainment of goals set by Maqasid *Shariah*. The concern for both types of governance information by stewards may be seen as an equilibrium response to the wide

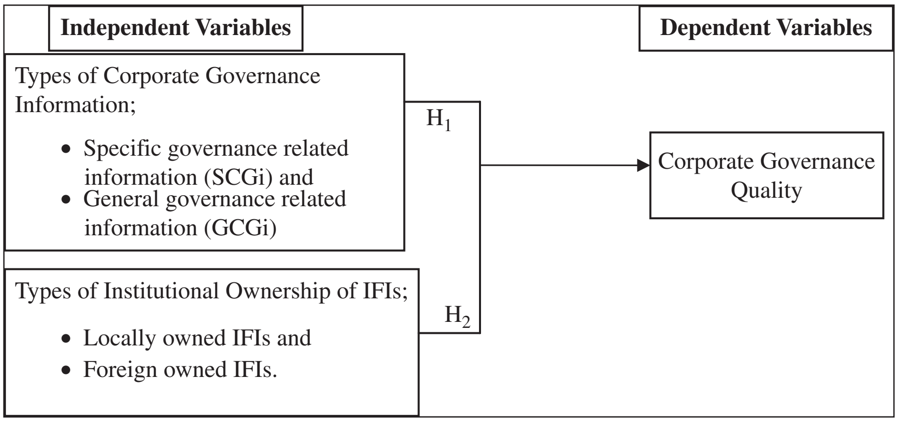

Figure 1. Research framework.

spectrum of an institution's obligation to commercial and religious affairs. The two types of governance information are: GCGi (general CG information), which is related to institutional efficiency in operation, and SCGi (specific CG information), which is related to the type of activities to protect the proper application of *Shariah* requirements. The SCGi is of particular importance as the philosophy of Islamic financial business dealings, as enshrined by the *Shariah*, promote relatively greater reliance on the equity (*Mudharabah* and *Musyarakah*) or the PLS modes of financing (Chapra and Ahmed, 2002:1). In such arrangements, IFIs and their stakeholders (particularly IAHs) become partners in the relationship. In such a relation, the partnership attributes (i.e., commitment, coordination and trust) and communication behavior are vital as determinants of the successful relationship between partners.

Based on the stewardship theory, the emphasis is on coordination where the relationship is based on trust and personal power (respect and expertise) (Davis et al., 1997). As stewards, the managers and directors of IFIs need to focus on managing the interaction process with their wide array of stakeholders by "increased value commitment and identification" (Davis et al., 1997). This ultimately aims at creating trust and enhancing goal alignment between the IFIs and their stakeholders. The establishment of CG information in the annual report, in particular the SCGi, is argued to be a direct expression of IFIs to gain the trust of stakeholders. Once confidence is achieved, it facilitates the collaboration and serves as an important lubricant of the social system (Sundaramurthy and Lewis, 2003) between IFIs and their stakeholders.

The application of a liaison device such as communication also enables firms to establish mutual understanding and cooperation. This is in line with the general theme of Islamic social order, which emphasises cooperation and mutual consultation (*Shura*) (Sulaiman, 2005: 22). This study proposes that the means of building shared understanding among managers, directors and executives with their stakeholders is through communication. Such disclosure may include the presentation of respective governance concerns and contributions (i.e., GCGi and SCGi) about the risks that they can assume through their involvement with the institutions to regulators and other stakeholders. This approach can provide a basis for dialogue between the firms and stakeholders, as they can evaluate the appropriate disclosure to match their expectations. Under the implicit assumption of stewardship theory, the study hypothesizes that the tendency of IFIs is to prioritize specific kinds of governance information (H1) as it is considered an expression by IFIs attempting to gain trust from their stakeholders. Furthermore it is directed to achieve goal alignment based on shared culture and norms strictly followed the requirements made in *Shariah*.

Theoretically, the PLS system practiced in IFIs is inextricably intertwined with collectivism spirits promoted in *Shariah* requirements. In this arrangement, management of IFIs are beneficiaries of trust. Similar claims were made by Bundt (2000:761) that "the principal-stewardship relationship depends on trust, where trust in this relationship is the expectation that the other will act in good faith in situations in which that party has the power to affect one's own interests." By adopting the stewardship perspective, this study expects that the management of IFIs would voluntarily adopt activities that can enhance the trust of stakeholders to enter into collaboration with IFIs.

The underlying ideas in reference to their focus on governance related information is that GCGi is usually pursued with the aim of maximising the financial performance of the banks. Meanwhile, the specific-governance information, which may not be directly related to the financial implications for the banks, might be important to serve as a basis "to build trust, elicit cooperation and create a shared vision amongst those involved in the firms" (Lewis and Algaoud, 2001:160). As the theory assumes that the steward possesses of a high value commitment, Bundt (2000:761) argued that,

> "the principal must believe that the steward will make decisions in the best interests of the organization and will be capable of carrying the decisions out. Failure to meet this condition may constrain the steward—either literally by rules and regulations or psychologically by demoralization."

This argument may partly clarify the claim made by Brown and Caylor (2006), who stated that governance matters, which are unrelated to firm value (in such case, SCGi does not necessarily directly contribute to economic enhancement), might be of importance for other purposes, such as for the case of IFIs. As the IFIs alter their policies to exactly match the intrinsic organizational motivations with their stakeholders' of creating a shared portfolio focusing on the preferred mix of financial and religious issues in business affairs.

Drawing on a simple steward and principal model, this study hypothesizes that firms will be particularly motivated to disclose specific-governance related information as and when they realize that these elements are the antecedent of their trustworthiness to guarantee their accountability towards the fair operation of the banks. Thus, the following hypothesis is formulated.

> H1: IFIs will disclose more specific-governance related information (SCGi) compared to general-governance related information (GCGi).

Additionally, under the implicit assumption of stewardship theory, the study hypothesizes that foreign owned IFIs have a broader group of community (ummah). Foreign owned IFIs are likely to make more disclosure relating to governance information as their status to put them in a position to adopt foreign governance guidelines in addition to domestic standards to attract the confidence of stakeholders both at home and abroad. This study argues that foreign owned IFIs will exhibit different levels of compliance to the Guidelines (hence CGD quality) to reflect the different quality of governance, which is dependent upon their operational specificity and motivations. It is an expectation that the roles played by foreign IFIs in the global marketplace also contribute to the disparity of their CG quality. The twin roles of institutions operating in foreign countries as identified by Kim, Prescott and Kim (2005), are that of specialized contributor and local implementer. These roles are assumed to have an effect on the stewardship objective of managing the IFIs interactions with their wider range of stakeholders, hence, the quality of their governance reporting.

As a specialized contributors, foreign banks are highly dependent on the global scale of stakeholders. As the case may be, the foreign banks may be subjected to close supervision by the headquarters (if they are subsidiaries) or the regulators of their origin countries. Thus, this study assumes that foreign banks are also affected by the standards and guidelines applied to headquarters for control purposes. Regulators in their country of origin may impose rules on foreign banks, which might not be the same as the rules of the domicile country. The tendency to adopt several standards in addition to the domestic guidelines is highly likely for foreign banks. Thus, this study assumes that higher governance information disclosure can be expected from foreign banks.

Porter (1986) argued that being local implementers, foreign banks seek to "meet unusual local needs in products, channels, and marketing practices in each country" (Kim et al., 2005: 50). As a result, this study assumes that foreign banks might comply with domestic governance guidelines as well as they are able. This approach can be seen as an effort by foreign owned banks to gain the trust of the local regulators concerning their capability to suit the local needs. Thus, it is an assumption of this theory to expect to see more CG disclosures in annual reports of foreign owned IFIs as compared to their local counterparts. On the basis of the above argument, the following hypothesis is developed.

> H2: The quality of corporate governance of foreign owned banks is likely to be of better quality than that of locally owned banks.

4. Data collection and findings

The index

A comprehensive CG index was first developed using the guidelines issued by the Central Bank of Malaysia (BNM), the standard on CG promulgated by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the framework introduced by the Islamic Financial Services Board (IFSB). Altogether there were 123 items grouped into 14 dimensions as follows:

D1: Board structure and functioning	(D1–1:21)*
D2: Nominating committee	(D2–25:32)
D3: Remuneration committee	(D3–33: 41)
D4: Risk management committee	(D4–42: 49)
D5: Audit committee/audit and governance committee	(D5–50: 61)
D6: *Shariah* committee/*Shariah* supervisory board	(D6–62: 76)
D7: Risk management	(D7–77: 85)
D8a and 8b: Internal audit and control	(D8–86: 93)
D9: Related parties transaction	(D9–94: 95)
D10: Management report	(D10–96: 97)
D11: Non-adherence to guidelines	(D11–98: 99)
D12: Customers/investment account holders	(D12–100: 113)
D13: Governance committee	(D13–114: 119)
D14: *Shariah* compliance	(D14–120: 123)

*Items in brackets denote the number of items in the dimension.

The maximum score that IFIs can achieve is 123 items. Disclosing all 123 items will indicate full compliance with the CGD Index. Further, in order to examine if IFIs are actually disclosing items that reflect their unique nature, the present study divides the dimensions into two specific categories: general-governance related information (GCGi) and specific-governance related information (SCGi). The former (i.e., GCGi) comprises D1 (board structure and functioning), D2 (nominating committee), D3 (remuneration committee), D4 (risk management committee), D5 (audit committee or audit and governance committee), D7 (risk management), D8 (internal audit and control; (a) general-governance information and (b) specific-governance information), D9 (related parties transaction), D10 (management report), and D11 (non-adherence to guidelines). These dimensions are oriented towards the achievement of operational efficiency to lead to an achievement in economic objectives. The SCGi consists of D6 (*Shariah* committee or *Shariah* supervisory board), D12 (customers/investment account holders), D13 (governance committee), and D14 (*Shariah* compliance). These dimensions extend the orientation towards the realization of ethical and socially corporate values through the application of partnership-based business principles. The split into 10 dimensions of general-governance related information, and 4 dimensions of specific-governance related information, provides an opportunity to understand the inclination of the type of CG information being disclosed by IFIs in Malaysia. Specifically, the CG information (SCGi) constitutes dimensions that align with the unique characteristics of IFIs, such as *Shariah* compliance, *Shariah* committee, Governance committee (specifically indicated in the IFSB guidelines) and Investment Account Holders (IAH).

5. The results

We examined the annual reports of 16 IFIs in Malaysia; 10 local banks and 6 foreign owned banks. Content analysis was used to determine the extent IFIs comply with the index. A score of "1" was given if a particular item was reported, and a score of "0" if the item was not included in the annual report. A CGD Index score, consistent with Pahuja and Bhatia (2010), was then computed using the following formula

$$\text{CGD Index} = \frac{\text{Total Score of the Individual Bank}}{\text{Maximum Possible Score Obtainable by the Bank}} \times 100$$

Table 1 presents the overall CG disclosure index score of each IFI. The extent of compliance indicates the quality of disclosure. Thus, the assumption taken in the study is that greater disclosure of CG information (according to the index) will be regarded as having higher quality CG disclosure. Theoretically, the CGD Index could range from zero (0) to one hundred (100) percent. A bank that reports all 123 items will score 100 percent.

As indicated in Table 1, RHB Islamic Bank Berhad had the highest score at 68.29%, while Standard Chartered Saadiq Berhad and OCBC Al-Amin Bank Berhad had the lowest at 42.28% in 2009. The highest score for foreign owned IFIs was Asian Finance Bank Berhad at 57.72%. Interestingly, it is the foreign owned IFIs that had the lowest CG score. The average score for all IFIs was 51.42%, which is just above the half way mark. Additionally, the results revealed that of the 16 IFIs, 10 (62.5%) had an index of more than 50%. Following Mohd Ghazali and Weetman (2006), it has been argued that IFIs having an index of more than 50% can be considered as "good disclosers." Thus, one may conclude that overall IFIs in Malaysia may be regarded as "good"

Table 1. CG disclosure quality of each IFI (N = 16).

No.	Names of IFIs	Total score	Disclosure as % of maximum possible score	Overall rank
	Local owned banks			
1	*Affin Islamic Bank Berhad*	53	43.09	12
2	*Alliances Islamic Bank Berhad*	76	61.79	2
3	*Bank Islam Malaysia Berhad*	62	50.41	8
4	*Bank Muamalat Malaysia Berhad*	66	53.66	6
5	*CIMB Islamic Bank Berhad*	69	56.10	4
6	*EONCAP Islamic Bank Berhad*	54	43.90	10
7	*Hong Leong Islamic Bank Berhad*	66	53.66	6
8	*Maybank Islamic Bank Berhad*	57	46.34	9
9	*Public Islamic Bank Berhad*	66	53.66	6
10	*RHB Islamic Bank Berhad*	84	68.29	1
	Total	**653**	**530.90**	
	Average score (N=10)	**65.3**	**53.09**	
	Foreign owned banks			
11	*Al Rajhi banking & Investment Corporation (Malaysia) Berhad*	63	51.22	7
12	*Asian Finance Bank Berhad*	71	57.72	3
13	*HSBC Amanah Malaysia Berhad*	67	54.47	5
14	*Kuwait Finance House (Malaysia) Berhad*	54	43.90	11
15	*OCBC Al-Amin Bank Berhad*	52	42.28	13
16	*Standard Chartered SaadiqBerhad*	52	42.28	13
	Total	**359**	**291.87**	
	Average score (N=6)	**59.83**	**48.65**	
	Grand total	1012	822.77	
	Average Score (N=16)	63.25	51.42	

disclosers of CG information. Further, it can be observed that the mean score recorded by locally owned IFIs at 53.09% is slightly higher than foreign-owned IFIs (48.65%). This evidence seems inconsistent with the expectation in the hypothesis (H2) that CG quality is better in foreign owned IFIs.

We then examined the extent IFIs are reporting on each CG dimension (D1 to D14). A comparison between local and foreign owned IFIs was also undertaken. Table 2 presents the results of the overall mean scores for each dimension partitioned by ownership classification of IFIs (i.e., whether local or foreign owned). The rankings for the overall mean scores are given to illustrate the relative importance of CG disclosure practices of IFIs. Additionally, a bar chart is included in the appendix for ease of reference on the overall rankings.

As can be observed, the overall results of the CG disclosure analysed by dimensions indicate that the most frequently reported elements are on the risk management committee (Dimension 4) followed closely by information on the nominating committee (Dimension 2). Interestingly, information on risk management had a score of only 54.86; a score that is way below that of the risk management committee. This appears to indicate that while IFIs do have risk management committees, they are not willing to provide as much information on their risk management procedures. Alternatively, this may signal a lack of proper risk management procedures in place. Thus, it may be interpreted that a well-established risk management committee does not necessarily lead to an enhanced disclosure on risk management issues or the presence of proper risk management procedures. The scores for Dimension 8a (internal audit and control; mean score of 33.33) and Dimension 14 (*Shariah* compliance; mean score of 28.12) were also considerably low. The least disclosed dimension was information pertaining to customers/ investment account holders (mean score of 2.68). However, what is most alarming is the total absence of information on the governance committee (Dimension 13).

A Mann-Whitney U test was then undertaken to examine if there exists any significant difference in the disclosure scores between local and foreign owned IFIs on each dimension. The only significant differences detected (at a 10% level of significance) were for D11 (Non-adherence to guidelines), D6 (*Shariah* committee) and D14 (*Shariah* compliance). For both D11 and D14, it is the foreign banks that were disclosing more. Accordingly, the hypothesis that foreign owned IFIs have better quality CG disclosure may be *partially* supported. On issues pertaining to the *Shariah* committee, however, it is the local IFIs that were disclosing more.

The literature advocating CG disclosures in IFIs emphasizes the necessity of reporting specific governance information unique to their nature such as the internal *Shariah* review and bases for profit allocation between owner equity and IAHs (Hameed and Sigit, 2005). In line with this, we

Table 2. CG Disclosure of IFIs Partitioned intoGCGi and SCGi.

Dimensions	No. of sub-items	Overall mean (N = 16)	Overall mean rank	Local owned IFIs mean (N = 10)	Sig.	Foreign owned IFIs mean (N = 6)
GCGi						
D1: Board structure and functioning	24	66.67	4	69.58	0.172	61.81
D2: Nominating committee	8	81.25	2	82.50	0.262	79.17
D3: Remuneration committee	8	69.53	3	85.00	0.106	43.75
D4: Risk management committee	8	85.16	1	87.50	0.415	81.25
D5: Audit committee/audit and governance committee	12	62.50	7	60.83	0.695	65.28
D7: Risk management	9	54.86	9	53.33	0.861	57.41
D8a: Internal audit and control	6	33.33	10	33.33	1.00	33.33
D9: Related parties transactions	2	65.63	5	70.00	0.628	58.33
D10: Management reports	2	62.50	6	55.00	0.182	75.00
D11: Non-adherence to guidelines	2	9.38	13	0.00	0.059*	25.00
Overall for GCGi	81	60.95		60.10	0.355	60.37
SCGi						
D6: Shariah committee/SSB	16	59.38	8	63.13	0.086*	53.13
D8b: Internal audit and control	2	9.38	12	15.00	0.150	0.00
D12: Customers/investment account holders	14	2.63	14	2.10	0.439	3.50
D13: Governance committee	6	0.00	15	0.00	–	0.00
D14: Shariahcompliance	4	28.13	11	22.50	0.059*	37.50
Overall for SCGi	42	26.37		27.07	0.151	25.20
Overall for CGDs index	123	51.42		53.09	0.301	48.64

(*) A significant difference at the 10 percent level (2-tailed).

examined the difference between SCGi and GCGi for all IFIs on an overall basis (i.e. all IFIs). Subsequently, the analysis for local and foreign owned IFIs were undertaken separately. Finally, we examined each individual IFI. The results of these analyses are presented in Tables 2 and 3.

Overall, it can be observed that IFIs in Malaysia were focusing more on general governance information (60.95%) as compared to specific CG information (26.37%). Overall, the percentage score for GCGi was higher (63.95%) as compared to the score for SCGi (26.37%) This seems to indicate that less emphasis is being placed by IFIs on matters related to its specificity (to demonstrate its uniqueness). To examine if the focus on SCGi and GCGi was statistically significant, a Wilcoxon Signed Rank test was undertaken. The results indicate a significant difference between disclosure on SCGi and GCGi. Similar results were obtained when local and foreign IFIs were examined. On the basis of this, we may conclude that HI is not supported. Accordingly, one may conclude that IFIs in Malaysia appear to disclose CG information of a more generic nature. Further, the percentage of specific-governance information (SCGi) met by IFIs ranged from 19.51% for Bank Islam Malaysia Berhad and EONCAP Islamic Bank Berhad to 34.15% for Maybank Islamic Bank Berhad and RHB Islamic Bank Berhad. Thus, one may conclude that CG disclosure of SCGi is still at a nascent stage amongst IFIs in Malaysia. On the other hand, the percentage for GCGi lies within a range from 50% (Affin Islamic Bank Berhad) to 85.37% (RHB Islamic Bank Berhad).

6. Conclusion

Over the past decade, CG of IFIs has moved to become main stream and is increasingly prevalent in both academic debates, and, more generally, the international business media and conference circuit. IFIs pursue two primary objectives: sound financial performance and ethical operations that align with the *Shariah*. More importantly, IFIs exist to serve the needs of the *ummah*. The unique aspect of IFIs emanates from its fundamental principle to conduct and operate in accordance with the Islamic *Shariah*, the primary issue being the prohibition of *riba* (interest). Given this, IFIs emphasize the PLS system. In such a system, transparency issues become pertinent as investment depositors would be exposed to the risk of

Table 3. The CG Disclosure Score of each IFI Partitioned by GCGi and SCGi.

No.	Names of IFIs	GCGi (Max. 81 items)	Disclosure as % of maximum possible score	SCGi (Max. 42 items)	Disclosure as % of maximum possible score	Sig.
	Local owned banks					
1	*Affin Islamic Bank Berhad*	41	50.00	12	29.27	
2	*Alliances Islamic Bank Berhad*	65	79.27	11	26.83	
3	*Bank Islam Malaysia Berhad*	54	65.85	8	19.51	
4	*Bank Muamalat Malaysia Berhad*	54	65.85	12	29.27	
5	*CIMB Islamic Bank Berhad*	58	70.73	11	26.83	
6	*EONCAP Islamic Bank Berhad*	46	56.10	8	19.51	
7	*Hong Leong Islamic Bank Berhad*	57	69.51	9	21.95	
8	*Maybank Islamic Bank Berhad*	43	52.44	14	34.15	
9	*Public Islamic Bank Berhad*	54	65.85	12	29.27	
10	*RHB Islamic Bank Berhad*	70	85.37	14	34.15	
	Overall mean (N=10)		**68.10**		**27.07**	**0.005*****
	Foreign owned banks					
11	*Al Rajhi banking & Investment Corporation (Malaysia) Berhad*	53	64.63	10	24.39	
12	*Asian Finance Bank Berhad*	59	71.95	12	29.27	
13	*HSBC Amanah Malaysia Berhad*	55	67.07	12	29.27	
14	*Kuwait Finance House (Malaysia) Berhad*	45	54.88	9	21.95	
15	*OCBC Al-Amin Bank Berhad*	43	52.44	9	21.95	
16	*Standard Chartered Saadiq Berhad*	42	51.22	10	24.39	
	Overall mean (N=6)		**60.37**		**25.20**	**0.028****
	Total	**839**	**1023.17**	**173**	421.95	
	Average Score (N=16)	**52.44**	**63.95**	**10.81**	**26.37**	**0.000*****

(***) A significant difference at the 1 percent level (2-tailed).
(**) A significant difference at the 5 percent level (2-tailed).

loss. This constitutes a core issue of IFIs to manage the exposed risks that primarily arise because of the absence of protection for investment depositors (Erricco and Farahbaksh, 1998). Accordingly, CG in IFIs is of utmost importance. Indeed the fundamental issue addressed in this research is the extent that IFIs in Malaysia provide CG information in their annual reports. For the overall basis, the mean score achieved by IFIs was recorded at 51.42 percent. Based on the benchmark rule set by Mohd Ghazali and Weetman (2006), the CG information disclosure in IFIs in Malaysia can be considered as "good." Additionally, the minimum disclosure score was 42.28 percent (Standard Chartered Saadiq Berhad and OCBC Al-Amin Bank Berhad) and the maximum disclosure score was 68.29 percent (RHB Islamic Bank Berhad). A possible explanation for such low scores can be attributable to the fact that all three guidelines were only issued quite recently. Thus, it may take time before IFIs actually comply with the guidelines.

Summing up, even if the intrinsic objectives that characterise the "best practices" governance are not perfectly attained yet, CG orientation in IFIs seems to converge on a pool of ethical and socially responsible issues that are wider than that in one generic industry. This can be traced back to the fourteen dimensions covered in the annual reports of IFIs. As may be recalled, D1 (board structure and functioning), D2 (nominating committee), D3 (remuneration committee), D4 (risk management committee), D5 (audit committee or Audit and governance committee), D7 (risk management), D8 (internal audit and control; (a) general-governance information and (b) specific-governance information), D9 (related parties transaction), D10 (management report), and D11(non-adherence to guidelines) were oriented towards the achievement of operational efficiency to lead to an achievement in economic objectives, while D6 (*Shariah* committee or *Shariah* supervisory board), D12 (customers/investment account holders), D13 (governance committee), and D14 (*Shariah* compliance) extended the orientation towards the realization of ethical and socially corporate values through the application of partnership-based business principles.

For the overall CG disclosure of IFIs for year 2009, eight dimensions are dominant, which, in order, are Dimension 4 (risk management committee), Dimension 2 (nominating committee), Dimension 3 (remuneration committee), Dimension 1 (board structure and functioning), Dimension 9 (related parties transactions), Dimension 5 (audit committee/Audit and governance committee) and Dimension 10 (management reports) and Dimension 6 (*Shariah* committee/*Shariah* supervisory board). The analysis goes on to test the first hypothesis concerning whether IFIs were actually disclosing more SCGi (i.e., D6, D8b, D12, D13 and D14). The expected strategy of CG structure in IFIs was that they must give due consideration to specific kinds of governance dimensions, which come together to compose the 'best practice' CG in the institution. The results, however, reveal that the formulated hypothesis was not supported. IFIs in Malaysia generally disclose more GCGi.

The considerations above allow this study to conclude that at the time this study was undertaken, IFIs tend to converge on general-governance related information–more related to information pertaining to risk management committee (RMC) and nominating committee (NC). It can be interpreted that the major concern for IFIs is handling various risks and hiring persons with the credentials to lead the institutions. Of less concern to IFIs is the disclosure of general-governance information pertaining to the non-adherence to guidelines (9.38 percent) and information pertaining to the specific kind of governance information, such as the information relating to *Shariah* compliance (28.13 percent), the specific part of internal audit and control (9.38 percent), and customers/ IAHs (2.63 percent). While information on governance committee was not a concern for any of the IFIs, other information, (in order of preference) on remuneration committee, board structure and functioning, related parties transactions, audit committee/AGC, management reports, *Shariah* committee/ SSB and risk management were satisfactorily disclosed by IFIs (scores more than the 50 per cent threshold). The provision of information on the general part of internal audit and control and *Shariah* compliance was minimal.

The analysis shows that IFIs seem to be in agreement about what structure should be set in the institution. The lack of SCGi disclosure may be attributable to deficiencies in the prevalent CG reporting framework and to the attitudes of IFIs management concerning the perceived costs and benefits of CG disclosure. Nevertheless, the presence of such information (however minimal) in the annual reports of the IFIs is an indication of a growing awareness of the importance of this type of governance information. The limited supply of specific-governance information in the annual report of IFIs may possibly indicate that this kind of information is uncommon in annual reports but could be disclosed through other means (i.e., websites, pamphlets, etc.).

The results, however, should be interpreted in light of certain limitations. First, the small number of IFIs considered in this study is a limitation in itself. Future studies should, therefore, attempt to include IFIs in other countries. Second is the use of cross sectional data that merely examined evidence on patterns at a particular moment as opposed to observing the changing levels of compliance over time (thus ignoring the trend of CG disclosure over time). Accordingly, a longitudinal study in the future may address this. Third, each item in the CG index in this study is assumed to have equal importance. However, this may not be necessarily so. Thus, the application of a weighted approach for the items in the CGD index would greatly improve the index. Fourth, the focus on just the 3 Guidelines; BNM/ GP1-i (2007), IFSB-3 (2006) and GSIFI (2008) in developing the CGD index is another limitation of the study. Future studies may want to include recommendations from other sources such as the Malaysian Code of Corporate Governance (MCCG) and Listing requirements of the Kuala Lumpur Stock Exchange (KLSE). Finally, the use of content analysis raises a methodological limitation to the analysis. However, according to (Florou and Galarniotis, 2007), content analysis of annual reports and web pages are expected to produce less subjective governance ratings as compared to self-completed questionnaires.

The study provides insights into the CG quality in both locally owned and foreign owned IFIs in Malaysia. In both instances, there is no requirement for an IFI to adopt suggested governance guidelines and yet this study found some evidence that they do so voluntarily. In addition, the overall qualities to which voluntary governance guidelines are implemented are considerably satisfactory as they met more than half of the items in the CGD index developed. Nascent development is also detected on the existence of the disclosure on the specific-governance related information.

The challenge before IFIs today is to improve all crucial aspects of CG that are unique to them as in the specific CG information that have suggested in this study. More specifically, IFIs should focus on information pertaining to the *Shariah* committee/SSB, specific matters on internal audit and control, customers/investment account holders, detailed information on governance committees and *Shariah* compliance aspects. Various banking crises over time have dramatically illustrated the catastrophic consequences flowing from the poor corporate governance of banks (Yunis, 2007). To provide a cushion against these flaws, there is a need to have a rigorous re-evaluation of CG principles of IFIs. This is important as CG may be regarded as a key factor in understanding the institution and its management. Good CG is pertinent as this will enhance investor confidence in the decision taken by the managers and board of directors of the institution (Gandia, 2008) – moreso in the case of IFIs.

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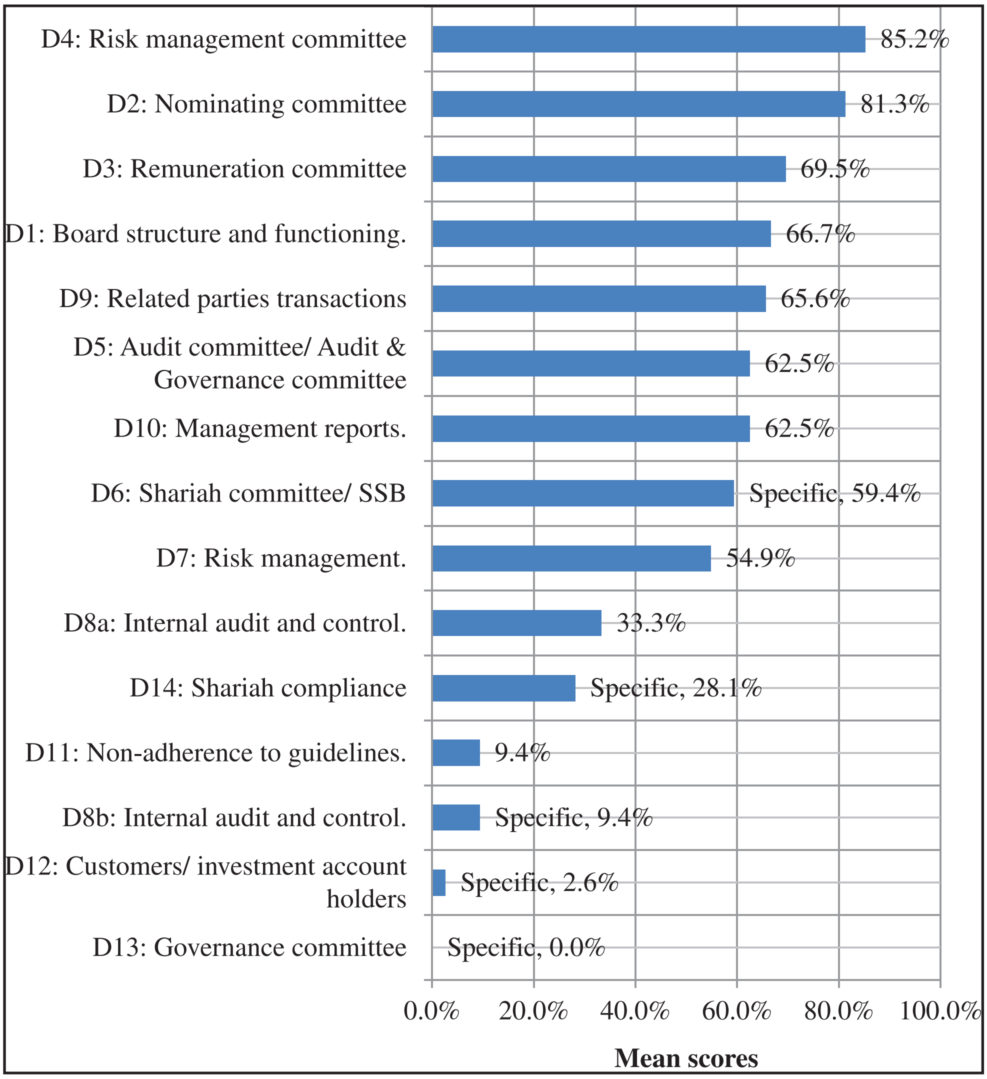
Appendix 1



Appendix 1. CG Disclosure Practices of IFIs in Malaysia.

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